## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 240 and 242

**[Release No. 34–49879; International Series Release No. 1278; File No. S7–26–04]**

**RIN 3235–AJ28**

## Regulation B

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (''Commission'') is publishing Regulation B for public comment. Regulation B proposes a number of new exemptions for banks from the definition of the term ''broker'' under Section 3(a)(4) of the Securities Exchange Act of 1934 (''Exchange Act''), as amended by the Gramm-Leach-Bliley Act (''GLBA''). The proposal would broaden a number of exemptions already available to banks, savings associations, and savings banks that effect transactions in securities. It also would define certain terms used in the GLBA. The proposal would exempt credit unions that engage in limited securities activities that are conducted under the terms applicable to certain of the bank exceptions from the definitions of ''broker'' and ''dealer.'' The Commission also requests comment on a proposed conforming amendment to an Exchange Act rule that grants a limited exemption from the broker-dealer registration requirement for foreign broker-dealers. The proposal is intended, among other things, to facilitate banks' compliance with the GLBA.

**DATES:** Comments should be received on or before August 2, 2004.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–26–04 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov/*). Follow the instructions for submitting comments.

*Paper Comments*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number S7–26–04. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Catherine McGuire, Chief Counsel; Lourdes Gonzalez, Assistant Chief Counsel—Sales Practices; Richard C. Strasser, Attorney Fellow; Linda Stamp Sundberg, Attorney Fellow; Joseph Corcoran, Special Counsel; Brice Prince, Special Counsel; or Norman Reed, Special Counsel, at (202) 942–0073, Office of the Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

**SUPPLEMENTARY INFORMATION:**

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## I. Introduction and Background

### *A. Statutory Background—The Gramm-Leach-Bliley Act*

The GLBA amended several federal statutes governing the activities and supervision of banks, bank holding companies, and their affiliates.[1] Among other things, it lowered barriers between the banking and securities industries erected by the Banking Act of 1933 (''Glass-Steagall Act''). [2] It also altered the way in which the supervisory responsibilities over the banking, securities, and insurance industries are allocated among financial regulators. Among other things, the GLBA repealed the complete separation of investment and commercial banking imposed by the Glass-Steagall Act, which was enacted as a response to the perceived abuses and conflicts of interest in the securities industry during the 1920s. The GLBA also revised the provisions of the Exchange Act that had completely excluded banks from broker-dealer registration requirements.[3]

Charters for U.S. banks, unlike those for most for-profit corporations, restrict bank activities to the ''business of banking.'' [4] For many years, U.S. banking regulators took a narrow view of what constituted the ''business of banking,'' which did not include securities activities.[5] Beginning in the 1980s, commercial businesses began directly to access the capital markets and banks faced more competitors in extending credit to commercial customers.[6] Prior to passage of the GLBA, many of the regulatory barriers preventing full-scale integration of commercial bank and securities firms were relaxed. For example, in 1982, the Federal Deposit Insurance Corporation (''FDIC'') determined that state banks that were not members of the Federal Reserve system were not subject to the Glass-Steagall Act's affiliation restrictions.[7] In 1987, the Board of Governors of the Federal Reserve System (''Federal Reserve''), through a series of administrative actions, began to lower the barrier between banks and securities firms by allowing bank holding companies to derive a percentage of their revenue from underwriting and dealing in securities that were, prior to the Federal Reserve's actions, impermissible for banks to underwrite and deal in.[8] Over time, the

[1] Pub. L. 106–102, 113 Stat. 1338 (1999).

[2] Pub. L. 73–66, ch. 89, 48 Stat. 162 (1933) (as codified in various sections of 12 U.S.C.).

[3] Congress originally adopted these complete exclusions in 1934, stipulating that under the Glass-Steagall Act, banks were not generally permitted to engage in the securities business. The House Committee on Commerce explained the rationale behind the original complete bank exclusion from the definitions of ''broker'' and ''dealer'' and Congress' rationale for its subsequent repeal:

The [Committee on Commerce] strongly believes that functional regulation—regulation of the same functions, or activities, by the same expert regulator, regardless of the nature of the entity engaging in those activities—has become essential to a coherent financial regulatory scheme, as activities and affiliations expand and change with the financial marketplace.

Subtitle A of title II amends the Exchange Act to eliminate the blanket exemptions for banks from the definitions of ''broker'' and ''dealer.'' These exceptions, which have been part of the Exchange Act since its inception, were * * * based on the assumption that the Glass-Steagall Act, which had become law just one year before the Exchange Act, had prohibited all but extremely limited specified bank securities activities. Specifically, at the time of its enactment, the Glass-Steagall Act included exceptions that permitted banks to underwrite and deal in obligations of the United States * * * and their subdivisions. Amendments to the Glass-Steagall Act made in 1935 permitted banks to provide limited securities brokerage services as an accommodation to their customers, by permitting banks to engage in stock purchases and sales in an ''agency'' capacity, at the request of customers.

Section 20 of the Glass-Steagall Act forbids affiliation of any Federal Reserve member bank with any business entity ''principally engaged'' in investment banking activities. For more than fifty years following the enactment of the Glass-Steagall Act, bank holding companies could not underwrite securities.

As noted above, however, the limitations on bank securities activities have eroded as a result of administrative actions by the Federal banking regulators. The rationale for the exemptions in the Federal securities laws that apply to banks is, thus, no longer sound, given the extensive and increasing securities activities in which banks are engaging.

H.R. 106–74, pt. 3, at 113 (1999).

[4] The ''business of banking'' provision refers to section 24 (seventh) of the National Bank Act. 12 U.S.C. 24 (seventh). Banks are chartered and regulated under a dual banking system—federal and state bank charters are available as are federal and state thrift charters. Unlike broker-dealers, banks may choose whether to be chartered at the state or federal level. Persons that register as broker-dealers, however, must be licensed at both the federal and state levels.

[5] As one observer has noted: ''In 1975, U.S. banks were largely barred from entering the securities or insurance businesses. The Glass-Steagall Act prohibited banks from underwriting or dealing in securities, except for certain narrowly defined categories of 'bank-eligible' securities such as U.S. government bonds and general obligation bonds issued by state and local governments.'' Arthur E. Wilmarth, *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. Ill. L. Rev. 215 at 225–6 (2002) [hereinafter ''Wilmarth Article''].

[6] The development of asset-backed securities, high-yield securities, and commercial paper has enhanced the ability of banks' traditional commercial borrowers to access capital markets directly and forego bank financing. In addition, non-bank competitors have entered the commercial and consumer lending markets, further putting pressure on banks' profits. At the same time, investors in search of higher yields have shifted assets from banks to money market funds and other securities. To replace the loss of revenue from traditional lending, large banks have shifted their focus to fee-based activities, including securities activities. As one industry observer has noted:

[C]onsolidation is dividing the banking industry into two distinct sets of institutions. The ten largest banks now hold almost half of the banking industry's assets, and the fifty largest institutions control three-quarters of such assets. These large institutions have shifted away from the traditional, relationship-based business of lending to long-term customers. Instead, big banks are pursuing a transaction-based strategy that emphasizes investment banking, derivatives, syndicated loans, securitized consumer loans, and other activities tied to the capital markets.

Wilmarth Article, *supra* note 5, at 251.

[7] In 1982, the FDIC adopted a policy statement on the applicability of the Glass-Steagall Act to securities activities of insured state non-member banks. *See* 47 FR 38984, (Sept. 3, 1982). In 1984, the FDIC adopted a rule regulating the securities activities of affiliates and subsidiaries of insured state non-member banks under the FDI Act. 49 FR 46709 (Nov. 28, 1984) (regulations codified at 12 CFR 337.4) (1986). Representatives of mutual fund companies and investment bankers unsuccessfully challenged the FDIC's Policy Statement (*Investment Company Institute* v. *United States*, D.D.C. Civil Action No. 82–2532, filed September 8, 1982, dismissed without prejudice) and later its regulations (*Investment Company Institute*, v. *FDIC*, 815 F.2d 1540 (D.C.1987) (regulations were upheld)).

[8] In 1987, the Federal Reserve began to permit Section 20 subsidiaries to underwrite or deal in commercial paper and other bank-ineligible securities provided that those activities accounted for less than five percent of the bank's annual gross revenues. *See* Citicorp Order, Approving

Continued

Federal Reserve increased the percentages of revenue that banks could derive from underwriting and dealing in such securities, repealed most of the conflict of interest firewalls between banks and securities firms, and approved the creation of the first U.S. universal bank—Citigroup.[9] During the past two decades, the Office of the Comptroller of the Currency (''OCC''), the Office of Thrift Supervision (''OTS''), and the FDIC also expanded the types of bank securities activities that, in the view of these agencies, were within the permissible ''business of banking.''[10]

By enacting the GLBA, Congress repealed most of the remaining vestiges of the ownership restrictions that prevented banks, securities, and insurance firms from combining, thereby allowing them to adopt the universal banking model through the creation of financial conglomerates known as ''financial holding companies.''[11] Congress recognized, however, that combined ownership would likely create conflicts that would need to be addressed through other safeguards.[12]

The Commission has consistently supported Congress' efforts to eliminate the few remaining legal barriers among the various types of financial service providers.[13] Because eliminating the legal distinctions or separations between commercial and investment banking increased the opportunity for conflicts of interest in the purchase and sale of securities, however, the Commission supported a system of functional regulation to ensure that investors receive the same high level of consumer protection no matter where they effect their securities transactions.[14] The Commission testified that complete functional regulation would mean that a bank—just like any other securities business—would have to obtain a broker-dealer license and adhere to consumer protections adopted under the federal securities laws to engage as a broker in securities transactions with investors or shift those activities to a registered broker-dealer that is obligated to provide those protections.[15]

In enacting the GLBA, Congress adopted functional regulation for bank securities activities, with limited exceptions from Commission oversight. In particular, the GLBA eliminated the complete bank exceptions from the definitions of ''broker'' and ''dealer'' in the Exchange Act and replaced them with narrower transaction-based bank exceptions. Although it granted a number of exceptions for banks' securities activities, Congress expressed concerns that banks were engaging in securities activities for investors who are not protected by the federal securities laws.[16]

With respect to the definition of ''broker,'' the Exchange Act, as amended by the GLBA, provides that a bank is not considered a broker to the extent it meets the requirements of eleven specific exceptions.[17] Each of these exceptions permits a bank to act as an agent with respect to specified securities products or in transactions that meet specific statutory conditions.

In particular, Section 3(a)(4) of the Exchange Act provides conditional exceptions from the definition of broker for banks that engage in third-party brokerage arrangements;[18] trust and fiduciary activities;[19] permissible securities transactions;[20] certain stock purchase plans;[21] sweep accounts;[22] affiliate transactions;[23] private securities offerings;[24] safekeeping and custody activities;[25] identified banking

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Applications to Engage in Limited Underwriting and Dealing in Certain Securities. 73 Fed. Res. Bull. 473 (1987) and Chase Manhattan Corp., Order Approving Application to Underwrite and Deal in Commercial Paper to a Limited Extent. 73 Fed. Res. Bull. 369 (1987).

In 1989, the Federal Reserve provided additional guidance on Section 20 subsidiaries, raising the revenue limit on underwriting and dealing in bank-ineligible securities from five percent to ten percent of the subsidiary's total revenues. Order Approving Modifications to Section 20 Orders, 75 Fed. Res. Bull. 751 (1989). Subsequently, the Federal Reserve raised the revenue limits from non-eligible securities to twenty-five percent, eliminated most of the firewalls between banks and securities firms, and added private placement services and riskless principal transactions to the list of approved non-banking activities. *See* Regulation Y, 12 CFR 225.

[9] Conditional approval of applications by Travelers Group Inc., (Sept. 23, 1998). 84 Fed. Res. Bull. 985 (1998). *http://www.federalreserve.gov/boarddocs/press/bhc/1998/19980923*

[10] *See* Julie L. Williams and Mark P. Jacobsen, The Business of Banking: Looking to the Future, 50 Bus. Law. 783 at 814 (May 1995) and Julie L. Williams and James F.E. Gillespie, *The Business of Banking: Looking to the Future—Part II*, 52 Bus. Law. 1279 (Aug. 1997) (''While the nature of the national bank charter is the grant of a banking franchise, it explicitly does not limit national banks to banking activities.'').

[11] For a general discussion, *see, e.g.*, Wilmarth Article, *supra* note 5 at 219–220.

[12] In eliminating the ownership separations, Congress understood the need to adopt other safeguards to mitigate the conflicts of interest that combined ownership could create. One of the bill's authors highlighted functional regulation as a key requirement of the GLBA:

The second major feature of the bill is that we promote and strengthen functional regulation. Under the bill, the general rule is that if you are a bank and you are in the securities business, you are regulated by the Securities and Exchange Commission. If you are a bank and you are in the insurance business, you are regulated by the state insurance commissioner in the area where you are engaged in the insurance business. If you are a bank and you are engaged in banking, you are regulated by bank regulators. By opting for functional regulation, we preserve consumer protection, we lower costs.

Statement of Senator Phil Gramm, 145 Cong. Rec. S13783–01.

[13] For a list of Commission testimony and related correspondence, *see* Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001) at n. 8.

[14] *Id.* The General Accounting Office recognized that investors have received unequal levels of investor protection (including disclosures) and disparate access to remedies depending on the market professional selling them securities. *See* U.S. General Accounting Office, Report to Congressional Requesters: *Bank Mutual Fund Sales Practices and Regulatory Issues* GAO/GGD–95–210, at p. 52 (Sept. 1995); U.S. General Accounting Office, Report to Congressional Requesters: *Banks' Securities Activities—Oversight Differs Depending on Activity and Regulator*, GAO/GGD–95–214, at p. 25 (Sept. 1995).

[15] Testimony of SEC Chairman Arthur Levitt Before the Committee on Commerce Concerning H.R. 10, ''The Financial Services Act of 1999'' (May 5, 1999).

[16] *See* H.R. Rep. No. 106–74, pt. 3, at 114 (1999). In adopting the GLBA, Congress also intended to level the playing field between banks and broker-dealers. As the House Committee on Commerce noted in the legislative history to the GLBA, the complete exception for banks from broker-dealer registration created a competitive disparity by permitting banks to engage in securities activities without being subject to the same regulatory requirements as registered broker-dealers. *See id.* In drafting the bank exceptions from broker-dealer registration, the Committee stated that, ''registration may not be required because the conditions imposed on the excepted activities are tailored to protect investors and to ensure competitive fairness among different types of financial services providers.'' *Id.* at 162.

[17] Exchange Act Section 3(a)(4) [15 U.S.C. 78c(a)(4)].

[18] Exchange Act Section 3(a)(4)(B)(i). This exception permits banks to enter into third-party brokerage, or ''networking'' arrangements with brokers under nine specific conditions.

[19] Exchange Act Section 3(a)(4)(B)(ii). This exception permits banks to effect transactions as trustees or fiduciaries for securities customers under two specific conditions.

[20] Exchange Act Section 3(a)(4)(B)(iii). This exception permits banks to buy and sell commercial paper, bankers' acceptances, commercial bills, exempted securities, certain Canadian government obligations, and Brady bonds.

[21] Exchange Act Section 3(a)(4)(B)(iv). This exception permits banks, as part of their transfer agency activities, to effect transactions for certain issuer plans.

[22] Exchange Act Section 3(a)(4)(B)(v). This exception permits banks to sweep funds into no-load money market funds.

[23] Exchange Act Section 3(a)(4)(B)(vi). This exception permits banks to effect transactions for affiliates, other than broker-dealers.

[24] Exchange Act Section 3(a)(4)(B)(vii). This exception permits certain banks to effect transactions in privately placed securities.

[25] Exchange Act Section 3(a)(4)(B)(viii). This exception permits banks to engage in certain enumerated safekeeping or custody activities, including stock lending as custodian.

products;[26] municipal securities;[27] and *de minimis* transactions.[28] As part of the Exchange Act, these provisions are subject to Commission interpretation.[29] A bank that effects transactions in securities as agent outside the scope of these exceptions is required to register as a broker in accordance with Section 15(a) of the Exchange Act.[30]

*B. Regulatory and Procedural Background—The Interim Final Rules, Public Comment, and the Temporary Exemptions*

In 2001, the Commission adopted interim final rules (''the Interim Rules'') largely in response to interpretive questions and industry concerns about the way in which the Commission would interpret the GLBA.[31] The Interim Rules were designed to provide banks with guidance regarding the GLBA by defining certain key terms used in the new statutory exceptions. The Interim Rules also provided banks with additional targeted exemptions from the definitions of ''broker'' and ''dealer'' for certain types of ongoing securities transactions or activities. The Commission adopted the Interim Rules in interim final form to provide the banking industry with immediate guidance and exemptive relief while also soliciting public comment. In response, the Commission received over 200 letters commenting on the Interim Rules.[32]

The Commission temporarily suspended the implementation of the exceptions in light of concerns that banks needed more time to adjust their operations to comply with the Interim Rules.[33] The Commission staff has used this period during the temporary suspension to continue discussions with banking industry representatives, staff from the Banking Agencies, and other interested parties to refine further the guidance and exemptions provided in the Interim Rules.[34]

## II. Discussion of Proposed Regulation B

After reviewing the comments on the Interim Rules and discussing the practical application of those Rules with representatives from the banking industry, banking regulators, and other interested parties, the Commission is proposing to revise and restructure the Interim Rules and to codify them in a new regulation, Regulation B. The proposed new rule series is Exchange Act Rule 710 through Rule 781 (17 CFR 242.710 through 781).

Proposed Regulation B includes rules designed to define and clarify a number of the statutory exceptions from the definition of ''broker.'' In addition, proposed Regulation B would grant new exemptions from the ''broker'' definition to banks and certain other financial institutions. These proposed exemptions would supplement the statutory exceptions to preserve bank securities activities where consistent with the statutory purpose of investor protection. For example, proposed Regulation B would provide a broad exemption for certain bank cash management services. This proposed exemption would allow banks to buy and sell money market securities for qualified investors and certain other bank customers who keep funds at banks.

Moreover, in response to banks' concerns about calculating their compensation as fiduciaries on an account-by-account basis, the proposal would provide a ''line-of-business'' compensation test that would permit banks to bypass the account-by-account test in the trust and fiduciary activities exception. In addition, the proposal would broaden an exemption for small banks and thrifts, which could greatly expand the number of smaller financial institutions that are excluded from broker-dealer registration requirements.

The proposal also would provide a number of specialized exemptions to accommodate banks' current business practices, balanced with conditions that are designed to protect investors. These proposed specialized exemptions include exemptions for banks that effect transactions for certain custody customers or pension plans, and those that effect transactions in Regulation S securities with non-U.S. persons.

The proposed titles and numbering of the rules in proposed Regulation B, including the proposed new rules, appear below, with parenthetical explanations added to the titles:

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[26] Exchange Act Section 3(a)(4)(B)(ix). This exception permits banks to buy and sell certain ''identified banking products,'' as defined in Section 206 of the GLBA [codified at 15 U.S.C. 78c(a)(4)(B)(ix)].

[27] Exchange Act Section 3(a)(4)(B)(x). This exception permits banks to effect transactions in municipal securities.

[28] Exchange Act Section 3(a)(4)(B)(xi). This exception permits banks to effect up to 500 transactions in securities in any calendar year in addition to transactions referred to in the other exceptions.

[29] In contrast, the Glass-Steagall Act is interpreted by the federal banking agencies.

[30] Exchange Act Section 15(a) generally prohibits broker-dealers that are not registered with the Commission from effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security.

[31] Exchange Act Release No. 44291, *supra* note 13.

[32] Nearly all of these letters came from the banking industry or its representatives. The federal banking agencies (the Federal Reserve, OCC, and FDIC) (collectively referred to as the ''Banking Agencies'') also submitted comments. *See* letter and appendix dated June 29, 2001 from Alan Greenspan, Chairman, Federal Reserve, John D. Hawke, Comptroller of the Currency, and Donna Tanoue, Chairman, FDIC (''Banking Agencies letter'').

Included in the comment letters were 111 comment letters in a form letter format. Many of the banking organizations that submitted these form comment letters sent multiple copies of a common form letter, including 54 letters from one banking organization. The following banks and persons submitted 116 form letters (''Bank Form Letters''): Amarillo National Bank (54 letters); American Bank Holding Co.; American Church Trust Co.; Austin Trust Co.; Bank Midwest; Bank of West (two letters); Bonham State Bank; Jeff Scribner, Senior Vice President, Financial Services Division Manager, Citizens National Bank; Steven M. Dow, Vice President and Trust Officer, Community Bank &Trust; Extraco Banks; First Command Bank; First National Bank; First National Bank of Abilene (seven letters); First National Bank; First National Bank of Mineola; First State Bank of Texas; First State Bank & Trust Co. (two letters); Richard Perryman, CPA, Vice President and Trust Officer, Guaranty Bank; Hibernia National Bank (two letters); Hibernia Trust (two letters); Murray Pate, Kanaly Trust Company; Legacy Trust Co.; Longview Bank & Trust; Lubbock National Bank; David Malleck; Charles Hall Jr., CEO, MaximBank; McAllen National Bank (four letters); Linda Park; Kimberly Miller, Senior Vice President and Trust Officer, PNB Financial; Luptis Rosales, VP & Trust Officer of unnamed bank; Secured Trust Bank; Sentinel Trust Co.; Southside Bank (two letters); Carol Preston, Senior Vice President and Trust Officer, Southwest Bank; Texas Bank; Texas Capital Bank; Wayne Spencer, President, Texas Community Bank and Trust; Texas Gulf Bank; Texas State Bank (nine letters); Debbie Truman; Willard B. III Wagner. Three additional form letters were submitted without identifying information.

[33] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR 27760 (adopting Interim Rules, including Exchange Act Rule 15a–7, which gave banks a temporary exemption from the definitions of ''broker'' and ''dealer'' until October 1, 2001, and provided an additional conditional exemption until January 1, 2002); Exchange Act Release No. 44570 (July 18, 2001) (providing banks, savings associations, and savings banks with an additional conditional exemption from the definitions of ''broker'' and ''dealer'' under the Exchange Act until May 12, 2002); Exchange Act Release No. 45897 (May 8, 2002) (order extending the exemption from the definition of ''broker'' until May 12, 2003, and from the definition of ''dealer'' until November 12, 2002); Exchange Act Release No. 46751 (Oct. 30, 2002) (extending the exemption from the definition of ''dealer'' until February 10, 2003); Exchange Act Release No. 47366 (Feb. 13, 2003) (extending the exemption from the definition of ''dealer'' until September 30, 2003); Exchange Act Release No. 47649 (April 8, 2003) (extending the exemption from the definition of ''broker'' until November 12, 2004).

[34] During this period, to facilitate a prompt and efficient resolution of remaining questions and concerns about the Interim Rules, the Commission bifurcated the rulemaking process to address the ''broker'' and ''dealer'' issues separately. For an explanation of this bifurcation, *see* Exchange Act Release No. 46745 (Oct. 30, 2002) 67 FR 67496 (Nov. 5, 2002) (''Dealer Proposing Release''). The dealer provisions, along with the Commission's implementing rules, became effective September 30, 2003. *See* Exchange Act Release No. 47364 (Feb. 13, 2003), 68 FR 8686, 8687 (Feb. 24, 2003) (''Dealer Release'').

**Regulation B: Securities Activities of Banks and Other Financial Institutions**

### Subpart A—Networking Exception: Defined Terms

242.710: Defined terms relating to the networking exception from the definition of ''broker'' (proposed amendment to provisions in Exchange Act Rule 3b–17).

### Subpart B—Trust and Fiduciary Activities Exception: Exemptions and Defined Terms

242.720: Exemption from the ''chiefly compensated'' condition for banks with existing personal trust accounts (proposed new rule).

242.721: Exemption for banks from determining whether they are ''chiefly compensated'' on a line of business (proposed expansion and redesignation of Exchange Act Rule 3a4–2).

242.722: Exemption for banks from determining whether they are ''chiefly compensated'' on an account-by-account basis (proposed new rule).

242.723: Exemption from the definition of ''broker'' for banks effecting transactions as an indenture trustee in a no-load money market fund (proposed expansion and redesignation of Exchange Act Rule 3a4–3).

242.724: Defined terms relating to the trust and fiduciary activities exception from the definition of ''broker'' (proposed amendment to terms in current Exchange Act Rule 3b–17, which would be repealed).

### Subpart C—[Reserved]

### Subpart D—Sweep Accounts Exception: Defined Terms

242.740: Defined terms relating to the sweep accounts exception from the definition of ''broker'' (proposed amendment to terms in current Exchange Act Rule 3b–17).

### Subpart E—Affiliate Transactions Exception: Defined Terms

242.750: Defined terms relating to the affiliate transactions exception from the definition of ''broker'' (proposed amendment to terms in current Exchange Act Rule 3b–17).

### Subpart F—Safekeeping and Custody Activities Exception: Exemptions

242.760: Exemption from the definition of ''broker'' for banks effecting transactions in securities in a custody account (proposed expansion and redesignation of Exchange Act Rule 3a4–5).

242.761: Exemption from the definition of ''broker'' for small banks effecting securities transactions in a custody account (proposed expansion and redesignation of Exchange Act Rule 3a4–4).

### Subpart G—Special Purpose Exemptions

242.770: Exemption from the definition of ''broker'' for banks effecting transactions in securities in certain employee benefit plans (proposed new rule).

242.771: Exemption from the definitions of ''broker'' and ''dealer'' for banks effecting transactions in securities issued pursuant to Regulation S (proposed new rule).

242.772: [Reserved][34a]

242.773: Exemption from the definitions of ''broker'' and ''dealer'' for savings associations and savings banks (proposed amendment to and redesignation of Exchange Act Rule 15a–9).

242.774: Exemption from the definitions of ''broker'' and ''dealer'' for credit unions (proposed new rule).

242.775: Exemption from the definition of ''broker'' for the way banks effect excepted or exempted transactions in investment company securities (proposed expansion and redesignation of Exchange Act Rule 3a4–6).

### Subpart H—Temporary Exemptions

242.780: Exemption for banks from liability under Section 29 of the Securities Exchange Act of 1934 (proposed amendment to and redesignation of Exchange Act Rule 15a–8).

242.781: Exemption from the definition of ''broker'' for banks for a limited period of time (proposed amendment to and redesignation of Exchange Act Rule 15a–7).

## III. Discussion of Comments on the ''Broker'' Rules and Proposed Amendments

*A. Networking Exception*

The third-party brokerage (''networking'') exception in Exchange Act Section 3(a)(4)(B)(i)[35] allows banks to partner with broker-dealers in offering their customers a wide range of financial services, including securities brokerage. Specifically, the exception provides that a bank will not be considered a broker if, under certain conditions, the bank enters into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers (''networking arrangement''). If the bank's networking activities meet the conditions of the exception, it may, without itself being registered as a broker-dealer, receive compensation related to brokerage transactions the broker-dealer effects as a result of the networking arrangement. The exception also allows unregistered bank employees[36] to engage in limited securities-related activities and to receive incentive compensation in the form of a ''nominal one-time cash fee of a fixed dollar amount'' for referring bank customers to the broker-dealer.[37]

To clarify the way in which bank employees may be compensated consistent with the networking exception, the Interim Rules defined certain terms used in the exception, such as ''nominal one-time cash fee of a fixed dollar amount'' and ''referral.''[38] These definitions establish objective standards for determining whether a referral fee would be nominal and the manner in which the fee must be structured.[39] For example, the fee may

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[34a] If the Commission adopts proposed Regulation B, it will redesignate Exchange Act Rule 15a–11 as Exchange Act Rule 772 without changing the language of the current rule.

[35] 15 U.S.C. 78c(a)(4)(B)(i).

[36] ''Unregistered'' bank employees are bank employees who are not also employed as registered representatives of a registered broker-dealer that supervises their securities activities.

[37] The statutory conditions under which banks may rely on the networking exception stem from a line of no-action letters in which the Commission staff indicated enforcement action would not be recommended against thrifts that entered into highly circumscribed networking arrangements. H.R. Rep. No. 106–74, pt. 3, at 163 (1999). The first of these letters was issued in response to a request from Chubb Securities Corp. *See* Letter re: *Chubb Securities Corp.* (Nov. 24, 1993) (''Chubb letter''). Because they are not banks, thrifts could not rely on the then-existing general exemption from the definition of ''broker'' enjoyed by banks, and these letters provided thrifts with a means to compete with banks in making securities brokerage services available to their customers. For the relief the Commission is proposing to extend to thrifts, *see* Section III.F.4 *infra*. Although the networking exception in Exchange Act Section 3(a)(4)(B)(i) allows banks to continue many of the networking activities in which they engaged before the GLBA was enacted, it also limits the scope of those activities.

Various aspects of bank networking activities are also subject to limitations and requirements in self-regulatory organization (''SRO'') rules, including NASD Rule 2350 (''Broker/Dealer Conduct on the Premises of Financial Institutions'') and NASD Rule 3040 (''Private Securities Transactions of an Associated Person''). *See also* Federal Reserve, FDIC, OCC, and OTS, *Interagency Statement on Retail Sales of Nondeposit Investment Products* (Feb. 15, 1994) (''Interagency Statement'').

[38] *See* Exchange Act Rule 3b–17 (g)(1) and (h).

[39] Exchange Act Rule 3b–17(g) states:

(g)(1) The term *nominal one-time cash fee of a fixed dollar amount* means a payment in either of the following forms that meets the requirements of subparagraph (2):

not exceed one hour of wages of the employee making the referral. The definition also anticipates that banks may pay referral fees in cash as well as through a points-based compensation system so long as the number of points the referring employee receives for a securities referral does not exceed the number of points the employee receives for non-securities related activities. These definitions also specify that payment of a referral fee may not be related to certain factors such as the value or successful completion of a securities transaction, or the financial stature of the customer being referred.

1. Comments on Definition of ''Nominal One-Time Cash Fee of a Fixed Dollar Amount''

We received numerous comments regarding the Interim Rules' definition of ''nominal one-time cash fee of a fixed dollar amount.''[40] The commenters generally opposed the definition, arguing, among other things, that it was unnecessary, unworkable, or overly restrictive. Some commenters contended that defining the term ''nominal'' unnecessarily limits referral fees. They maintained that the term should be left undefined or interpreted to allow market-rate referral fees up to a set amount, such as $25, $100, or $250.[41] Other commenters opined that Congress did not intend for the limitations on incentive compensation included in the networking exception to affect year-end bank bonus programs even if those programs were in part based on the number of referrals made.[42] Commenters also asserted that the definition imposed limits on networking compensation beyond those contained in the Exchange Act.[43] Some commenters contended that the definition would unduly limit the fees banks could pay based on points for activities involving non-securities products and services.[44] Several commenters stated that tying referral fees to hourly wages is impractical or unworkable because it does not permit a single, flat fee that would be high enough to provide a meaningful incentive for tellers and platform personnel to make referrals to the broker-dealers.[45] Others indicated that

(i) A payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making a referral; or

(ii) Points in a system or program that covers a range of bank products and non-securities related services where the points count toward a bonus that is cash or non-cash if the points (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities.

(2) Regardless of the form of payment, the payment may not be related to:

(i) The size, value, or completion of any securities transaction;

(ii) The amount of securities-related assets gathered;

(iii) The size or value of any customer's bank or securities account; or

(iv) The customer's financial status.

Exchange Act Section 3b–17(h) states: ''The term *referral* means a bank employee arranging a first securities-related contact between a registered broker-dealer and a bank customer, but does not include any activity (including any part of the account opening process) related to effecting transactions in securities beyond arranging that first contact.''

[40] *See, e.g.*, letter dated June 4, 2001 from James D. McLaughlin, Director, Regulatory and Trust Affairs, American Bankers Association (''ABA'') and Beth L. Climo, Executive Director, American Bankers Securities Association (''ABASA'') and the letter dated July 17, 2001 from Edward L. Yingling, Deputy Executive Vice President and Executive Director, ABA, and Beth L. Climo, Executive Director, ABASA (''ABA/ABASA letters''); letter dated July 17, 2001 from John Duncan, the Banking Law Committee of the Business Law Section of the American Bar Association (''ABA Banking Law Committee letter''); letter dated July 17, 2001 from Robert M. Kurucza, General Counsel, Bank Securities Association (''BSA letter''); letter dated July 17, 2001 from Charlotte M. Bahin, Director of Regulatory Affairs, Senior Regulatory Counsel, America's Community Bankers (''ACB letter''); the Banking Agencies letter; letter dated July 17, 2001 from John H. Huffstutler, Associate General Counsel, Bank of America Corporation (''Bank of America letter''); letter dated July 17, 2001 from J. Michael Shepherd, Executive Vice President and General Counsel, Bank of New York (''BONY letter''); letter dated July 16, 2001 from John M. Kramer, Deputy General Counsel, Bank One Corporation (''Bank One letter''); letter dated July 16, 2001 from Roger D. Wiegley, Chair, Committee on Banking Law, The Association of The Bar of the City of New York (''Bar of NY letter''); letter dated July 13, 2001 from Jim Goudge, President and CEO, Broadway National Bank (''Broadway letter''); letter dated July 12, 2001 from Terry Jones Cox, Vice President, HR/Compliance, Central National Bank (''Central letter''); letter dated August 22, 2001 from Andrew Trainor, President and CEO of Community Banks of Southern Colorado (''Community Banks of Southern Colorado letter''); letter dated July 17, 2001 from Gerald M. Noonan, President, the Connecticut Bankers Association (''Connecticut Bankers letter''); letter dated July 16, 2001 from William C. Mutterperl, Executive Vice President, General Counsel and Secretary, FleetBoston Financial Corporation (''Fleet letter''); the Frost letter; letter dated August 30, 2001 from Edward J. Eason, Vice President, Granite Bank (''Granite bank letter''); letter dated July 16, 2001 from Paul V. Reagan, Senior Vice President and U.S. General Counsel, Bank of Montreal Group on behalf of Harris Trust and Savings Bank (''Harris Trust letter''); letter dated July 17, 2001 from Robert I Gulledge, Chairman, Independent Community Bankers of America (''ICBA letter''); letter dated July 17, 2001 from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers (''IIB letter''); letter dated July 16, 2001 from Michael E. Bleier, General Counsel, Mellon Financial Corporation (''Mellon letter''); letter dated July 16, 2001 from David A. Daberko, Chairman and Chief Executive Officer, National City Corporation (''National City letter''); letter dated July 17, 2001 from Guy Messick, General Counsel to the National Association of Credit Union Service Organizations (''NACUSO letter''); letter dated August 1, 2001 from Jeffrey P. Neubert, President and Chief Executive Officer, New York Clearing House (''NYCH letter''); letter dated July 16, 2001 from Deborah R. Bortner, President, the North American Securities Administrators Association (''NASAA letter''); letter dated July 17, 2001 from James S. Keller, Chief Regulatory Counsel, PNC Financial Services Group (''PNC letter''); letter dated July 17, 2001 from Samuel E. Upchurch, Jr., Executive Vice President, General Counsel and Secretary, Regions Financial Corporation (''Regions letter''); letter dated July 17, 2001 from Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable (''Roundtable letter''); letter dated July 17, 2001 from Barry P. Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association (''SIA letter''); letter dated July 17, 2001 from A. Michelle Roberts, Executive Director, The Trust Financial Services Division of the Texas Bankers Association (''Texas Bankers Trust Division letter''); letter dated July 17, 2001 from Lawrence A. Knecht, Senior Vice President and Legal Counsel, UMB Bank (''UMB Bank letter''); letter dated July 17, 2001 from Norimichi Kanari, President and CEO, Union Bank of California (''Union Bank letter''); letter dated July 12, 2001 from W. Steve Meacham, Senior Vice President and Senior Trust Officer, letter dated August 31, 2001 from David S. Hickman, Chairman and CEO, United Bank & Trust (''United Bank letter''); letter dated July 12, 2001 from W. Steve Meacham, Senior Vice President and Senior Trust Officer, First Victoria National Bank (''Victoria letter''); and letter dated July 13, 2001 from Bruce Moland, Vice President and Assistant General Counsel, Wells Fargo & Company (''Wells Fargo letter''). The Bank Form Letters criticized the Interim Rules'' limitations on the value of referral fees and expressed the view that those limitations are unfair, but did not comment specifically on the definition of ''nominal one-time cash fee of a fixed dollar amount.''

[41] *See, e.g.*, Central letter; ABA Banking Law Committee letter; and Wells Fargo letter. Similarly, in a September 23, 2003 meeting, banking agency staff told the Commission staff that some banks pay fees of as much as $100 for referrals of high net-worth customers and that members of the banking agencies staff believe such fees should be considered nominal, although currently referral fees typically range from $5 to $50, with $50 representing the top of the range at large banks in coastal metropolitan areas. One commenter asserted that because the Commission has considered $250 a ''*de minimis*'' amount in the context of Municipal Securities Rulemaking Board Rule G–37, the term ''nominal'' should be interpreted to allow referral fees of the same amount in this context. *See* Wells Fargo letter. MSRB Rule G–37 relates to political contributions that might improperly influence municipal officials in awarding underwriting business. The fact that some may look to wholly unrelated contexts to argue that a particular amount should be considered ''nominal'' in this context underscores the importance of giving quantitative meaning to the term in the proposed amended definition of ''nominal one-time cash fee of a fixed dollar amount.''

[42] *See,e.g.*, Bank of America letter; Harris Trust letter; and Mellon letter.

[43] *See, e.g.*, Bank of America letter; Fleet letter; Harris Trust letter; IIB letter; Mellon letter; PNC letter; Regions letter; and Wells Fargo letter.

[44] *See, e.g.*, Bank of America letter; Harris Trust letter; and Mellon letter.

[45] *See, e.g.*, SIA letter; Bank One letter; Regions letter; Harris Trust letter; PNC letter; and Wells Fargo letter (criticizing the definition's methodology for determining nominal value as impractical and unworkable); and Bank of America letter; Fleet letter; Harris Trust letter; IIB letter; letter dated July 16, 2001 from Carol L. Klimas, Executive Vice President and Chief Fiduciary Officer, KeyBank National Association (''KeyBank letter''); Mellon letter; and Roundtable letter (arguing that requiring banks regularly to adjust payment of referral fees based on salary levels

Continued

the definition should not list categories of factors on which referral fees could not be made contingent.[46]

The Commission continues to believe that the term ''nominal'' as used in the GLBA should be defined as that term is commonly understood. Nominal means inconsequential or trifling.[47] In the context of compensation, and in common legal usage, a ''nominal'' fee is a small one of no concern to the payor and little value to the payee.[48]

Some published data suggests that banks' referral fees have increased in recent years and sometimes exceed levels that a reasonable person would deem to be ''nominal.''[49] Thus, leaving ''nominal'' undefined could lead some to read the term as meaning ''market rate.'' The Commission believes that such an interpretation could lead to unregistered bank employees being given an incentive not just to make referrals, but actually to sell securities brokerage services to bank customers. The Commission and courts have long interpreted the broker-dealer registration provisions in the federal securities laws to require persons with this kind of incentive to register as broker-dealers or be registered representatives of broker-dealers.[50]

Accordingly, in response to many of these comments, we propose only to amend the definition of ''nominal one-time cash fee of a fixed dollar amount'' to clarify further the application of the statutory limitations to banks' existing practices, to give meaning to the investor protections embodied in this provision of the Exchange Act.[51]

2. Proposed Amendments to Definition of ''Nominal One-Time Cash Fee of a Fixed Dollar Amount''

We propose to amend the definition of ''nominal one-time cash fee of a fixed dollar amount'' to mean that a referral payment must have a value that does not exceed the greater of three alternative measures: the employee's base hourly rate of pay, a dollar amount equal to $15 in 1999 plus an adjustment for inflation, or $25.[52] The fee could be paid to a bank employee no more than one time per customer referred by that employee. If the referral is not paid entirely in cash, the value of the non-cash payment must be ''readily ascertainable'' (*i.e.*, its value or potential value must have been known by the bank and the employee at the time of the referral). Also, any non-cash portion of the payment would have to have a value such that the value of the entire payment is nominal, and the non-cash portion would have to be paid under an incentive program that covers a broad range of products and that is designed primarily to reward activities unrelated to securities. Finally, the fee would have to be the same for any securities referral made by that particular employee, with a flat value that does not vary based on factors such as the financial status of a customer the employee refers, the identity of the broker-dealer to which the customer is referred, the number of referrals the employee makes, or whether the customer expresses an interest in a particular type of securities product.

a. Meaning of ''Nominal''

We propose to amend the definition of ''nominal'' to replace the standard of ''one hour of gross cash wages'' used in the Interim Rules with ''base hourly rate of pay'' to clarify that this alternative measure could be used with respect to salaried as well as unsalaried employees. As amended, the Commission believes this option would permit highly compensated bank employees to receive scaled referral fees without giving them an inappropriate promotional interest in the brokerage services a broker-dealer offers under a networking arrangement. We request comment on this proposed alternative and, in particular, on whether it might lead to some highly compensated bank employees being given a salesman's stake in the securities activities of the bank's customers.

Second, the proposed amended definition of ''nominal one-time cash fee of a fixed dollar amount'' would include a new, specific dollar-amount measure of nominal value that should simplify compliance with the networking exception in Exchange Act Section 3(a)(4)(B)(i). In particular, we are proposing a dollar amount of $15 with annual adjustments to account for inflation, based on 1999 dollars.[53] In

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would create an unnecessary administrative burden). *See also* Bank Form Letters, which suggested that the Interim Rules' limitations on referral fees would result in banks being charged with calculating and tracking referral fee compensation.

[46] *See* ABA/ABASA letters; Banking Agencies letter; Bank of America letter; NYCH letter; and SIA letter.

[47] *See, e.g., Webster's New Collegiate Dictionary* at 786 (2002) (indicating that one common meaning of ''nominal'' is ''existing or being something in name or form only,'' and that ''nominal'' is synonymous with the terms ''trifling'' and ''insignificant'').

[48] *Black's Law Dictionary* (7th ed. 1999) defines ''nominal consideration'' as, ''Consideration that is so insignificant as to bear no relationship to the value of what is being exchanged (*e.g.*, $10 for a piece of real estate.'').

[49] The Consumer Bankers Association's *2000 Consumer Investments Study* indicates that in 1998, the latest year for which figures were available when the GLBA was being drafted, 79 percent of referral fees were $10 or less (approximately $12 or less in 2004 dollars). However, according to the same study, in 1999 the percentage of fees over $10 jumped from 21 percent to 31 percent. This recent trend of sharp increases in referral fees is evidenced by other data as well. For example, according to an October 17, 1996 *American Banker* story, in an effort to compete with larger banks, Placer Savings Bank, a Northern California thrift, began paying its employees investment referral fees for the first time in August 1995. The fee initially was $5 per referral (approximately $6 in 2004 dollars), and then, in September 1996, it was increased to $10 (approximately $12 in 2004 dollars).

At some banks, it appears that referral fees may already exceed nominal levels. The Consumer Bankers Association's *2001 Consumer Investments Study* indicates that in 2001, the percentage of banks paying cash referral fees of $10 or less was 45 percent. However, this figure fell by 4 percent in only one year, from 49 percent in 2000, and the percentage of banks paying fees between $11 and $25 rose by 2 percent in this period, from 31 percent in 2000 to 33 percent in 2001. The report also indicates that no bank included in the study paid fees of more than $25 in 2000, but that in 2001, a small proportion of banks (2 percent) had begun paying fees of more than $25. The available data on referral fee amounts suggests that just before the GLBA was enacted in 1999, the great majority of referral fees were $10 or less (approximately $12 or less in 2004 dollars), but that without a definition of nominal value, the average amount of a referral fee has been increasing, and in some cases clearly has exceeded a nominal value. The Commission staff recently learned from staff of the federal banking agencies that some large banks pay referrals fees of as much as $100 for particularly valuable referrals. Unless they are paid to highly compensated bank employees, fees of such amounts clearly are not nominal.

[50] *See* Exchange Act Section 15(a)(1). *See also SEC* v. *Hansen,* Fed. Sec. L. Rep. ¶ 91,426 (S.D.N.Y. 1984) (receipt of commissions instead of salary was factor in identifying broker activity); *SEC* v. *Margolin,* Fed. Sec. L. Rep. ¶ 97,025 (S.D.N.Y. 1992) (same). The Commission similarly has noted the importance of transaction-based compensation in identifying broker activity. *See* Exchange Act Release No. 22172 (June 27, 1985) (adopting release for Exchange Act Rule 3a4–1; ''[T]he receipt of transaction-based compensation often indicates that [a] person is engaged in the business of effecting transactions in securities. Compensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation under the Act.''); Litigation Release No. 15654 (Feb. 26, 1998) (receipt of transaction-based compensation was factor in finding violation of broker-dealer registration requirement and violation of order barring individual from associating with broker).

[51] As indicated above, SRO rules and banking agency guidance may also limit networking activities. *See supra* note 37.

[52] *See* proposed Exchange Act Rule 710(b).

[53] We propose that the definition specify 1999 as the reference year because that is the year in which the GLBA was enacted. The definition also would provide that the $15 amount could be adjusted for inflation on an annual basis by order of the Commission. $15 in 1999 dollars after adjustment for inflation equals approximately $17 in 2004 dollars.

The $15 inflation-adjusted amount is consistent with the range of referral fees in thrift networking arrangements that were the subject of no-action relief that the Commission staff has granted. See, *e.g.*, letter re: *Coast Federal Bank, Federal Savings Bank* (May 13, 1993) ($7 in 1993 dollars is equivalent to approximately $8 in 1999 dollars). *See also* letter re: *First Piedmont Federal Savings and* addition, the definition would specify $25 (without an adjustment for inflation) as an alternative measure of nominal value.[54]

The proposed inflation-adjusted $15 and non-adjusted $25 alternative measures of nominal value should address concerns some commenters raised that administering an hourly, wage-based standard might be burdensome or unworkable. As proposed, the amended definition of ''nominal one-time cash fee of a fixed dollar amount'' should permit many banks to continue paying referral fees with values comparable to fees they pay under their existing referral incentive programs, but others may be required to reduce the amount paid for referrals of customers meeting certain financial criteria.[55]

*Loan Association* (July 22, 1991) (the fee specified was $15 (approximately $18 in 1999 dollars)). This amount also is consistent with the $5 to $15 fee range most banks were understood to pay their employees for securities brokerage referrals when the GLBA was drafted in 1998. FDIC, *Nondeposit Investment Products and Recordkeeping Requirements—Questions and Answers* at 10 (July 16, 1998) (citing results of a 1996 survey on bank retail investment services conducted by American Brokerage Consultants, Inc., which ''indicated that most banks pay referral fees in a range between $5 and $15.'').

Estimates of inflation-adjusted dollar amounts in this footnote and elsewhere in this release were calculated with the online inflation calculator available on the U.S. Department of Labor Bureau of Labor Statistics' website, which uses the average Consumer Price Index for a given calendar year, available at *http://data.bls.gov/cgi–bin/cpicalc.pl.*

[54] Twenty-five dollars approximates the value of the larger fees some banks have begun to pay their employees for brokerage referrals in the past few years, although it appears that at such levels the fees may be contingent on factors inconsistent with the conditions of the networking exception. *See infra* note 55.

[55] We anticipate that the most significant changes that may be required at some banks could involve steps such as discontinuing certain types of brokerage-related conditions on referral fees.

Information on existing incentive programs provided through the ABASA, the Bank Insurance Securities Association (''BISA''), and the Independent Community Bankers Association (''ICBA'') suggests that the proposed amendments would accommodate levels of referral fees consistent with the existing referral incentive programs of most banks that provided information to the Commission staff, to the extent such programs do not create inappropriate sales incentives for unregistered bank employees. A representative of the ICBA told the Commission staff that $8 is the average referral fee paid by community banks. Information from BISA on fees for brokerage referrals paid by ten banks that provided a dollar amount in response to a survey indicates a range from zero to $30: one bank pays $5; one bank pays $7 per qualified referral, which is paid into a branch-wide pool of funds that the branch will receive if it meets certain goals that include investment and insurance production; three banks pay $10; one bank pays a range between zero and $14.84, depending on whether employees meet or exceed a threshold number of qualified referrals; one bank pays $20; one bank pays $10 for a discount brokerage referral and $20 for a full-service brokerage referral; one bank pays either $18.75 or $25, depending on whether an employee has already made referrals that have resulted in twelve meetings with a registered representative; and one bank pays points with a value of $25, $25 in cash, or a cash award of between $25 and $30 for referrals exceeding quarterly target levels. One sample plan from ABASA provides for payments in points having a value of $10 for referrals that result in a kept appointment with a registered representative. Another, apparently used by multiple banks, provides for referral fees of either $25 or $35 in cash, depending on whether a bank utilizing the incentive plan selects a minimum investable assets amount of $10,000 or $25,000 for ''qualified'' customers—*i.e.*, those to whom the referring bank employee has spoken personally, meet the $10,000 or $25,000 minimum investable assets level, and keep an appointment with a registered representative of the broker-dealer within 60 days.

As discussed above, some commenters criticized the definition of ''nominal one-time cash fee of a fixed dollar amount'' in the Interim Rules[56] for listing conditions on referral fees that are inconsistent with the networking exception.[57] As amended, the definition would not list impermissible referral fee conditions. Instead, such conditions would be addressed by the meaning given to the phrase ''fixed dollar amount'' in the definition, and the proposed new definition of ''contingent on whether the referral results in a transaction,'' as described below.

We request comment on the proposed dollar-amount and hourly compensation standards for measuring nominal value in the proposed amended definition of ''nominal one-time cash fee of a fixed dollar amount.'' In particular, are the $15-inflation adjusted and $25 amounts the most appropriate levels?

The Commission also solicits comments on the merits of providing another alternative standard for determining whether a referral fee is nominal that would be based on the incentive a bank would pay its employee for the sale or renewal of a certificate of deposit (''CD''). To avoid such a standard leading to referral fees with non-nominal values equivalent to what a bank might pay for the sale of a large, long-term CD, the measure would refer to a CD with a term and value equal to the term and value of the CDs banks most frequently issue. The Commission solicits comments on whether such a standard would provide a useful means for measuring a nominal value in this context. In particular, we request comment on what compensation, if any, banks pay for the sale or renewal of a CD. Does the compensation for the sale or renewal of a CD vary based on economic factors such as the bank's level of interest in gathering deposits? Does the incentive vary depending on whether the transaction is a new purchase or a renewal? Does the incentive vary depending on the value of the CD or based on the term of the CD? For example, would the average incentive that a bank pays for the sale of a one-year, $5,000 CD be nominal? The Commission also solicits comments on other possible objective measures banks could use to gauge whether the referral fees they pay are nominal.

[56] *See* 17 CFR 240.3b–17(g)(2).

[57] *See, e.g.*, Harris Trust letter and QMellon letter (arguing that the Interim Rules should not identify impermissible conditions on referral fees that are not explicitly identified in the statute).

b. Meaning of ''One-Time''

Exchange Act Section 3(a)(4)(B)(i)(VI)[58] permits unregistered bank employees to receive a ''one-time'' fee for the referral of a customer. Commenters expressed the view that banks should be able to pay fees more often than contemplated by the statute.[59] This could include, for example, making a payment at the time of a referral and then a second one later if the employee makes a particular number of referrals in a period of time covering the referral for which the employee was already paid. Such an approach would be inconsistent with the plain language of the networking exception, which limits banks to paying unregistered employees only ''one-time'' referral fees.

We therefore propose to include in the amended definition of ''one-time nominal cash fee of a fixed dollar amount'' an interpretation of the term ''one-time'' to clarify that a referral fee may be paid to a bank employee no more than one time per customer referred by that employee. This proposed amendment should help clarify the issue, raised by some commenters, of the circumstances under which compensation paid in the form of bonuses falls within the networking exception's prohibition on the payment of brokerage-related incentive compensation to unregistered bank employees.[60]

Some commenters argued that only bonus plans used as a conduit to pay

[58] 15 U.S.C. 78c(a)(4)(B)(i)(VI).

[59] *See, e.g.*, NYCH letter.

[60] The proposed provision would not require a bank to determine whether a customer had ever been referred by any of the bank's unregistered employees to pay the referring employee a referral fee. A bank could not, however, pay additional fees to the same unregistered employee based on additional referrals of the same customer, including additional referrals for different types of brokerage products. In other words, a bank could not pay a particular employee more than one referral fee based on multiple referrals of the same customer, and an unregistered bank employee who referred a customer more than once could receive only one fee related to that customer.

brokerage-related compensation to unregistered employees under the exception are prohibited.[61] We do not agree. Any bonus or other incentive compensation that is payable based in part, directly or indirectly, on a referral for which the employee has already received a referral fee, would violate the exception's requirement that brokerage-related incentive compensation paid to unregistered employees under the exception be limited to ''one-time'' referral fees. However, consistent with the meaning we propose to give ''cash fee'' (described below) in the definition of ''nominal one-time cash fee of a fixed dollar amount,'' a referral fee could be paid partially in cash at the time of the referral and partially in points to be paid to the employee as a bonus at a later time, if the total value of the cash and points in which the fee is paid has a nominal value under the definition.

Other types of bonuses that do not give unregistered bank employees a promotional interest in securities brokerage would not be prohibited by the exception's ''one-time'' requirement. As we explained in adopting the Interim Rules, while the exception does not permit unregistered bank employees to receive bonuses based on brokerage referrals, it does not prohibit bonuses based on the overall profitability of a bank that are determined and paid regardless of the brokerage-related activities of an employee receiving such a bonus.[62] This is true even though the financial performance of the bank as a whole would in part depend on the bank's securities networking activities, because such activities are unlikely to represent a significant source of the bank's overall profits and such bonuses are not likely to give unregistered employees a promotional interest in the brokerage services offered by the broker-dealers with which the bank networks.

In addition, some commenters stated that a bonus program applicable to all employees of a bank holding company, or based on the profitability of a bank holding company as a whole, should not be limited by the networking exception's restrictions on brokerage-related compensation.[63] The Commission believes that a bonus based on the profitability of a bank's ultimate parent company should be analyzed in the same way as a bonus based on the bank's profitability. We believe that bonuses based on measures more closely related to securities brokerage, however, would be inconsistent with the statutory limitations on referral fees.

We request comment on the interpretation of the term ''one-time'' in the proposed amended definition of ''nominal one-time cash fee of a fixed dollar amount.'' We are also soliciting comment on what additional guidance, if any, commenters would find useful with respect to bonus programs.

c. Meaning of ''Cash Fee''

In addition to cash payments, the definition of ''nominal one-time cash fee of a fixed dollar amount'' in the Interim Rules provided for payments in points in a system or program covering a range of bank products and non-securities related services in which points count toward a bonus, so long as the value of the points awarded for referrals involving securities are not greater than the value of the points awarded for activities not involving securities.[64] While Exchange Act Section 3(a)(4)(B)(i) does not contemplate the payment of referral fees in points instead of cash, the Commission included this provision in recognition of banks' existing practices to give them additional flexibility. While some commenters supported the provision, others expressed concern or raised questions about it. For example, some asserted that it should not be limited to points awarded for securities referrals as part of a broader program or argued that it unfairly limited the value of fees paid in points.[65]

In response to questions and concerns expressed about this provision, the Commission is proposing to modify it. The amended definition of ''nominal one-time cash fee of a fixed dollar amount'' [66] would allow the payment of referral fees or portions of referral fees other than in cash to the extent that: (1) Such payments are in units of value with a readily ascertainable cash equivalent;[67] (2) the total value of the referral fee meets the nominal value conditions of the proposed amended definition; and (3) the payment is made under an incentive program that covers a broad range of products and that is designed primarily to reward activities unrelated to securities.[68] As noted above, this interpretation of the networking exception's ''cash fee'' requirement would permit banks to continue using certain types of point-based incentive programs under which points are accumulated toward a cash bonus or other incentive. These provisions are intended to maintain the flexibility provided in the Interim Rules for banks to continue using such programs, while providing greater certainty as to the conditions under which such programs may be used to reward securities brokerage referrals. Of course, a referral fee paid in part or entirely in points must not only have a nominal value, but it must also meet the other conditions of the networking exception.

We request comment on the proposed interpretation of the exception's''cash fee'' requirement. In particular, commenters are invited to discuss whether the limitations in this provision

[61] *See, e.g.*, July 17, 2001, ABA/ABASA letter; Banking Agencies letter; and PNC letter. The Bank One letter, Mellon letter, and SIA letter also sought clarification regarding the circumstances under which bonuses would not be impermissible incentive compensation under the networking exception.

[62] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27766. The explanation continued with the caveat that a bank could not rely on the networking exception and use bonuses as a means of indirectly paying their unregistered employees brokerage-related incentive compensation based on the performance of a branch, department or line of business of the bank. This is also true for bonuses based on points paid under the proposed interpretation of ''cash fee.'' Such bonuses also must not be contingent on factors on which the payment of a referral fee, or the value of a referral fee, may not be conditioned. *See* discussions regarding ''fixed-dollar amount'' and ''contingent on whether the referral results in a transaction,'' *infra*. Of course, whether an unregistered employee receives a bonus based in part on brokerage referrals could be contingent on factors unrelated to securities brokerage, such as whether the employee opens a certain number of deposit accounts or consistently follows the bank's risk management policies. However, as explained below, the exception's ''fixed dollar amount'' condition means that the value of any points paid for brokerage referrals that might count toward the bonus would need to have a set, nominal value at the time the referrals were made.

[63] *See e.g.*, letter dated July 12, 2001 from Michael P. Smith, President, New York Bankers Association (''NYBA letter''); Harris Trust letter; Mellon letter; and SIA letter.

[64] *See* 17 CFR 240.3b–17(g)(1)(ii).

[65] *See* Banking Agencies letter; BSA letter; Harris letter; Mellon letter; NYCH letter; Regions letter; and letter dated July 17, 2001 from Ted T. Cecala, Chairman & CEO, Wilmington Trust Company (''Wilmington Trust letter''). Moreover, in meetings with the Commission staff, bank representatives explained they were uncertain regarding the scope of services a program would need to cover to qualify for the exception.

[66] *See* proposed Exchange Act Rule 710(b)(1).

[67] The ''readily ascertainable cash equivalent'' condition would limit the value of a referral fee paid in points to an amount that is determined by a bank and known to an employee before the employee makes a brokerage referral. This requirement would not permit the value of a ''point'' to be based on the number of points an employee earns from brokerage referrals. For example, the size of a points-based bonus could not be based on the number of brokerage referrals an employee makes over a target number of brokerage referrals. Similarly, the value of a points-based bonus could not be increased by the percentage of an employee's total points earned from securities brokerage referrals.

[68] *See* proposed Exchange Act Rule 710(b)(3). The condition that the incentive program cover a broad range of products and be designed primarily to reward activities unrelated to securities means the program provides incentives for activities such as selling bank products or services not involving securities or for making referrals for non-securities products such as insurance, and that the program is not focused on brokerage referrals.

would be sufficient to assure that unregistered bank employees are not given incentives to promote a broker-dealer's brokerage business by engaging in more than the limited activities permitted under the exception. We are also soliciting comment on what additional guidance, if any, commenters would find useful with respect to such programs.

d. Meaning of ''Fixed Dollar Amount''

We also propose to amend the definition of ''nominal one-time cash fee of a fixed dollar amount'' to specify that a fee of a ''fixed dollar amount'' means a flat fee.[69] The proposed definition would state that fees paid for brokerage referrals made by a particular employee must have a set value and may not vary based on factors such as the financial status of a customer the employee refers, the identity of the broker-dealer to which the customer is referred, the number of referrals the employee makes, or whether the customer expresses an interest in a particular type of securities product.

3. Comments on Definition of ''Referral'' and Proposed Amendments

The Interim Rules define the term ''referral'' to exclude any activity beyond arranging a first securities-related contact between a registered broker-dealer and a bank customer. We received over a dozen comments on the definition of ''referral.''[70] Commenters characterized the definition as excessively narrow,[71] and generally took the position that it was more restrictive than required by the Exchange Act, the Banking Agencies, and the Interagency Statement.[72] Several commenters indicated that they saw no need to restrict referral payments at all.[73] A few objected to the use of the phrase ''first securities-related contact,'' or suggested that the phrase be defined.[74]

In response to these comments and to address concerns commenters expressed about difficulties they might have in meeting the definition in the Interim Rules, we propose to eliminate the first securities-related contact limitation from the definition of ''referral.'' We also propose to simplify the definition in a manner consistent with pre-GLBA networking arrangements. Under the amended definition, a ''referral'' would mean the action taken by a bank employee to direct a customer of the bank to a registered broker or dealer for the purchase or sale of securities for the customer's account.[75]

The proposed amendment also would specify that a bank may pay a fee for a brokerage referral only to the employee who made the referral and not to other employees, such as a branch manager or other supervisor. This interpretation of the statute is consistent with existing networking practices and banking agency guidance. We request comment on these proposed changes and clarifications to the definition of ''referral.'' Commenters are invited to discuss whether banks need additional guidance on what constitutes a referral.

4. Proposed New Definition of ''Contingent on Whether the Referral Results in a Transaction''

The Interim Rules stated that the payment of a ''nominal one-time cash fee of a fixed dollar amount'' for a referral cannot be related to certain enumerated factors, including the value of any securities transaction or a customer's financial status.[76] Although some commenters indicated that limitations on the conditions under which referral fees may be paid are unnecessary,[77] the networking exception is clear that the payment of referral fees in reliance on this exception may not be contingent on whether the referral results in a transaction.[78]

Thus, to provide guidance on those contingencies on which incentive compensation may not be based under the exception, we propose to define the term ''contingent on whether the referral results in a transaction'' to mean, with two exceptions, contingent on any factor related to whether the referral results in a transaction, including whether it is likely to result in a transaction, whether it results in a particular type of transaction, or whether it results in multiple transactions.[79]

For example, under the proposed definition, a bank could not make referral fees contingent on whether a customer opens a brokerage account because such a contingency would make it more likely that the referral would result in a securities transaction.[80] Referral fees also may not be contingent on whether the customer invests more than a specified amount in securities or maintains a brokerage account for a specified time.

In response to commenters' requests,[81] however, the proposed definition specifically would permit referral fees to be contingent on two factors. First, the term would permit referral fees to be contingent on whether a customer contacts or keeps an appointment with a broker-dealer as a result of a referral.[82] Second, referral fees may be contingent on whether a bank customer has assets meeting any minimum requirement that the registered broker-dealer, or the bank, may have established generally for referrals for securities brokerage accounts.[83] Both of these factors give broker-dealers the flexibility to avoid paying fees for worthless referrals without inappropriately aligning the financial interests of the bank's employee with those of the broker-dealer. A customer could fail to keep an appointment scheduled at the time of a referral but still contact a broker-dealer as a result of the referral. Banks may wish to pay referral fees in those contexts. These contingencies appear to be commonly used in existing networking arrangements. In contrast, contingencies based on whether a referral results in a customer opening or funding a brokerage account, on

[69] The proposed definition would clarify that rewarding referrals with non-flat fees that vary in amount based on ''success'' factors would be inconsistent with the ''fixed dollar'' amount requirement in the statute.

[70] *See, e.g.*, Banking Agencies letter; Bank of America letter; BONY letter; Connecticut Bankers letter; NYCH letter; Regions letter; Roundtable letter; UMB Bank letter; and Wells Fargo letter.

[71] *Id.*

[72] *See* Interagency Statement, *supra* note 37.

[73] *See* Banking Agencies letter; Connecticut Bankers letter; and UMB Bank letter.

[74] *See, e.g.*, NYCH letter and Wells Fargo letter.

[75] *See* proposed Exchange Act Rule 710(c). Representatives of banks have expressed an interest in paying their unregistered employees for broker-related activities other than referrals, such as screening potential brokerage customers. The Commission believes that such activities constitute brokerage activities beyond those intended to be covered by the networking exception. The Commission believes it would be inconsistent with the networking exception for banks to pay fees to unregistered bank employees to perform functions—other than those expressly permitted by the GLBA or an applicable exemption—that are traditionally performed by a registered representative of a broker-dealer. A broker-dealer has a duty to know its customers, which involves obtaining financial information from them through its registered representatives. Moreover, whether investing in securities through a broker-dealer is appropriate for a particular individual must be determined by that broker-dealer's registered representative, not unregistered bank employees that are not subject to suitability obligations.

[76] *See* 17 CFR 240.3b–17(g)(2). Proposed Regulation B uses the word ''including'' as expanding or illustrative, not as exclusive or limiting. The use of the term ''including, but not limited to'' in Exchange Act Rules 10b–10 and 15b7–1 is not intended to create a negative implication regarding the use of ''including'' without the term ''but not limited to'' in Regulation B or other Exchange Act rules.

[77] *See* Bank of America letter and SIA letter.

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

[79] *See* proposed Exchange Act Rule 710(a).

[80] Opening a brokerage account is the first step in a securities transaction. Typically, opening a brokerage account results in the purchase or sale of securities.

[81] *See* Bank of America letter and SIA letter.

[82] *See* proposed Exchange Act Rule 710(a)(1).

[83] *See* proposed Exchange Act Rule 710(a)(2).

whether the customer keeps the account open for a certain period of time, or on whether the referral results in brokerage-related fees above a certain amount or assets invested above a certain amount are the type of success-based factors that are close measures of whether a referral results in a transaction.

We request comment on the proposed definition of ''contingent on whether the referral results in a transaction.'' In particular, we seek comment on whether there are additional contingencies that banks currently place on referral fees that should be permissible under the proposed definition of ''contingent on whether the referral results in a transaction.'' In addition, we encourage commenters to discuss other areas where they believe the Commission should grant exemptive relief related to networking arrangements. For example, in addition to the asset, net worth, and income contingencies excluded from the proposed definition, we seek comment on whether banks should be able to condition the payment of referral fees on other criteria relating to other aspects of a customer's financial profile, such as tax bracket. Banks also are invited to discuss whether they would be able to continue their existing networking activities if the current rules were amended as described above. If not, banks should explain what proposed rule provisions would prevent them from doing so. Banks should also explain what changes, if any, they would need to make to their existing networking programs to comply with the amended rules.

5. Interpretations of ''Contractual or Other Written Arrangement'' and ''Qualified Pursuant to the Rules of a Self-Regulatory Organization''

The Commission has received requests to provide further guidance on certain terms used in the Interim Rules in connection with the networking exception that were not defined in the Interim Rules. Therefore, it may be useful to clarify the meaning of some of these terms. First, one commenter proposed that the Commission interpret the networking exception requirements expansively to ''apply to any bank subsidiary expressly formed for the purpose of engaging in securities transactions.'' [84] We decline to expand the scope of the networking exception in this manner. The Exchange Act's functional exceptions for banks from the definitions of ''broker'' and ''dealer'' apply only to banks, and only under limited circumstances. Non-bank affiliates of banks are not subject to the same level of regulation as banks, and such entities were not exempted from the Exchange Act's broker-dealer registration requirements by the general exemption that the GLBA replaced with limited, functional exceptions for banks. Non-bank subsidiaries or affiliates of a bank may not rely on a bank exception or exemption from broker-dealer registration.[85] This interpretation is consistent with the plain language of the GLBA. Non-bank entities that refer customers, including bank customers, to broker-dealers would generally have to register as broker-dealers.[86]

Second, the Commission has received informal requests to clarify the term ''qualified pursuant to the rules of a self-regulatory organization.'' This term means to be qualified to effect a securities transaction as a natural person associated with a registered broker or dealer under Exchange Act Rule 15b7–1, which requires broker-dealers to comply with SRO qualification standards.[87]

We request comment on these interpretations, and on whether banks require additional clarification of these terms or explanations of other terms used in the networking exception. We also seek comment on whether these interpretations or any other suggested interpretations related to the networking exception should be included as amendments to the Interim Rules.

The Commission staff also has received informal requests for guidance on whether particular activities are clerical or ministerial, and thus can be performed by unregistered bank employees within the scope of the networking exception. Clerical and ministerial functions are those such as scheduling appointments with a broker-dealer that do not require specific qualifications or licensing when performed by an employee of a broker-dealer. These functions do not require familiarity with the securities industry, or the exercise of judgment concerning securities. Detailing all of the activities that would constitute clerical and ministerial functions is beyond the scope of this release. Nevertheless, the Commission would welcome requests for exemptive or no-action relief or interpretive guidance with respect to specific activities that interested parties believe are clerical or ministerial in the banking context.

*B. Trust and Fiduciary Activities Exception*

Section 3(a)(4)(B)(ii) of the Exchange Act [88] permits a bank, under certain conditions, to effect transactions in a trustee or fiduciary capacity without registering as a broker. Under this exception, a bank must effect such transactions in its trust department, or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.[89] The bank also must be ''chiefly compensated'' for such transactions, consistent with fiduciary principles and standards, on the basis of: (1) An administration or annual fee, (2) a percentage of assets under management, (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions, or, (4) any combination of such fees.[90] The term ''chiefly compensated'' is not defined in the GLBA. Therefore, in the Interim Rules, the Commission provided a definition for the term to establish clear standards for complying with the ''chiefly compensated'' requirement under the GLBA.[91]

[84] *See* letter dated July 17, 2001 from Neil Milner, President and CEO, Conference of State Bank Supervisors (''CSBS letter''). Similarly, the Commission staff has received informal requests for guidance on whether the networking exception would permit a bank to avoid being considered a broker based on a networking arrangement entered into by an affiliate or a subsidiary of the bank, and whether a bank could participate in networking activities under arrangements entered into by an affiliated insurance agency.

[85] *See* Exchange Act Section 3(a)(6) which defines ''bank.''

[86] In general, absent an exception or exemption, a person who regularly refers securities business prospects for compensation to a broker-dealer would be a broker required to be registered with the Commission. *See* Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013, 30017–18 (July 18, 1989).

[87] *See* 17 CFR 240.15b7–1.

[88] 15 U.S.C. 78c(a)(4)(B)(ii).

[89] *Id.*

[90] 15 U.S.C. 78c(a)(4)(B)(ii)(I). Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities in conjunction with advertising their other trust activities. 15 U.S.C. 78c(a)(4)(B)(ii)(II). The exception also provides that a bank's trust and fiduciary activities that result in a transaction in the United States of any security that is publicly traded must meet the conditions set out in Section 3(a)(4)(C) of the Exchange Act. 15 U.S.C. 78c(a)(4)(C). These conditions require a bank to direct a trade to a registered broker or dealer for execution, to effect the trade through a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary that is not in contravention of fiduciary principles established under applicable federal or state law, or to effect the trade in some other manner permitted by the Commission. 15 U.S.C. 78c(a)(4)(C)(i)–(iii). The term ''assets under management'' is not defined in the Exchange Act or in the proposed rules.

[91] Exchange Act Rule 3b–17(a) defines the term ''chiefly compensated'' to mean that ''the 'relationship compensation' received by a bank from a trust or fiduciary account exceeds the 'sales compensation' received by the bank from such account during the immediately preceding year. * * *''

Provisions of the Interim Rules relating to the ''chiefly compensated'' requirement engendered a great deal of public comment and have been a primary focus of the discussions the Commission staff has had with banking industry representatives and bank regulators since the Interim Rules were adopted. As a result of these comments and discussions, the Commission is proposing to modify substantially the ''chiefly compensated'' provisions in the Interim Rules. In the Commission's view, these proposed improvements should facilitate their compliance with the ''chiefly compensated'' requirement while permitting banks to continue many of their current practices. This, in turn, should ease their costs of transition to the new statutory scheme without compromising investor protection.

1. Chiefly Compensated

a. Statutory Requirements and Existing Rules

To qualify for the trust and fiduciary activities exception, Exchange Act Section 3(a)(4)(B)(ii) requires a bank to be ''chiefly compensated'' for transactions effected in its trustee or fiduciary capacity, consistent with fiduciary principles and standards. This condition reflects Congress' goals to implement the functional regulation of securities activities and to permit banks to continue to conduct limited securities activities while acting as, and being paid as, fiduciaries.[92] The statutory conditions that a bank must meet to qualify for this exception are designed to ensure that bank trustees and fiduciaries conducting securities activities outside of the protections of the securities laws are compensated as traditional trustees and fiduciaries.[93]

By its terms, the ''chiefly compensated'' condition divides a bank's compensation into qualifying (traditional fees received by trustees and fiduciaries) and non-qualifying types (traditional fees received by broker-dealers), and limits the amount of non-qualifying compensation a bank may receive and still rely on the exception. In other words, Section 3(a)(4)(B)(ii) contemplates that a bank relying on the trust and fiduciary activities exception will need to limit its non-qualifying compensation and will need to have a mechanism in place to determine whether it has succeeded in doing so.

While defining the types of compensation to compare is essential to making the test meaningful, the statutory limitations require many banks to categorize and compare their compensation in a manner that is new to them. Current Exchange Act Rule 3b–17 was intended to facilitate that categorization and comparison. The Rule defines ''chiefly compensated'' to mean that more of a bank's payments for securities transactions must come from qualifying, or ''relationship compensation,'' [94] than from non-qualifying, or ''sales compensation.'' [95]

To determine compliance with the ''chiefly compensated'' condition, current Exchange Act Rule 3b–17 requires banks to compare their ''relationship compensation'' to their ''sales compensation'' annually, on an account-by-account basis. Unrelated compensation is not included in the ''chiefly compensated'' calculation because it is not relevant to whether a bank is acting as a broker.[96]

The Interim Rules also provided two exemptions from the general requirements of the ''chiefly compensated'' condition. First, current Exchange Act Rule 3a4–2 exempts banks that receive less than ten percent sales compensation from making calculations on an account-by-account basis. Second, Exchange Act Rule 3a4–3 exempts banks from the definition of broker when they act in the narrow role of indenture trustees investing in no-load money market funds. These exemptions are explained in more detail below.

b. Comments on ''Chiefly Compensated'' Requirement

We received multiple comments addressing the ''chiefly compensated'' condition.[97] Many commenters agreed

[92] By enacting a trust and fiduciary activities exception in the Exchange Act, Congress acknowledged that banks held securities in trust accounts. In the GLBA's legislative history, the conference committee stated that ''[t]he Conferees expect that the SEC will not disturb traditional bank trust activities under this provision.'' H.R. Conf. Rep. No. 106–434, 164 (1999).

The House Committee on Commerce further stated that it expected the Commission ''to interpret this exception, and, in particular the references to ''chiefly'' and ''fiduciary principles and standards'' contained in this exception, so as to limit a bank's ability to receive incentive compensation or similar compensation that could foster a salesman's stake in promoting securities transactions.'' That Committee also stated that it did not intend for a bank to conduct a full-scale securities brokerage operation in the trust department that would be exempt from Commission regulation and the imposition of appropriate investor protections under the Federal securities laws. H.R. Rep. No. 106–74, pt. 3, at 164 (1999).

[93] The question of when a bank may be acting in a fiduciary *capacity* is separate and distinct from the question of whether a specific account is established for a fiduciary *purpose*. For example, a bank may be acting in a fiduciary *capacity* when it provides investment advice to a common investment fund. Such a fund, however, will be excluded from the definition of investment company under the Investment Company Act of 1940 (''Investment Company Act'') only if it is employed solely as an aid to the administration of accounts maintained for a traditional fiduciary *purpose*. *See* Section 3(c)(3) of the Investment Company Act.

[94] *See* Exchange Act Rule 3b–17(i). The term ''relationship compensation,'' an amended version of which the Commission is proposing to codify in Exchange Act Rule 724, includes administrative or annual fees (payable on a monthly, quarterly, or other basis), fees based on a percentage of assets under management, a flat or capped per order processing fee limited by the bank's cost in effecting the transaction, or any combination of such fees.

[95] *See* Exchange Act Rule 3b–17(j). The ''sales compensation'' definition, an amended version of which the Commission is proposing to codify in Exchange Act Rule 724, includes compensation that a bank receives for a securities offering that the bank does not receive directly from a customer, beneficiary, or the assets of the trust or fiduciary account. ''Sales compensation'' also includes Rule 12b–1 fees. ''Rule 12b–1 fees'' or ''12b–1 fees'' are fees paid out of fund assets pursuant to a distribution plan adopted under Rule 12b–1 under the Investment Company Act. 17 CFR 270.12b–1. The ''sales compensation'' definition reflects the fact that bank trust departments, like broker-dealers, receive payments for securities transactions from third parties. Many of the sales practice provisions of the federal securities laws, including a number of NASD rules, are designed to address such conflicts of interest. ''Sales compensation'' also includes revenue sharing payments that bank trust departments receive from mutual fund companies.

[96] Any fee a bank receives that is not related to effecting securities transactions is considered ''unrelated compensation'' and, except as discussed below, is not included in the definition of ''relationship compensation.'' Unrelated compensation includes fees charged separately for activities, including taking deposits, lending funds (including margin lending), preparing taxes, or providing other services that are not related to managing securities accounts pursuant to the trust and fiduciary activities exception. Unrelated compensation also includes compensation received as permitted under the terms of another bank exception from the definitions of ''broker'' and ''dealer.'' This exclusion includes any payment made to the bank or one of its employees pursuant to the networking exception. *See* Exchange Act Section 3(a)(4)(B)(i)(VI).

[97] *See, e.g.*, ABA/ABASA letters; ACB letter; Bank of America letter; ABA Banking Law Committee letter; Bank One letter; Banking Agencies letter; BONY letter; Broadway letter; CSBS letter; letter dated July 17, 2001 from Jerry W. Powell, General Counsel, Compass Bancshares (''Compass letter''); Connecticut Bankers letter; letter dated July 2, 2001 from Melanie L. Fein, Attorney at Law, on behalf of Federated Investors, Inc. and letter dated June 18, 2001 from Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated Investors, Inc. (''Federated letters''); letter dated July 10, 2001 from William Nappi, CTCP, Trust Compliance Officer, FirstMerit Corp., N.A. (''FirstMerit letter''); letter dated July 13, 2001 from Michael Watkins, Senior Vice President and Deputy General Counsel, First Union Corporation (''First Union letter''); Fleet letter; Harris Trust letter; IIB letter; Mellon letter; National City letter; Bar of NY letter; NYCH letter; PNC letter; Regions letter; Roundtable letter; letter dated July 17, 2001 from Stewart P. Greene, Chief Counsel, Securities Law, Teacher Insurance and Annuity Association (''TIAA–CREF letter''); Texas Bankers Trust Division letter; UMB Bank letter; Victoria letter; Virginia Bankers letter; Wells Fargo letter; letter on behalf of an unnamed client, dated July 17, 2001 from Satish M. Kini of Wilmer, Cutler & Pickering (''Wilmer, Cutler letter''); and letter dated July 16, 2001 from W. David Hemingway, Chief Financial

Continued

that the term ''chiefly compensated'' should not be interpreted to require a higher percentage threshold than the fifty percent standard in the Interim Rules.[98] Many commenters disagreed with the Commission's interpretation, however, that the ''chiefly compensated'' calculation should be made on an account-by-account basis.[99] Commenters opposing an account-by-account calculation argued that the GLBA does not expressly require such a calculation and that determining compliance in this manner would be unduly costly and complicated. Some commenters expressed the view that the ''chiefly compensated'' condition should instead be interpreted to allow banks to determine compliance on a line-of-business basis because they believe that Congress intended a line-of-business approach.[100]

Some commenters also raised concerns about the way in which the Commission proposed to categorize certain types of compensation. For example, under the Interim Rules, Rule 12b–1 fees are considered ''sales compensation'' rather than ''relationship compensation.'' Some commenters believed that 12b–1 fees should be categorized as ''relationship compensation.''[101] In addition, one commenter asserted that banks should be able to treat fees based on a percentage of assets under management, such as separately charged fees for managing real property, as ''relationship compensation.''[102]

One commenter recommended that the Commission ''grandfather'' trust and fiduciary arrangements that were entered into prior to the establishment of the parameters for categorizing compensation.[103] Others emphasized the need for a cure period or ''safe harbor'' for banks that inadvertently failed to meet the ''chiefly compensated'' condition during a particular time period.[104]

c. Proposed Changes in Response to Comments

In response to comments on provisions of the Interim Rules dealing with the ''chiefly compensated'' condition, the Commission is proposing new exemptions and expanding the existing exemptions. To simplify compliance, the Commission also is proposing to expand the definition of ''relationship compensation'' to expand the types of assets that could qualify for assets under management fees paid directly by the customer, beneficiary, or account.[105] The Commission believes that the proposed amendments to the provisions of the Interim Rules that address the ''chiefly compensated'' condition should significantly simplify compliance with the condition, alleviate concerns about inadvertent noncompliance, and reduce the costs banks were likely to have incurred in making the ''chiefly compensated'' calculation under the Interim Rules.

For example, the Commission is proposing a ''line-of-business'' alternative to the account-by-account methodology in response to requests by representatives from the banking industry. Moreover, the Commission is proposing to exempt existing living, testamentary, and charitable trust accounts from the ''chiefly compensated'' calculation. Finally, the Commission is proposing to establish a multi-tiered ''safe harbor'' for banks determining compliance on an account-by-account basis that find themselves out of compliance with respect to particular accounts. The proposed safe harbors would provide banks with legal certainty during those periods in which they were not compliant and would provide them opportunities to come into compliance with the ''chiefly compensated'' condition. These proposed changes to the Interim Rules, as well as Commission guidance on other aspects of the Interim Rules, are discussed below.[106]

d. Proposed Line-of-Business Exemption

i. Description of Existing Rule

Exchange Act Rule 3a4–2 permits a bank to rely on the trust and fiduciary activities exception from broker registration under the GLBA if the bank's total ''sales compensation'' during the previous year was less than ten percent of its total ''relationship compensation'' for that period, provided the bank meets other conditions in the exception.[107] The rule was intended to provide banks with an alternative to the account-by-account calculation of the ''chiefly compensated'' requirement.

Commenters generally agreed that an alternative to the account-by-account ''chiefly compensated'' calculation was desirable. [108] Some argued, however, that the alternative that the Commission adopted in Exchange Act Rule 3a4–2 was unduly restrictive and in practice would not provide meaningful relief from the account-by-account calculation. In particular, several commenters stated that the procedural conditions in the exemption essentially require an account-by-account calculation, thereby defeating the purpose of the exemption.[109]

Officer, Zions Bank Capital Markets, Zions First National Bank, letter dated July 17, 2001 from Rick D. Burtenshaw, Senior Vice President, Investment Division, Zions National Bank (''Zions Bancorporation letters'').

[98] *See, e.g.*, Banking Agencies letter.

[99] *See, e.g.*, ABA/ABASA letters; ACB letter; Banking Agencies letter; BONY letter; Compass letter; Connecticut Bankers letter; Mellon letter; NYCH letter; PNC letter; Regions letter; UMB Bank letter; Wells Fargo letter; and Wilmer, Cutler letter.

*But see* Statement of the ABASA Before the Committee on Banking and Financial Services, U.S. House of Representatives, on The Financial Services Act of 1999, H.R. 10, February 16, 1999:

[H.R. 10's] fee provisions . . . will force every trust bank to analyze each fiduciary account to ensure that the account satisfies the exemption's fee requirements. . .. Despite the regulatory burdens associated with complying with the fee aspect of the exemption, the overall exemption is, ABASA believes, workable. . . .

The Commission notes that H.R. 10 contained language regarding bank securities activities within a trust and fiduciary exception to the definition of broker that was virtually identical to the version that Congress ultimately adopted.

[100] *See, e.g.*, ABA/ABASA letters.

[101] *See* NYCH letter and PNC Bank letter.

[102] *See* Texas Bankers Trust Division letter.

[103] *See* NYCH letter.

[104] *See* ABA/ABASA letters; Banking Agencies letter; Roundtable letter; Bar of NY letter; and Wilmer, Cutler letter. The Commission also received a number of comments regarding the exemptions from the ''chiefly compensated'' requirement in current Exchange Act Rules 3a4–2 and 3a4–3. These comments are discussed below in connection with proposed amendments to those exemptions.

[105] Although the term ''assets under management'' is defined in Section 203A(a)(2) of the Advisers Act, it is not defined in the Exchange Act or in these proposed rules and would include non-securities assets. *See* section III.B.1.h *infra.*

[106] Despite commenters' suggestions, an annual account-by-account calculation is consistent with implementing functional regulation to protect investors. It also is consistent with the way in which both broker-dealers and banks establish their obligations and duties to their customers which, in turn, defines the capacity in which they will act. It is also consistent with accounting requirements and other fundamental determinations that trustees must make under state trust law. Moreover, bank trust departments primarily charge fees at the same level at which securities transaction fees are assessed—the account level.

[107] A bank relying on the Exchange Act Rule 3a4–2 exemption must comply with all other terms of the trust and fiduciary activities exception and must maintain procedures reasonably designed to ensure compliance with the ''chiefly compensated'' requirement with respect to a trust or fiduciary account. Exchange Act Rule 3a4–2 currently requires those procedures to provide that an account will be reviewed when it is opened, when the compensation arrangement for the account is changed, and when sales compensation received from the account is reviewed by the bank for purposes of determining an employee's compensation. Exchange Act Section 3(a)(4)(C) requires that a bank must also execute any securities orders through a broker-dealer (or in a cross trade or other means that the Commission may prescribe).

[108] *See, e.g.*, Banking Agencies letter and BSA letter.

[109] *See, e.g.*, Banking Agencies letter; BONY letter; Bank One letter; Federated letters; Fleet letter; ICBA letter; Mellon letter; PNC letter; Regions letter; and UMB Bank letter. Commenters expressed concern about the costs and burdens associated with these requirements. *See, e.g.*, Mellon letter. One commenter suggested eliminating one of the

ii. Description of Proposed Line-of-Business Exemption

In response to comments, we propose to adopt a ''line-of-business'' approach in proposed Exchange Act Rule 721.[110] The proposal would define a ''line of business'' as an identifiable department, unit, or division of a bank organized and operated on an ongoing basis for business reasons with similar types of accounts and for which the bank acts in a similar type of fiduciary capacity as listed in Exchange Act Section 3(a)(4)(D).[111] Under the proposal, a bank could use an alternative calculation for ''chiefly compensated'' during one year if it could demonstrate that during the preceding year its ratio of ''sales compensation'' to ''relationship compensation'' was no more than one to nine either on a line-of-business or bank-wide basis (*i.e.*, ''one to nine ratio'').[112]

A bank could use this proposed alternative on a line-of-business basis provided that the ''sales compensation'' and ''relationship compensation'' from all trust and fiduciary activity accounts within a particular line of business (or all such accounts within a particular line of business established before a single date certain) is used to determine whether the bank meets this condition.

For example, the bank could limit the accounts in a personal trust line of business that would be used in the line-of-business compensation comparison to all of the accounts established before a single date certain. The enhanced flexibility in this part of the proposal would permit a bank to phase in the use of account-by-account exemptions for qualifying fiduciary activities as long as the bank establishes a specific cut-off date for older accounts within a line of business. This flexibility also should allow them to use this proposal consistent with their changing business practices.

Banks relying on the proposed line-of-business alternative would be required to meet the other conditions in the trust and fiduciary activities exception and would be required to maintain procedures reasonably designed to ensure that, before opening or establishing an account, the bank reviews the account to ensure that the bank is likely to receive more ''relationship compensation'' than ''sales compensation'' with respect to that account.[113] In addition, in contrast to the requirement in current Exchange Act Rule 3a4–2 that the bank review an existing account whenever the compensation arrangement for the account changes, the proposal would only require the bank to maintain procedures reasonably designed to ensure that, after opening or establishing an account, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of ''sales compensation'' as compared to ''relationship compensation,'' the bank reviews the account to ensure that the bank is likely to receive more ''relationship compensation'' than ''sales compensation'' with respect to that account.[114] In other words, only when the bank is revising the fees of a particular account with the accountholder or beneficiary in a way that would increase the proportion of ''sales compensation,'' would it also have to review the account to ensure that it is likely to receive more ''relationship compensation'' than ''sales compensation.''[115]

The proposed line-of-business alternative is intended to give banks legal certainty for each year based on their demonstrated compliance for the previous year.

We request comment on the line-of-business alternative in proposed Exchange Act Rule 721. Generally, would the proposed line-of-business alternative make it easier for banks to comply with the ''chiefly compensated'' condition? If so, please provide quantitative information regarding the cost savings banks that choose the line-of-business alternative could expect versus the account-by-account calculation. In this regard, we request comment on how banks are generally compensated with respect to their existing trust and fiduciary activity accounts. The one to nine ratio is essentially the same comparison used in the Interim Rules, but expressed as a ratio rather than as a percentage to align the comparison in the proposed rules more closely with the ''chiefly compensated'' condition in the statute. We request comment on whether the use of a ratio makes the comparison more clear, or whether the comparison should be expressed as a percentage. We also request comment on whether a one to nine ratio (or, if expressed as a percentage, 11 percent) is the most appropriate comparison, if a one to ten ratio would be sufficient to accommodate banks' current business, or if another ratio would be more practicable. Commenters should include specific information on each particular bank's ''sales compensation'' compared to its ''relationship compensation.''

In addition, we request comment on what impact the expanded definition of ''relationship compensation,'' which would now include separately charged assets under management fees for managing other assets (such as real property, oil and gas, etc.), would have on banks' ability to meet the proposed line-of-business alternative.[116]

Further, we solicit comment on the procedural requirement that a bank review an account when the proportion of ''sales compensation'' is increased, and the impact of this condition on waiving ''relationship compensation'' for a particular account.[117] Is there an alternative that would allow for fee waivers without allowing the bank to be continually compensated by a significant number of accounts entirely through ''sales compensation''?

We also request comment on what impact the requirement that the bank use the compensation from all trust and fiduciary activity accounts within a particular line of business would have on the bank's ability to use the other exemptions proposed in this release,

procedural conditions so that banks could adopt an across-the-board fee increase without triggering an account-by-account compliance review. *See* Federated letters.

[110] *See* proposed Exchange Act Rule 721(c). We do not expect banks to be in compliance with the ''chiefly compensated'' condition during the delayed compliance period for the Interim Rules. Moreover, given that the exemption we are proposing under Exchange Act Rule 721 depends on compliance during the preceding year, this condition would not apply during the first year that the broker exceptions apply to banks. Of course, banks would be expected to demonstrate compliance at the end of the first year after the delayed compliance period. Then, by demonstrating year-end compliance, a bank would have legal certainty for the following year under the terms of the proposed exemption.

[111] *See* proposed Exchange Act Rule 724(e).

[112] We are proposing a one to nine ratio, which is similar to the test in the Interim Rules, because we understand that many banks would fit within this proposed exemption using this threshold. *See* Exchange Act Release No. 44291, *supra* note 13. A one to nine ratio allows banks to receive slightly more than ten percent in sales compensation and not run afoul of the proposed exemption. The proposal would require that the comparison be made based on compensation from accounts within the scope of Exchange Act Section 3(a)(4)(D). For this exception and all of the proposed related exemptions, year continues to be defined as a calendar year or other fiscal year consistently used by a bank for recordkeeping and reporting purposes.

[113] *See* proposed Exchange Act Rule 721(a)(3).

[114] *See* proposed Exchange Act Rule 721(a)(4). This proposed requirement would not be triggered, for example, when the fees received by the bank change due to changes in assets or asset allocation, or if the bank makes across-the-board changes in fees to address inflation.

[115] We also propose to eliminate the requirement in current Exchange Act Rule 3a4–2 that a bank review an account when sales compensation is reviewed for purposes of determining an employee's compensation. *See* Exchange Act Rule 3a4–2(a)(2)(iii).

[116] *See* proposed Exchange Act Rule 724(h) and section III.B.1.h *infra*.

[117] *See* proposed Exchange Act Rule 721(a)(4).

such as the exemptions in proposed Exchange Act Rules 720 and 776. In particular, we solicit comment on whether living, testamentary, and charitable trust accounts are grouped with other non-exempt accounts in a line of business. We also request comment on whether banks place employee benefit plan accounts and other accounts not subject to a special purpose exemption within a particular line of business. Banks that believe they will need additional flexibility for their personal trust and retirement business should provide a detailed explanation of the type of relief they believe would be useful and discuss the sources of their compensation in connection with that business. In addition, we request comment on whether the definition of line of business is practicable. Is this definition subject to manipulation by banks that may have difficulty meeting the line-of-business test in a particular year, and if so, how should it be modified to prevent this?

We also request comment on whether it is appropriate that banks be permitted to use the proposed line-of-business alternative for some lines of businesses, and use an account-by-account calculation or other proposed exemptions for its other lines of business if available. In addition, we request comment on whether it is appropriate for banks to choose whether to use this proposed exemption for particular accounts based on a cut-off date that the bank determines.

Bank representatives informed Commission staff that it would be simpler and more cost effective if banks were permitted to compare ''sales compensation'' to a bank's total trust and fiduciary activities compensation rather than to ''relationship compensation.'' Presumably, total trust and fiduciary activities compensation would include ''relationship compensation,'' ''sales compensation,'' and any compensation that a bank receives for the sale of other products and services. We are soliciting comment on the feasibility and desirability of amending the ''one to nine ratio'' in the line-of-business calculation to require banks to compare their ''sales compensation'' to their total compensation from qualifying fiduciary activities, as opposed to the current comparison of ''sales compensation'' to ''relationship compensation.'' What ratio would be appropriate if the basis were expanded?

In particular, we solicit comment on what compensation items, in addition to ''sales compensation'' and ''relationship compensation,'' would be included in a bank's total compensation for qualifying fiduciary activities and the quantitative impact of including these compensation items on the line-of-business proposal. In addition, what impact, if any, would such a change in the calculation have on the number of banks that could meet the trust and fiduciary activities exception? Moreover, what would be the cost savings to banks in complying with the ''chiefly compensated'' condition if we were to permit banks to compare ''sales compensation'' to total compensation rather than to ''relationship compensation?'' We would like to know the types of compensation that banks would include in total compensation from qualifying fiduciary activities. To evaluate the recommendation that we permit banks to compare ''sales compensation'' to total compensation for trust and fiduciary activities, we are soliciting quantitative information from banks that would illustrate how such a bank would fare under each of the tests.[118] What other changes, if any, do commenters believe should be made to the ''chiefly compensated'' calculation?

Finally, we are seeking comment on the way in which banks are likely to use the proposed calculation alternatives to determine whether additional flexibility is needed in this particular exemption and how best to provide it. For example, do banks have lines of business containing both accounts covered by the special purpose exemptions (*e.g.*, for Regulation S or employee benefit plan accounts) and accounts that are not? If so, which lines of business contain both types of accounts?

e. Proposed New Living, Testamentary, and Charitable Trust Account Exemption

Commenters indicated that banks need flexibility with respect to established personal trust accounts that have terms that cannot readily be changed without consequences to both the bank and the trust beneficiaries. These commenters explained that fees received in connection with these accounts were negotiated in the past and may be difficult to change to meet the ''chiefly compensated'' condition based on, for example, the age or type of the trust.[119] Banks may administer trusts that were created by settlors who have died or who may have become incompetent. In addition, we understand that state law may make it impracticable to change the compensation structure of existing trusts.

In response to these concerns, we are proposing new Exchange Act Rule 720. This proposed rule would exempt a bank from meeting the ''chiefly compensated'' condition to the extent that it effects transactions for a living, testamentary, or charitable trust account opened, or established before July 30, 2004, in a trustee or fiduciary capacity if the bank does not individually negotiate with the accountholder or beneficiary of the account to increase the proportion of ''sales compensation'' as compared to ''relationship compensation'' after July 30, 2004.[120] For purposes of this proposed rule, a testamentary trust may be deemed to be established as of the date of the will that directed that the trust be established. Banks making an account-by-account calculation that rely on a particular exemption must comply with all of the requirements in that exemption, but have the option of choosing the exemption or exemptions they need to match their business.

We invite comment on the proposed exemption for existing personal trust accounts. Banks are particularly invited to explain the ways in which they are compensated for administering existing personal trust accounts.

f. New Conditional Safe Harbor

We also propose to adopt a one-year conditional safe harbor for a bank that exceeds the one to nine ratio that it would need to meet to rely on the line-of-business alternative in proposed Exchange Act Rule 721.[121] Under this safe harbor, a bank that exceeds the one to nine ratio in any given year may continue to rely on the proposed line-of-business alternative for the following year if it meets three requirements.[122] First, it must meet the other requirements of the rule and the other requirements of the trust and fiduciary activities exception. Second, the bank's ratio of ''sales compensation'' to ''relationship compensation'' the bank received from its qualifying fiduciary business must have been no more than one to seven.[123] Third, it may not have relied on this safe harbor during any of the five preceding years.

Used in conjunction with the line-of-business alternative, discussed above,

[118] To the extent that such information would be deemed proprietary, banks could request confidential treatment for that information.

[119] *See, e.g.*, Banking Agencies Letter and NYCH letter.

[120] This date was chosen for administrative simplicity.

[121] *See* proposed Exchange Act Rule 721(b).

[122] *See supra* note 112 for a discussion of the term ''year.''

[123] The one to seven ratio is intended to provide legal certainty to banks that are working in good faith to comply with the terms of the proposed exemption.

this proposed new safe harbor should provide banks with time to adjust their ''sales compensation,'' when necessary, to ensure that it does not exceed the exemption's limit. For example, a bank that finds its ''sales compensation'' is likely to exceed the one to nine compensation ratio could begin to adjust its compensation immediately. The legal assurance that it would have time to make this adjustment without consequence should permit banks to refine their compensation sufficiently to assure that they will remain in compliance.

This new safe harbor should supplement the rule's general exemption in addressing banks' concerns that if they inadvertently exceed the exemption's ''sales compensation'' percentage in one year, they would immediately need to conduct an account-by-account analysis to determine whether they are in compliance with the ''chiefly compensated'' condition. We understand that banks relying on proposed Exchange Act Rule 721 may not have compliance procedures in place to do account-by-account monitoring. Banks could rely on the proposed new safe harbor for one year while taking steps to ensure that they will meet the terms of the general exemption before the end of that year.[124]

We invite comment on the proposed one-year safe harbor in proposed Exchange Act Rule 721, including whether an additional year is a sufficient amount of time and whether one to seven is the appropriate ratio.

[124] These steps could include employing brokers to execute transactions for trust and fiduciary activity accounts, or charging those accounts only a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers. A bank could also rebate 12b-1 fees to the account. Alternatively, the bank could restructure the compensation from some or all of its trust and fiduciary activity accounts to change the proportion of ''relationship compensation'' by reducing the price it charges for executing transactions, executing transactions at cost so the reimbursement would be characterized as ''relationship compensation,'' or raising the bank's annual fee and offering unlimited securities transactions at no additional cost to the account.

A bank could implement any, or several, of these alternatives at any time during the year. For example, a bank might identify a problem in November of a calendar year that it finds is caused by a large account with high ''sales compensation'' that would likely cause the bank to fail its compensation comparison. The bank could waive securities transaction fees, or refund fees already charged to the account. The bank could also restructure the compensation in the account by not charging for additional securities transactions, or by converting to an annual fee that includes unlimited transactions.

g. New Proposed Account-by-Account Exemption

Proposed Exchange Act Rule 722 would provide banks with a new exemption designed to give additional flexibility and legal certainty to banks that determine their compliance with the ''chiefly compensated'' requirement on an account-by-account basis.

i. Proposed Account-by-Account Exemption

Proposed Exchange Act Rule 722 is intended to provide banks that determine compliance with the ''chiefly compensated'' condition through an account-by-account calculation with legal certainty for one year based on their demonstrated compliance for the previous year. Under proposed paragraph (a) of Rule 722, a bank would be exempt from the ''chiefly compensated'' condition with respect to a particular account during any year if it meets four conditions. First, the bank would be required to meet the other conditions of the trust and fiduciary activities exception. Second, the bank must have met the ''chiefly compensated'' condition with respect to that particular account during the preceding year.[125] Third, a bank would be required to maintain procedures reasonably designed to ensure that, before opening or establishing an account, the bank reviews the account to ensure that the bank is likely to receive more ''relationship compensation'' than ''sales compensation'' with respect to that account. Fourth, a bank would be required to maintain procedures reasonably designed to ensure that, after opening or establishing an account, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of ''sales compensation'' as compared to ''relationship compensation,'' the bank reviews the account to ensure that the bank is likely to receive more ''relationship compensation'' than ''sales compensation'' with respect to that account.

We request comment on the proposed exemption. Banks are particularly invited to discuss the extent to which the proposed exemption would provide them with legal certainty. In addition, we are seeking comment from those who believe that the account-by-account calculation should be eliminated. In particular, we invite comment on how banks would satisfy the ''chiefly compensated'' requirement of the trust and fiduciary exception in the absence of an account-by-account calculation requirement.

[125] This condition would not apply during the first year that the broker exceptions apply to banks. During that first year, banks will be expected to demonstrate compliance at the end of the year. By demonstrating compliance during the first year that the broker exceptions are implemented for banks, a bank will have legal certainty for the following year under the terms of the exemption.

ii. New Safe Harbor for Account-Specific Exemption

Commenters expressed concern that banks that determine their compliance with the ''chiefly compensated'' condition on an account-by-account basis would need flexibility if they discovered that their ''sales compensation'' for a particular account had exceeded their ''relationship compensation'' in a particular year.[126] To mitigate banks' compliance concerns, we are proposing a one-year conditional safe harbor for a bank that does not meet the ''chiefly compensated'' requirement with respect to a particular account.[127] This new safe harbor would provide a bank the time to bring its compensation arrangements for that account into compliance with the ''chiefly compensated'' condition.

Under the proposed safe harbor, a bank with one or more accounts that exceed the ''chiefly compensated'' requirement could continue to rely on the trust and fiduciary activities exemption in the next year for these ''sales compensation'' accounts so long as these accounts represent ten percent or less of the total number of accounts for which the bank acts in a trustee or fiduciary capacity.[128] A bank relying on this exemption would need to meet two requirements. First, it must meet the other requirements of the rule, as well as the other requirements of the trust and fiduciary activities exception. Second, the bank may not have relied

[126] Some commenters indicated that occasionally, prudent financial management of an individual customer account, such as a position concentration, could result in a particular account exceeding the chiefly compensated requirement in a particular year. For example, a bank could need to lessen a customer's concentration in a particular investment. *See, e.g.*, Banking Agencies Letter.

In addition, the Banking Agencies, bank trade associations and a law firm stated that banks would be at risk of unintentionally violating the securities laws because a bank can fall out of compliance with the exception for the preceding year based on one account without any type of cure period. *See* Roundtable letter and Wilmer, Cutler letter.

We note that there are many ways that a concentrated portfolio may be diversified without incurring high transaction payments to the bank.

[127] *See* proposed Exchange Act Rule 722(b) and (c). This alternative safe-harbor is not necessary until after the first year that the bank broker exceptions apply.

[128] The ten percent limitation is intended to provide legal certainty to banks that are working in good faith to comply with the terms of the proposed exemption.

on this safe harbor with respect to the particular ''sales compensation'' account during any of the five preceding years.

This safe harbor is intended to provide banks with time to restructure the compensation arrangement with respect to a particular account or accounts. It would not require banks to expand or otherwise modify their overall compliance procedures. Rather, it would permit them to target particular accounts and adjust their compensation accordingly.

We would expect banks to use the safe harbor period to ensure that their new compensation arrangement with respect to the ''sales compensation'' account will allow them to meet the ''chiefly compensated'' condition in the future for that account. While this should theoretically mean that an account that exceeds the ''chiefly compensated'' threshold would not exceed that threshold again, the character of an account can change over time. Therefore, the safe harbor would be available for a bank to use for the same account once every five years.

Banks that choose to calculate their compliance with the ''chiefly compensated'' condition on an account-by-account basis will need to have systems in place to monitor their own compliance. We would expect banks' systems to ensure that few accounts actually exceed the ''chiefly compensated'' threshold. While the proposed safe harbor would permit up to ten percent of a bank's trust and fiduciary activities accounts to exceed the compensation threshold in a given year, we would expect banks to monitor their compliance closely enough that their percentage of non-complying accounts remains small. We request comment on the ten percent limit. Banks that believe the limit should be higher are encouraged to discuss what limit would be consistent with the compliance systems they plan to put in place.

In addition to the general one-year safe harbor, we are proposing to give additional flexibility to banks when a small number of accounts do not meet the ''chiefly compensated'' condition more frequently than once in a five-year period. Under this proposal, a bank can continue to be exempt even though the lesser of 500 accounts or 1 percent of the total number of its qualifying fiduciary activity accounts continued not to meet the ''chiefly compensated'' condition, provided the bank has documented the reason that each such account continued not to meet the condition and linked that reason to the bank's exercise of fiduciary responsibility.[129]

Commenters are invited to discuss the utility of the proposed safe harbors and whether they would provide banks with sufficient legal certainty. We also request comment on whether the general limit on using the exemption once every five years for a particular account together with the additional flexibility for a few accounts that exceeded the ''chiefly compensated'' condition more than once in a five-year period would provide banks with sufficient flexibility while remaining consistent with the statutory purpose. We also solicit comment on the additional safe harbor for a small number of accounts that fail the ''chiefly compensated'' test more than once in a five-year period and on whether the lesser of 500 or one percent of the total number of a bank's qualifying accounts is the appropriate threshold. Banks likely to need additional flexibility are invited to include a discussion of their planned compliance systems.

### h. Other Provisions

#### i. ''Chiefly Compensated'' and Related Definitions

In addition to expanding the exemptions to facilitate banks' compliance and eliminate unnecessary burdens, we are proposing several technical changes to the definitions and proposing to expand the definition of ''relationship compensation.'' Otherwise, we are not proposing to change substantially the definition of ''chiefly compensated'' or related definitions. The technical changes to these rules are intended to simplify and clarify the definitions. Moreover, we believe the proposed exemptions discussed above should address many of the practical problems commenters noted in discussing these definitions.[130]

The expansion of the definition of ''relationship compensation'' that we are proposing would add types of assets that could qualify for assets under management fees paid directly by the customer, beneficiary, or account. This amended definition would include, for example, separately charged assets under management fees for managing real property, and would affect the ratio in the line-of-business exemption in proposed Exchange Act Rule 721 discussed above.[131] While the original definition of ''relationship compensation'' required the bank to be engaged in securities management activities for these fees to be included in the definition, we propose this change to address banks' accounting and systems concerns that it would be difficult to treat assets under management fees differently for managing different types of assets.

One commenter urged the Commission to amend the definition of ''flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers;'' in current Exchange Act Rule 3b–17(b) to allow banks to include the cost of shared resources as opposed to the ''exclusively dedicated'' standard in the Interim Rules.[132] In response, we propose to amend the definition to

[129] See proposed Exchange Act Rule 722(c)(4). For example, during a particular year, an accountholder may have unexpectedly inherited a large number of shares of stock that a trust instrument required to be deposited into an account for which the bank was acting in a trust or fiduciary capacity. This proposed threshold is intended to provide banks that are working in good faith to comply with the provisions of the proposed exemption with an additional safety valve.

[130] For example, we address commenters' concerns about defining Rule 12b-1 fees as ''sales compensation'' by proposing amendments to simplify the exemption in Exchange Act Rule 3a4–2 to allow banks to compare ''sales compensation'' to ''relationship compensation'' derived from its trust and qualifying fiduciary activity accounts on a line-of-business basis and proposing a separate exemption in proposed Exchange Act Rule 770. We also note that an investment company may restructure its fee arrangement to pay shareholder servicing fees that are not being paid for sales or distribution outside of a Rule 12b–1 plan. This type of fee arrangement is unrelated compensation under the Interim Rules rather than ''sales compensation.'' We also propose to replace the term ''trust or fiduciary account'' with the term ''an account for which the bank acts in a trustee or fiduciary capacity.'' Because this language more closely matches the statutory language in the trust and fiduciary activities exception, it should reduce confusion.

We also note that the definition of ''sales compensation'' includes revenue sharing payments. As we discussed in proposing targeted disclosure requirements for broker-dealers selling mutual funds, revenue sharing arrangements not only pose potential conflicts of interest for the recipient, but also may have the indirect effect of reducing investors' returns by increasing the distribution-related costs incurred by funds. *See* Exchange Act Release No. 49148 (Jan. 29, 2004), 69 FR 6437 (Feb. 10, 2004). Revenue sharing arrangements may give broker-dealers heightened incentives to market the shares of particular mutual funds, or particular classes of fund shares. These incentives may be reflected in the use of ''preferred lists'' that explicitly favor the distribution of certain funds, or they may be reflected in other ways, including incentives or instructions to employees of a bank or broker-dealer. The magnitude of revenue sharing payments—estimated in 2001 at $2 billion annually—suggests that those arrangements influence the mutual fund choices presented to investors. *See* ''How high can costs go?,'' *Institutional Investor,* May 2001 at 56.

[131] Banks determining compliance on an account-by-account basis would not need to consider accounts that did not contain securities, such as an account that only contained real estate, since broker-dealer registration is not necessary for these accounts.

[132] *See* ABA/ABASA letters.

include the direct marginal cost of any resources of the bank that are used for transaction execution, comparison, or settlement for trust and fiduciary activity accounts if the bank makes a precise and verifiable allocation of these resources according to their use. We believe this proposed change is consistent with the statutory requirement of cost recovery. We also propose to amend the definition to clarify that the account, rather than the bank, pays the fee. We request comment on the proposed amendments to the definition of ''flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers;'' in proposed Exchange Act Rule 724(b).

We request comment on these proposed amendments to the definitions. Commenters are invited to discuss whether the ''sales compensation'' definition should include additional sales-related arrangements that may create conflicts of interest, such as sales or distribution-related payments to affiliates or employees of banks. We also invite banks to provide us with any specific information on their compensation arrangements that might help us to further simplify the ''chiefly compensated'' calculation while implementing the statutory provisions.

ii. Formulas to Allocate Sales Compensation to Individual Accounts

A. 12b–1 Fees

Rule 12b–1 under the Investment Company Act permits investment companies to use their assets to finance sales-related expenses.[133] Unlike fees for assets under management by the bank, which do not differ depending on the investment that the bank selects, Rule 12b–1 fees paid to banks and other distributors often vary from investment company to investment company. Rule 12b–1 fees create incentives to distribute particular investment company securities and create conflicts between the bank and investors. Such conflicts of interest drive much of broker-dealer regulation. Accordingly, Rule 12b–1 fees are included in the ''sales compensation'' definition.[134]

Commenters pointed out that because Rule 12b–1 fees are paid based on the amount of assets in an omnibus account, it would be difficult to allocate such fees on an account-by-account basis.[135] We therefore propose to add a formula to the definition of ''sales compensation'' in proposed Exchange Act Rule 724 to allow banks to estimate the amount an individual account pays annually in Rule 12b–1 fees that are paid on an entity basis. The proposed formula would allow a bank to calculate the Rule 12b–1 fees for each account using one of two methods. First, a bank could calculate the 12b–1 fees based on the number of each class of an investment company's shares held in each account on the last business day of the preceding year, multiplied by the net asset value per share on that day and by the annual Rule 12b–1 fee rate applicable to that class of securities. Alternatively, a bank could use another allocation method if it fairly and consistently measures the amount of ''sales compensation'' attributable to each account during the preceding year.[136]

We request comment on whether the proposed formula would facilitate banks' allocation of the 12b–1 fees to individual accounts. We also invite commenters to discuss any alternative allocation methods they believe would more accurately measure the amount of ''sales compensation'' attributable to each account. In addition, commenters are invited to suggest other allocation methods that they believe would be simpler, while providing a reasonably accurate allocation of these fees to individual accounts. Commenters should explain how the results from any alternative method would compare to the results from the proposed allocation method.

*B. Other Fees*

We also propose to amend the definition of ''sales compensation'' in proposed Exchange Act Rule 724(i)(4) and (6) to allow a bank to estimate the amount that it receives annually that is attributable to an individual account, but that is not paid directly from the account. This formula would allow a bank to calculate these fees for each account by using one of two methods. First, a bank could divide the number of shares of each class of each type of investment company held in each account on the last business day of the preceding year by the total number of the same type of investment company shares that the bank held in a trustee or fiduciary capacity on the same day, and multiply the resulting number by the total dollar amount of these fees the bank received in connection with that class during the preceding year. Second, a bank could use its own method of allocation if it fairly and consistently measures the amount of ''sales compensation'' attributable to each account during the preceding year. [137]

We request comment on the proposed formula. Commenters are invited to discuss whether it will facilitate banks' allocation of these fees to individual accounts. We also invite comment on whether there would be a simpler method that would provide a reasonably accurate allocation of these fees to individual accounts. We also invite comment on how to address the problem of the sale of shares at the end of the year. For example, an account that held a substantial proportion of a bank's total holdings in a given fund for most of a year, but whose shares were sold just before year-end, may be allocated none of the bank's fees earned from that fund. At the same time, an account with relatively small holdings in the same fund that did not sell at the end of the year might be allocated a disproportionately large amount of the bank's fees earned from that fund. In addition, we invite comment on whether this formula should be revised to make it more consistent with other proposals on which the Commission is currently seeking comment regarding revenue sharing payments that occur at the fund complex level, as opposed to the fund level.[138] Commenters are specifically requested to consider whether the formula should compare the value of the account with the value of all assets held by the bank in a fund complex if revenue sharing is paid on a fund complex basis.

iii. Indenture Trustee Exemption

Exchange Act Rule 3a4–3 currently provides a limited exemption from broker registration for a bank that serves

[133] *See* Investment Company Act Release No. 11414, 45 FR 73898 (Nov. 7, 1980).

[134] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27775.

[135] *See* NYCH letter and PNC Bank letter. We note, however, that in connection with E*Trade's Rule 12b–1 fee rebate program, E*Trade explains its fifty percent rebate formula as follows: ''For example, if the average daily value of your eligible mutual fund holdings for the year is $200,000 and we receive 12b–1 fees at the annual rate of 0.25% (25 basis points) from the funds you selected, you would receive an annual rebate of $250 (0.0025 x $200,000÷2).'' *See* (*https://us.etrade.com/e/t/home?SC=LBH4249*).

[136] We chose the year-end formula to allow banks performing the ''chiefly compensated'' calculation on an account-by-account basis to make a reasonable estimate, consistent with the chiefly timeframe, of the amount of 12b–1 fees paid by an account during the preceding year. The proposed formula also is intended to provide banks with the additional flexibility to measure the changing value of an account during the year to determine the amount of 12b–1 fees paid by that account, provided that the bank uses the same fair method for each account.

[137] *See id.* for a discussion of the reasons why we are proposing this formula.

[138] *See infra* note 405.

as an indenture trustee in a no-load money market fund, provided that it meets certain conditions. Comments we received on this rule criticized its utility in part based on the definition of ''indenture trustee,'' which is currently codified in Exchange Act Rule 3b–17.[139] For example, two commenters recommended that we expand the ''indenture trustee'' definition to include trustees appointed pursuant to pooling and servicing agreements, trust agreements, bond resolutions, and mortgages, given that, according to these commenters, documents appointing trustees generally are not limited to indentures.[140]

In lieu of modifying the ''indenture trustee'' definition (which we are proposing to move to Exchange Act Rule 724), as discussed previously, the Commission is proposing a broad general exemption (proposed Exchange Act Rule 776) that would permit banks to effect transactions for qualified investors and certain other investors in money market funds.[141] As discussed below, we propose to eliminate the definition of ''trustee capacity,'' which defined the term to include the capacity of a trust indenture trustee. As a result, banks acting in an indenture trustee capacity would not need to look to the definition of ''indenture trustee'' to determine whether they qualify for the trust and fiduciary activities exception.

We propose to move the definition of ''indenture trustee'' to proposed Exchange Act Rule 724(c), where the term would be defined for purposes of the exemption in proposed Exchange Act Rule 723, which would provide an exemption from the ''chiefly compensated'' calculation for banks to effect transactions as an indenture trustee in no-load money market funds. While the exemption would still be available on the same terms as before, we believe that banks acting as indenture trustees may opt for the exemption in proposed Exchange Act Rule 776.

We request comment on proposed Exchange Act Rule 723. Commenters are specifically invited to discuss whether the exemption would be necessary if we adopt proposed Exchange Act Rule 776.

2. Definition of ''Trustee Capacity'' and Indenture Trustees

We received numerous comments on the definition of ''trustee capacity,'' which was included in the Interim Rules to clarify that for purposes of the trust and fiduciary activities exception, the term includes indenture trustees and trustees for tax-deferred account described in sections 401(a), 408, and 408A under subchapter D and in section 457 under subchapter E of the Internal Revenue Code of 1986 (26 U.S.C. 1, *et seq.*) [142] Some commenters supported the definition's provision of legal certainty for indenture trustees and trustees for certain tax-deferred accounts.[143] However, some commenters urged the Commission to expand the definition to cover banks acting as custodial trustees for Individual Retirement Accounts (''IRAs'').[144] Commenters also indicated that the definition should cover both indenture trustees operating under appointive documents other than indentures, and indenture trustees serving on issues or transactions outside those delineated in the Interim Rules.[145] Some commenters urged the Commission to withdraw the definition of ''trustee capacity'' and instead interpret the trust and fiduciary activities exception to cover all types of ''trustees.'' [146] Several commenters indicated that defining ''trustee capacity'' as including an indenture trustee or a trustee for certain tax-deferred accounts may create ambiguity by suggesting that other ''trustees'' may not be able to rely on the trust and fiduciary activities exception.[147] One commenter took issue with the analysis of trustee relationships because, in the commenter's view, it focused on whether a bank exercises investment discretion.[148] This commenter asserted that there are numerous trustee relationships in which a bank may not exercise investment discretion, but would still be subject to fiduciary duties, such as personal trusts, charitable foundation trusts, insurance trusts, rabbi trusts, secular trusts, conservatorships and guardianships.[149] Two commenters stated that the governing trust instrument under state and federal fiduciary law, and not the Commission, should determine the nature of a trust or fiduciary relationship.[150] One commenter maintained that it is unclear how banks could ''push out'' trust accounts to broker-dealers.[151]

After considering these comments, we propose to withdraw the definition of ''trustee capacity'' and not specifically identify the types of trustee capacities in which banks may act in reliance on the trust and fiduciary activities exception. This should simplify compliance and allow banks that effect transactions in a trustee capacity to continue doing so even if they do not assume significant fiduciary responsibilities as trustee. As discussed in more detail below, however, we do not propose to broaden the meaning of the term ''trustee capacity'' to include banks acting in non-trustee capacities, such as IRA bank custodians, for purposes of Exchange Act Section 3(a)(4)(B)(ii).[152] We request comment on our proposal to eliminate the definition of ''trustee capacity'' and not specifically identify trustee capacities that would provide a basis for relying on the trust and fiduciary activities exception. We also request comment on whether additional clarification regarding the meaning of ''trustee capacity'' would be helpful.

3. Interpretations of ''Fiduciary Capacity'' and ''Similar Capacity''

The definition of ''fiduciary capacity'' in Exchange Act Section 3(a)(4)(D) provides that a bank may qualify for the trust and fiduciary activities exception if it acts in certain specified fiduciary capacities or ''in any other similar capacity.'' In adopting the Interim Rules, the Commission identified several capacities from state uniform acts and codes that were not expressly listed in the statutory definition of

[139] 17 CFR 240.3b–17(c). Current Exchange Act Rule 3a4–3 permits banks to effect transactions as indenture trustees in no-load money market funds without meeting the ''chiefly compensated'' condition in the trust and fiduciary activities exception.

[140] *See* ABA/ABASA letters and Bank One letter.

[141] *See* Section III.F.1 *supra* for discussion of proposed Exchange Act Rule 776, under which banks not acting in an indenture trustee capacity could effect transactions for customers who are ''qualified investors'' and customers for whom they act in a trustee or fiduciary capacity or in certain escrow capacities in money market funds, including those that charge a ''load.''

[142] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR 27767–69. *See, e.g.,* ABA/ABASA letters; Bank One letter; Banking Agencies letter; BONY letter; Bar of NY letter; Fleet letter; KeyBank letter; Mellon letter; NASAA letter; NYCH letter; PNC letter; Regions letter; letter dated August 31, 2001 from Andrew Cecere, Vice Chairman, Private Client and Trust Services, U.S. Bancorp (''U.S. Bancorp letter''); Wells Fargo letter; and Zions Bancorporation letters.

[143] *See, e.g.,* ABA/ABASA letters and Federated letters.

[144] *See* ABA/ABASA letters; Federated letters; and Wells Fargo letter.

[145] *See* ABA/ABASA letters.

[146] *See, e.g.,* Banking Agencies letter; BONY letter; Federated letters; PNC letter; Roundtable letter; and Wells Fargo letter.

[147] *See, e.g.,* Banking Agencies letter; BONY letter; Federated letters; Frost letter; Harris Trust letter; NYCH letter; PNC letter; Roundtable letter; UMB Bank letter; and Wells Fargo letter.

[148] *See* Roundtable letter.

[149] *Id.*

[150] *See* ICBA letter and National City letter.

[151] *See* NYCH letter.

[152] As discussed above and below, however, we propose other exemptions that may address some of the business needs of banks that are not trustees but act in capacities that commenters suggest should be recognized as such—*e.g.,* IRA custodians, escrow agents, and paying agents.

''fiduciary capacity.'' [153] The Commission also noted that in some cases, state authorities used different nomenclature to refer to the same fiduciary capacity.[154] The Commission did not expand the term ''similar capacity'' to include agency activities that are not subject to the standards applicable under trust and fiduciary law to banks acting as fiduciaries.

Some commenters indicated that, because the definition of ''fiduciary capacity'' in Exchange Act Section 3(a)(4)(D) [155] is similar to the definition of the same term in regulations issued by the OCC,[156] the Commission should interpret the term to include the same range of activities.[157] Some commenters suggested, for example, that the Commission should treat banks that act as IRA custodians as if they were IRA trustees for purposes of the trust and fiduciary activities exception.[158] Other commenters urged us to define a bank that performs escrow services to be acting in a similar capacity to an indenture trustee.[159] Similarly, commenters have suggested that the Commission consider various other capacities as ''similar'' to the fiduciary capacities listed in the statute. Examples of such other capacities include escrow agent, commercial paper listing and paying agent, debt securities paying agent, collateral agent, custodian for mortgage loan files, and titleholder or qualified intermediary in like-kind exchange transactions. As discussed above in connection with indenture trustees, some of these capacities would be within the scope of proposed Exchange Act Rule 776.

We do not propose to identify additional capacities as similar to those specified in the statute because such capacities, for example the capacity of IRA custodian, do not involve fiduciary duties similar to those exercised by banks acting in true fiduciary capacities; nor are they trustees, which are separately identified in the statute as well as included within the definition of fiduciary.[160] In addition, the Commission understands from discussions with bank representatives that many of the capacities some commenters suggest should be considered as ''similar to fiduciary capacities'' typically do not involve investing in securities, but rather involve financial record keeping. While we recognize that some state laws may use nomenclature different from that used in the Exchange Act to refer to certain fiduciary capacities,[161] we do not consider additional capacities that are merely the functional or economic equivalent of capacities listed in Exchange Act Section 3(a)(4)(D) [162] to be ''similar'' capacities for purposes of the definition of ''fiduciary capacity.'' These capacities do not necessarily involve fiduciary obligations or carry the same legal obligations as those assumed by the types of fiduciaries identified in the statute. Banks acting in some of these types of agency capacities, however, would be able to rely on the general exemption contained in proposed Exchange Act Rule 776.[163]

In contrast to a bank's ability under banking law to engage in a wide variety of activities not implicating the broker-dealer registration requirements, a bank cannot rely on the trust and fiduciary activities exception to avoid being considered a broker merely because it is performing any function under state law that is permitted for a competitor of that national bank. A term does not necessarily have the same meaning under different statutes enacted for different purposes.[164] Moreover, the purpose of the functional regulation approach taken in the GLBA's bank exceptions from ''broker'' and ''dealer'' was to ensure that broker-dealer functions outside the scope of certain narrow bank activities specifically identified in the statute will be performed by registered broker-dealers.

We request comment on this approach. We specifically invite comment on any capacities similar to the fiduciary capacities listed in the statute in which banks assume fiduciary obligations equivalent to those assumed by banks acting in the listed capacities.

4. Comments on Definition of ''Investment Adviser if the Bank Receives a Fee for its Investment Advice'' and Proposed Amendments

Exchange Act Section 3(a)(4)(D) defines the term ''fiduciary capacity'' to include acting as an ''investment adviser if the bank receives a fee for its investment advice.'' [165] The Interim Rules defined ''investment adviser if the bank receives a fee for its investment advice'' to mean that a bank investment adviser provides, in return for a fee, continuous and regular investment advice to a customer's account that is based upon the individual needs of the customer, and that under state law, federal law, contract, or customer agreement, the bank owes the customer a duty of loyalty, including an affirmative duty to make full and fair

[153] For example, the Uniform Probate Code uses the term ''Personal Representative'' and similar successor titles in place of executor or administrator as the representative of a decedent. Similarly, under the Uniform Custodial Trust Act, the terms that are used for fiduciaries who act for persons who have become incapacitated include ''conservator'' and ''custodial trustee.''

[154] For example, Exchange Act Section 3(a)(4)(D)(i) refers only to the capacity of a ''custodian under a uniform gift to minor act,'' while the Uniform Transfers to Minors Act uses both the terms ''conservator'' and ''custodian'' for fiduciaries that act for minors.

[155] 15 U.S.C. 78c(a)(4)(D).

[156] *See* 12 CFR 92(e). Notably, the range of permitted banks activities under the OCC's regulations is significantly broader than activities in which banks could engage in reliance on the trust and fiduciary activities exception under our definition. In particular, the OCC's regulations provide that a national bank may act in any fiduciary capacity in which national banks' competitors may act under the law of the state where the national bank is located. *See* 66 FR 34792 (July 2, 2001). In addition to the enumerated fiduciary capacities, OCC staff has identified escrow agent and personal investment management (other than in the capacity of an investment adviser for a fee) as functions they believe should be added to those a bank may perform in reliance on the exception.

[157] *See, e.g.,* July 17, 2001 ABA/ABASA letter; Banking Agencies letter; PNC letter; and NYCH letter. Commenters suggested adding to the list of permissible fiduciary capacities certain non-fiduciary capacities such as escrow agent, commercial paper issuer, distribution agent, collateral agent, exchange accommodation, titleholder, and qualified intermediary. To the extent that any of these capacities do not involve effecting transactions in securities, a bank would not need to rely on any exception or exemption to engage in that activity.

[158] *See* ABA/ABASA letters; Federated letter; and Wells Fargo letter.

[159] *See, e.g.,* ABA/ABASA letters; Compass letter; and Federated letters.

[160] For example, we would not consider a bank, if effecting transactions in securities as an IRA custodian which may act in a capacity that is the functional equivalent of a directed trustee, to be acting in a capacity that is similar to one of the capacities listed in Exchange Act Section 3(a)(4)(D). In guidance to trust examiners, the OCC states, ''Agency service arrangements that do not involve the exercise of discretion or other similar responsibilities, such as escrow, safekeeping and custody, may be performed by a bank under the incidental powers of banking, without having trust powers.'' OCC, *Handbook for Trust Examiners* at 9.2600.

[161] *See* discussion of ''other similar capacity'' in Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27772.

[162] 15 U.S.C. 78c(a)(4)(D).

[163] *See* Section III.F.1 *supra.*

[164] Just as the meaning of the term ''security'' under the securities law does not determine the term's meaning under the Glass-Steagall Act, the meaning of the terms ''fiduciary capacity'' and ''similar capacity'' under Exchange Act Section 3(a)(4)(D) is not determined by meanings these terms may have been given by the OCC's regulations and interpretations for purposes of the federal banking laws. *See Investment Co. Institute* v. *Conover,* 790 F. 2d 925, 933 n.7 (D.C. Cir. 1986) (citing *Securities Industry Ass'n* v. *Board of Governors of Fed. Reserve Sys.,* 468 U.S. 137, 175, 104 S. Ct. 2979, 2999–3000, 82 L. Ed. 2d 107 (1984) (O'Connor, J., dissenting) as support for the proposition that the definition of the term ''security'' under the securities laws should be different than the definition under the Glass-Steagall Act because ''the purposes of the banking and securities laws are quite different'') *cert. denied, Investment Co. Inst.* v. *Clarke,* 479 U.S. 939, 107 S. Ct. 421, 93 L. Ed. 2d 372 (1986).

[165] *See* 15 U.S.C. 78c(a)(4)(D).

disclosure to the customer of all material facts relating to conflicts of interest.[166]

We received multiple comments on the definition of ''investment adviser if the bank receives a fee for its investment advice.'' [167] One commenter stated that this definition is appropriate because it is consistent with current law regarding investment advisers.[168] Another stated that the ''continuous and regular'' requirement is consistent with its understanding of how such activities are performed by bank trust departments.[169] This commenter suggested that the Commission provide banks with a safe harbor if they review customers' accounts at least annually.[170] In addition, this commenter also urged the Commission to take the position that periodic rebalancing of asset allocation models by banks would be viewed as providing ''continuous and regular'' investment advice.[171]

In contrast, several commenters viewed the definition as contrary to their understanding of the statute, inconsistent with their interpretation of congressional intent, or too restrictive.[172] One commenter stated that some customers may only want or need a one-time portfolio review.[173] Another commenter indicated that a ''continuous and regular'' requirement could create undesirable pressure on banks to recommend inappropriately frequent transactions in a customer's investment account.[174] One commenter expressed the view that banks should be able to provide advice that is based principally on market events.[175]

Three commenters urged the Commission to eliminate the condition that a bank must have a duty of loyalty to its customer.[176] The Banking Agencies expressed a similar opinion.[177] In their view, a duty of loyalty may arise as a consequence of a bank or other person acting as an investment adviser, but is not a precondition to acting as an investment adviser.[178] While the Banking Agencies agreed that banks providing investment advice for a fee have fiduciary obligations to their customers, including the duty to disclose potential conflicts of interests, they asserted that the bank regulation and examination process provides the most appropriate method for ensuring banks' compliance with these important duties.[179] Another commenter stated that a duty of loyalty is not determinative of whether an entity or an individual is functioning as an investment adviser.[180] This commenter indicated that the duty of loyalty is derived from bank regulation, ERISA, federal tax law, state statutes, common law, and case law.[181] Other commenters remarked that there is no need to place another duty of loyalty on banks under the federal securities laws.[182] Another commenter stated that because disclosure of material facts relating to fiduciary conflicts of interest is an area that has historically been regulated by state fiduciary laws, it would not be appropriate for the Commission to scrutinize the fiduciary disclosure obligations of banks.[183]

While it appears that most banks conduct continuous and regular reviews of the accounts of customers to whom they provide investment advice for a fee, we understand that they may not necessarily communicate with each customer on a continuous and regular basis. Accordingly, we propose to revise the definition of ''acting as an investment adviser if the bank receives a fee for the investment advice'' to eliminate the implication that a bank must communicate continuously and regularly with customers.[184] The revised definition would omit the phrase ''continuous and regular.'' Instead, the amended definition would provide that to rely on the exception a bank must have an ongoing responsibility to review, select, or recommend specific securities for its customers.[185]

The proposed amendment recognizes that a bank's advice must relate to specific securities or other investments the customer may purchase or sell, and is intended to ensure that the securities transactions the bank effects in an investment advisory capacity are effected subject to the bank's fiduciary obligations that attach when it is acting as an investment adviser for a fee.[186] Under the amended definition, a bank would be able to rely on the trust and fiduciary activities exception to continue to effect transactions for advisory customers such as mutual fund wrap account customers, provided the investment advice the bank provides to its wrap account customers includes the review, selection or recommendation of specific securities, and the transactions result from customers acting on the bank's advice. A bank providing only general asset allocation advice not relating to specific securities, however, could not rely on the exception to effect transactions resulting from that advice.

The amended definition would also retain the concept that a bank acting as an investment adviser for a fee has a duty of loyalty to the customer and must make full and fair disclosure of all conflicts. This duty, in part, differentiates a bank acting as an investment adviser from one acting as a broker.[187] As we recently explained, an

[166] *See* current Exchange Act Rule 3b–17(d).

[167] *See, e.g.,* ABA/ABASA letters; Banking Agencies letter; Frost letter; Harris Trust letter; NASAA letter; Regions letter; Roundtable letter; TIAA–CREF letter; UMB Bank letter; and Wilmer, Cutler letter.

[168] *See* NASAA letter.

[169] *See* Federated letters.

[170] *Id.*

[171] *Id.*

[172] *See* ABA/ABASA letters; ABA Banking Law Committee letter; ACB letter; Banking Agencies letter; Bank One letter; BSA letter; Fleet letter; Frost National letter; Harris Trust letter; ICBA letter; IIB letter; KeyBank letter; Mellon letter; NationalCity letter; NYCH letter; Regions letter; Roundtable letter; TIAA–CREF letter; UMB Bank letter; Wells Fargo letter; and Wilmer, Cutler letter.

[173] *See* ICBA letter.

[174] *See* Federated letters. We note, however, that the Interim Rules do not require banks relying on this exception to provide continuous and regular advice to trade.

[175] *See* Wilmer, Cutler letter.

[176] *See* ACB letter and Regions letter.

[177] *See* Banking Agencies letter.

[178] *Id.*

[179] *Id.*

[180] *See* ABA/ABASA letters.

[181] *Id.* National banks, however, are not subject to uniform disclosure obligations with respect to their material conflicts. The source of fiduciary law governing national banks' fiduciary relationships may include federal law, state laws, the terms of the instrument governing a fiduciary relationship, and any court order pertaining to the relationship. *See* OCC, Fiduciary Activities of National Banks, 61 FR 68543, 68544 (Dec. 30, 1996).

[182] *See* ABA/ABASA letters; ABA Banking Law Committee letter; and NYCH letter.

[183] *See* TIAA–CREF letter.

[184] *See* proposed Exchange Act Rule 724(d).

[185] This interpretation is consistent with the view expressed by staff of the Banking Agencies, who indicated that a bank may not fairly be considered to be acting as an ''investment adviser if the bank receives a fee for its investment advice'' unless the bank provides investment advice based on the particular needs of a customer and the bank's advice or recommendations to the customer concern the purchase or sale of specific securities. *See* appendix to the Banking Agencies letter at 14 (citing 12 CFR 9.101(a), and 12 CFR 9.101(b)(2)(i) (''[a] bank does not provide 'investment advice' merely by providing market information to customers in general.'')). Similarly, instructions to the Commission's Form ADV Uniform Application for Investment Adviser Registration explain that an investment adviser without discretionary authority over an account provides continuous and regular supervisory or management services with respect to the account if the adviser has ''ongoing responsibility to select or make recommendations, based upon the needs of the client, as to *specific* securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, [the adviser is] responsible for arranging or effecting the purchase or sale.'' *See* Form ADV: Instructions for Part 1A, at 4 (available at *http://www.sec.gov/about/forms/formadv.pdf*) (emphasis added).

[186] *See* proposed Exchange Act Rule 724(d). This proposal is consistent with the definition in the Interim Rules. *See* Exchange Act Rule 3b–17(d).

[187] As explained by the Supreme Court in 1963 in *SEC* v. *Capital Gains Research Bureau, Inc.,*

Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction.

investment adviser must act for the benefit of its clients and not use its clients' assets for its own benefit.[188] This duty of loyalty is implicit in the role of an investment adviser.[189]

We propose to clarify that the trust and fiduciary activities exception is available to a bank providing investment advice for a fee only if the bank does so in a fiduciary capacity in which the bank owes its advisory customer a duty of loyalty. In other words, a bank may only rely on the exception if it takes on fiduciary obligations, including obligations to disclose conflicts of interest and other material facts. This duty of loyalty requirement is inherent in the fiduciary obligations of a bank that is in a position to rely on the exception based on the bank's acting in an investment advisory capacity—which include a duty of loyalty to the customer for whom the bank is effecting securities transactions under the exception. Because this duty is implicit in the role of an investment adviser, the amended definition would not specify any particular source of such a duty, such as contract or state law.[190]

We request comment on the proposed amendments to the definition of ''investment adviser if the bank receives a fee for its investment advice.'' We are particularly interested in receiving information about activities commenters believe the proposed definition would, but, in the commenter's view, should not, preclude. We also would appreciate descriptions of any fiduciary obligations that banks acting in such capacities owe their customers.

5. Comments on ''Other Department That Is Regularly Examined by Bank Examiners for Compliance With Fiduciary Principles and Standards''

Exchange Act Section 3(a)(4)(B)(ii) requires a bank to effect transactions in a trustee or fiduciary capacity in a trust department or other department that is ''regularly examined by bank examiners for compliance with fiduciary principles and standards.'' In adopting the Interim Rules, we explained that this statutory requirement means that ''all aspects'' of effecting securities transactions in compliance with the trust and fiduciary activities exception must be conducted in the part of a bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards.[191] Moreover, at that time we clarified that effecting transactions in securities includes more than just executing trades or forwarding securities orders to a broker-dealer for execution.[192]

Some commenters expressed the view that requiring ''all aspects'' of securities transactions conducted by a bank for its trust and fiduciary customers to be conducted in a part of the bank regularly examined by bank examiners for compliance with fiduciary principles and standards is overly broad and could unduly restrict new business and cross-selling efforts.[193] Other commenters noted that banks conducting fiduciary activities often delegate securities processing and settlement activities for cost or operational efficiencies to either a separate department, an affiliate or a third-party service provider, and that those entities may not be regularly examined for compliance with fiduciary principles and standards.[194] Some banks and bank trade groups also explained that banks may use the trading desk of a registered investment adviser to process trades in fiduciary activity accounts, or bank fiduciaries may find it more economical to outsource certain trust back office functions.[195] One commenter maintained that the examination requirement set forth in the Interim Rules would require banks to set up parallel back offices and other facilities solely for the purpose of relying on the trust and fiduciary activities exception and asked the Commission to clarify that this requirement would only apply to the part of the bank managing fiduciary activity accounts.[196] Another commenter stated that because certain activities are not typically examined for compliance with fiduciary standards and principles, the Interim Rules' interpretation would constrain a bank's normal business operations.[197] One commenter noted that small banks often conduct trust activities outside of their trust departments and urged us to clarify that it is the activity that qualifies for the exception, and not where the activity is conducted.[198]

In light of these comments, we propose to recast the examination requirement to more closely correlate with how bank trust and fiduciary activities are currently examined. We propose to interpret this requirement to mean that ''all aspects'' of effecting securities transactions in compliance with the trust and fiduciary activities exception must be regularly examined by bank examiners for compliance with fiduciary principles and standards. In other words, we would view this requirement to mean that the activities, rather than the department in which they are conducted, would need to be regularly examined. For example, a bank could meet the terms of the exception if bank examiners regularly examined a trading desk located outside of the trust department for compliance with fiduciary principles and standards in executing the trades for the bank's trust and fiduciary customers. Similarly, advertising for the trust department activities could be examined without

Courts have imposed on a fiduciary an affirmative duty of ''utmost good faith, and full and fair disclosure of all material facts,'' as well as an affirmative obligation ''to employ reasonable care to avoid misleading'' his clients.

*SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 194 (1963) (footnotes omitted) (citing Prosser, *Law of Torts* (1955), 534–535; Keeton, *Fraud—Concealment and Non-Disclosure,* 15 Texas L. Rev. 1 (1936); 1 Harper and James, *The Law of Torts* 541 (1956)). In contrast, although a broker may have disclosure obligations with respect to matters entrusted to it by a client with whom it has a relationship of trust and confidence, absent such a relationship ''there 'is no general fiduciary duty inherent in an ordinary broker/customer relationship.' '' *See United States* v. *Szur,* 289 F.3d 200 (2d Cir. 2002) (quoting *Independent Order of Foresters* v. *Donaldson, Lufkin & Jenrette, Inc.,* 157 F.3d 933, 940 (2d Cir. 1998)).

[188] *See In re Alliance Capital Management, L.P.,* Investment Advisers Act Release No. 2205, Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 and Sections 9(b) and 9(f) of the Investment Company Act, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (Dec. 18, 2003), available at *http://www.sec.gov/litigation/admin/ia-2205.htm* (adviser's activities permitting inappropriate market timing were found to have constituted breaches of the investment adviser's fiduciary duty).

[189] *See* Investment Advisers Act Release No. 2209, Investment Company Act Release No. 26337, *Investment Adviser Codes of Ethics* (Jan. 20, 2004), 69 FR 4039, 4040 (Jan. 27, 2004) (proposing new rule and related rule amendments under the Investment Advisers Act of 1940 (''Investment Advisers Act'') that would require registered advisers to adopt codes of ethics, and citing *Capital Gains Research Bureau* at 375 U.S. 181, 181–82 for the proposition that ''[a]dvisers are fiduciaries that owe their clients a duty of undivided loyalty.'').

[190] The duty is not established by the definition, but rather an element of the relationship between an investment adviser and its fee-paying client that must exist if the bank is to satisfy the definition of ''fiduciary capacity'' on that basis—that is, it is acting as an investment adviser for a fee.

Of course, a fiduciary has a duty to disclose fully all material conflicts of interest. For guidance on the fiduciary disclosure obligations that characterize the status of a bank acting as an investment adviser for a fee, a bank seeking to rely on the exception may look to the disclosure obligations applicable to an investment adviser under the Investment Advisers Act. *See* 15 U.S.C. 80b *et seq. See also* Rule 204–3 under the Investment Advisers Act and Form ADV, Part II.

[191] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27772.

[192] *Id.* at 27772–73.

[193] *See, e.g.,* UMB Bank letter.

[194] *See, e.g.,* Bank Agencies letter; letter dated July 17, 2001, from Maureen W. Sullivan, Associate General Counsel, Manufacturers and Traders Trust Company (''M&T letter''); IIB letter; Bankers Trust (Iowa) letter; and Harris Bank letter.

[195] *See, e.g.,* ABA/ABASA letters; KeyBank letter; and M&T letter.

[196] *See* NYCH letter.

[197] *See* Harris Bank letter.

[198] *See* ICBA letter.

reviewing the other advertising of the bank. As noted in the Interim Rules, we rely primarily on the Banking Agencies to ensure that banks meet the examination requirements of this condition.[199]

This interpretation does not extend to bank affiliates and third-party service providers that carry out brokerage activities. Bank affiliates and third-party service providers cannot rely on any bank exception from registration, unless these affiliates and third-party service providers are themselves banks.[200] This means that if some aspect of a securities transaction occurs outside of a bank, unless the securities-related activity in question is located within a registered broker-dealer,[201] the bank would be unable to rely upon the trust and fiduciary activities exception for that transaction. Moreover, an affiliate participating in key points of securities transactions would be required to register as a broker-dealer, absent an exemption or no-action relief.

We note that the Banking Agencies distinguish between core and ancillary bank fiduciary activities.[202] The Banking Agencies' analysis and our analysis serve two different purposes.[203] A bank intending to qualify for the exception would need to rely on its banking regulator to ensure that all of its activities that constitute effecting securities transactions are regularly examined for compliance with fiduciary principles and standards.

The proposed amendments should give banks increased flexibility in satisfying this statutory requirement, while ensuring that investors receive all of the protections contemplated by this exception to the definition of broker. We also expect it to accommodate the needs of the Banking Agencies in fulfilling their supervisory functions by permitting them to target their examination resources more precisely. We solicit comment on the proposed amendments to this interpretation of the ''other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards'' requirement of trust and fiduciary activities exception. Do commenters believe that this proposed approach would make it easier for banks to comply with this statutory requirement?

### *C. Sweep Accounts Exception*

In general, any person that induces transactions in securities for the account of others by selling securities products or services together with other, non-securities products or services sold by that person would be a broker required to register with the Commission.[204] The sweep accounts exception set out in Exchange Act Section 3(a)(4)(B)(v), however, permits a bank to participate in mixed product arrangements in which the bank offers a mutual fund ''sweep'' service linked to deposit accounts under certain conditions. Specifically, this section excepts a bank from the definition of ''broker'' to the extent it ''effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund.'' [205]

To provide guidance to banks seeking to rely on the sweep accounts exception, the Interim Rules defined the terms ''money market fund'' and ''no-load.'' We propose to retain the definition of ''no-load'' substantially as in the Interim Rules, with a minor adjustment to recognize that some investment companies offer both load and no-load shares. We are also proposing to provide a new exemption for banks effecting transactions for certain customers in money market funds, including, with certain disclosures, money market funds that would not qualify as ''no-load'' funds.[206]

#### 1. Comments on Definition of ''No-Load'' and Proposed Amendments

Exchange Act Rule 3b–17(f)[207] provides that an investment company is ''no-load'' for purposes of the sweep accounts exception if: (1) it does not have a sales load [208] or a deferred sales load; and (2) its total charges against net assets to provide for sales-related expenses and service fees (including

[199] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27772. We note the use by the federal financial institutions' regulators of the Uniform Interagency Trust Rating System in evaluating financial institutions' fiduciary activities. In 2000, there were 2,886 banks and trust companies (both insured and uninsured) that were subject to reporting requirements of the Federal Financial Institutions Examinations Council regarding their trust assets. *See http://www2.fdic.gov/structur/trust/00trustdata.asp.* Any institution that intends to rely on a bank exception from broker-dealer regulation must determine whether it falls within the definition of ''bank'' in Exchange Act Section 3(a)(6).

[200] *See also Division of Market Regulation, Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules* (Sept. 2003), which clarified the exceptions found in the GLBA and that the additional exemptions granted by the Commission apply only to bank activities. Available at *http://www.sec.gov/divisions/marketreg/bankdealerguide.htm.*

''Question #1: May a bank holding company, subsidiary of a bank, or affiliate of a bank use the bank exceptions in the Exchange Act?

Answer #1: No. The exceptions in the Exchange Act only exclude banks' securities activities from broker-dealer regulation, and then only in certain specified circumstances. Only the bank itself may claim an exception or exemption. The exceptions and exemptions are not available to a subsidiary or affiliate of a bank (unless the subsidiary or affiliate is itself a bank).'' (emphasis omitted)

[201] Certain securities related activities may occur in a registered investment adviser. Trustees routinely turn to registered investment advisers for professional asset management of a trust's portfolio. The adviser is hired as an agent, usually pursuant to a limited power of attorney, and the trustee is able to receive client disclosure and, when necessary, provide client consent.

[202] Activities that are considered to be ancillary to a bank's or savings association's business include many activities that constitute key points of a securities transaction, such as advertising, marketing, or soliciting fiduciary business. *See, e.g.,* 12 CFR 9.2(k) (OCC) (''Examples of ancillary activities include advertising, marketing, and soliciting for fiduciary business; contacting existing or potential customers, answering questions, and providing information about matters related to their accounts; acting as liaison between the trust office and the customer (*e.g.,* forwarding requests for distribution or changes in investment objectives, or forwarding forms and funds received from the customer); inspecting or maintaining custody of fiduciary assets or holding title to real property.''); *See also* 12 CFR 550.60 (OTS).

[203] The Banking Agencies focus on providing guidance to national banks regarding their multi-state fiduciary activities. For example, the OCC explains at the Supplementary Information section of its release on this topic that ''[t]he purpose of the rulemaking was to provide clarity and certainty for national banks' multi-state fiduciary activities.'' *See* 66 FR 34792 (July 2, 2001); *See also* 67 FR 76293 (Dec. 12, 2002) (OTS) (amending 12 CFR 550.60 to include a definition of the term ''activities ancillary to your fiduciary business.'' The amendment codified OTS legal opinions that concluded that a Federal savings association is not ''located'' in a state for purposes of Section 5(n) of the Home Owners'' Loan Act when the association conducts in that state activities that are ancillary to the association's fiduciary business.).

In contrast, our interpretation is intended to provide guidance to banks on the requirements necessary to qualify for the trust and fiduciary activities exception from registering as a broker pursuant to Section 15 of the Exchange Act.

[204] *See* Exchange Act Release No. 27017, *supra* note 86, 54 FR at 30017–18 (explaining, in the context of the broker-dealer registration requirements as applied to foreign broker-dealers, that the Commission generally views solicitation requiring broker-dealer registration ''as including any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates,'' and stating, ''[s]olicitation includes efforts to induce a single transaction or to develop an ongoing securities business relationship.'').

[205] *See* Exchange Act Section 3(a)(4)(B)(v).

[206] *See* proposed Exchange Act Rule 776.

[207] 17 CFR 240.3b–17(f).

[208] For purposes of determining whether a fund is a ''no-load'' fund, ''sales load'' includes any charges related to the offering price of a fund, such as contingent deferred sales charges. *See Order Approving Proposed Rule Change Relating to the Limitation of Asset-Based Sales Charges as Imposed by Investment Companies,* Exchange Act Release No. 30897 (July 13, 1992), 57 FR 30985 n.8 (citing interpretation of definition of ''sales load'' in Section 2(a)(35) of the Investment Company Act [15 U.S.C. 80a–2(a)(35)] in NASD Notice to Members 89–35, Apr. 1989).

12b–1 fees)[209] do not exceed 0.25 of one percent of average net assets annually and are disclosed in the mutual fund's prospectus. This definition is consistent with the way in which the term ''no-load'' is used under the federal securities laws. In particular, it is consistent with the NASD's definition of ''no-load'[210] and the interpretative position taken by Commission staff,[211] under which NASD member firms and others may not describe a fund as being ''no-load,'' or as having ''no sales charge,'' if it is subject to Rule 12b–1 fees exceeding a minimal amount.

We received numerous comments on the definition of ''no-load.''[212] One commenter expressed the view that defining the term to be consistent with the NASD definition of ''no-load'' was a ''logical and appropriate'' approach.[213] Most commenters asserted that the term should be interpreted to mean only that a fund is not subject to front-end or back-end sales charges. In their view, this approach would be consistent with Congressional intent.[214] Some claimed that the definition of ''no-load'' in the Interim Rules would require revisions to banks'' existing sweeps programs that would involve significant administrative expense for banks, as well as inconvenience for bank customers.[215]

Commission staff consulted with banks and bank representatives to gather more information about sweep account practices. Industry groups confirmed that mutual fund transactions in sweep programs are effected regularly, typically on a daily or overnight basis.[216] One group indicated that banks often charge account-level fees for sweep services, typically on a monthly basis.[217] In addition to possibly receiving Rule 12b–1 fees that exceed 25 basis points, this group indicated that banks might directly charge customers ''rate spread fees''[218] as well as direct servicing fees.

We understand that banks generally offer sweep account services to customers seeking higher interest rates than the rates that banks pay on deposits. The most common types of sweep account fee structures appear to involve a minimum balance requirement, and some banks also charge a monthly fee of between $25 and $100. Banks also receive Rule 12b–1 fees from funds into which deposit balances are swept, which we understand range from 25 to 55 basis points.[219]

After considering comments, we continue to believe that ''no-load'' as used in the statute should be given its customary meaning under the securities laws. We believe customers have come to rely on this term no-load as denoting not more than minimal Rule 12b–1 fees and no front-end or deferred sales charge. Thus, consistent with common industry and investor understanding, Commission staff guidance, and NASD rules, a bank may not use the sweep accounts exception, which covers only transactions in *no-load* money market fund securities, to effect transactions in securities that are subject to more than 25 basis points in charges against net assets for distribution. Although payments by investment companies of asset-based fees to distributors of their securities create conflicts of interest for the distributors, the sweep accounts exception mitigates these conflicts by restricting the funds eligible to be used under the exception to no-load money market funds that are subject to only certain types of minimal distribution fees. In addition, limiting the type of funds that may be used in sweep arrangements offered under the exception to no-load money market funds regulated under Rule 2a–7 under the Investment Company Act [220] limits the risks to investors. The customary emphasis of such funds on maintaining a constant net asset value, the absence of a sales load, and the minimal distribution fees that funds could pay to their bank distributors under the Interim Rules are also important conditions of the exception that could reduce the risks to investors who choose to invest in mutual funds through sweep accounts without using a broker.

Allowing banks that rely on the sweep accounts exception to use mutual fund shares subject to asset-based sales fees exceeding a level that sweep account holders might expect to pay for a ''no-load'' fund would effectively strike the term ''no-load'' from the exception. Indeed, interpreting the term to mean only that a fund does not charge a front-end or deferred sales load could mislead investors, who would end up with accounts paying distribution fees they reasonably did not expect to pay. As understood by the investing public and the securities industry when the GLBA was being drafted and after it was enacted, the term ''no-load'' meant having Rule 12b–1 fees of not more than 25 basis points.[221]

We considered the comment that the definition of ''no-load'' in Exchange Act Rule 3b–17 would create significant administrative expenses for banks and

[209] As we noted in adopting the Interim Rules, 12b–1 fees, which funds are permitted to impose under Investment Company Act Rule 12b–1, are asset-based charges whose purpose may be entirely for the distribution of fund shares. *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27775 and 27779 n.167.

[210] *See* NASD Rule 2830(d)(4).

[211] *See* letter dated August 22, 1994 from Barry P. Barbash, Director, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute, regarding use of ''no-load'' terminology (observing that investors ''have a reasonable expectation that terminology will be used uniformly for all funds with similar fees,'' and that using a description such as ''no-load'' or ''no sales charge'' in connection with a fund having a Rule 12b–1 fee or service fee of more than 0.25% of average net assets per year, ''may be misleading and may constitute a violation of the antifraud provisions of the federal securities laws,'' whether or not the description is attributable to an NASD member firm).

[212] *See, e.g.,*, ABA/ABASA letters; Bank of America letter; Bank One letter; Banking Agencies letter; BONY letter; Compass letter; Fleet letter; Frost letter; Harris Trust letter; KeyBank letter; Mellon letter; NASAA letter; National City letter; NYCH letter; PNC letter; Regions letter; Roundtable letter; Shaw Pittman letter; Texas Bankers Trust Division letter; and Wells Fargo letter.

[213] *See* NASAA letter.

[214] *See, e.g.,* ABA/ABASA letters; Compass letter; and NYCH letter.

[215] *See, e.g.,* Banking Agencies letter; PNC letter; and Regions letter.

[216] *See* Letter dated January 22, 2004 from America's Community Bankers, the American Bankers Association, the Bank Insurance and Securities Association, the Financial Services Roundtable, the Independent Community Bankers of America, the Institute of International Bankers, and the New York Clearing House Association (''ACB/ABA letter''). The letter does not comment on the definition of ''no-load'' in the Interim Rules.

[217] *See* ACB/ABA letter.

[218] We understand a rate spread fee to be the difference between the return that the money market fund pays the bank's customer whose deposit funds are swept into the fund and the fee the bank charges the customer for the sweep service.

[219] In addition, some banks may retain a portion of the yield on a money market account, but this does not appear to be a common practice. In the rare cases in which a bank and its customer agree that the bank will retain a portion of the yield from a fund in a sweep arrangement, it appears that the retained yield would likely be between 25 and 50 basis points. For example, the bank might reduce a 2 percent yield on a fund to 1.5 percent and keep the 0.5 percent difference. This type of fee appears to be the same as the ''rate spread fee'' discussed above.

[220] 17 CFR 270.2a–7.

[221] For example, the Glossary of Mutual Fund Terms in the 1997 edition of the Investment Company Institute's publication *A Guide to Understanding Mutual Funds* defines a ''no-load fund'' as, ''[a] mutual fund whose shares are sold at net asset value,'' and the 1998, 2000 and 2002 editions of the same publication define a ''no-load fund'' as, ''[a] mutual fund whose shares are sold without a sales commission and without a 12b–1 fee of more than .25 percent per year.'' A banking trade group also communicated this commonly understood meaning of the term to Congress as it considered the bill that became the Gramm-Leach-Bliley Act. *See The Financial Services Modernization Act of 1999: Hearings on H.R. 10 Before the House Comm. on Banking and Fin. Services,* 106th Cong., 1st Sess. 354 (1999) (''Statement for the Record of the ABA Securities Association (''ABASA'')'' citing NASD Rule 2830 as support for the statement, ''Mutual funds that assess service fees that do not exceed .25 of 1% of average net assets per annum are generally understood to be no-load.'').

inconvenience bank customers. We understand that the conditions of the statutory exception may require banks to modify some sweep arrangements involving funds that impose more than minimal charges against fund assets. In particular, some banks that wish to rely on the exception may need to begin charging customers directly for sweep services if they wish to continue receiving fees for the services equivalent to what they currently may receive from funds in the form of sales loads, deferred sales loads, Rule 12b-1 fees, and shareholder service fees. As we explained in adopting the Interim Rules, banks are not prohibited by the statute's ''no-load'' condition or our interpretation of it from directly charging their customers for sweep services, because those direct charges would not be charges against fund assets.[222] While some banks may need to restructure some of their sweep arrangements to comply with the statute's ''no-load'' condition, and such restructuring may entail some expense to banks or inconvenience to bank customers, these considerations do not justify changing our interpretation of ''no-load'' in ways that could subject bank customers to unexpected fees. Identifying funds that meet the definition of ''no-load'' should not be burdensome because the Commission's definition is the industry standard.[223]

Some commenters indicated that our definition of ''no-load'' should be changed because limitations on asset-based sales charges might cause some banks to increase their account fees to offset losses of fees from money market funds or cause them to stop offering sweep accounts. If a bank can only offer sweep services by charging its customers additional fees above the built-in fees of true no-load funds, however, we believe investors should understand that and make their investment decisions accordingly.[224] Fees charged directly to the account of a sweep account customer would permit the customer to evaluate the worth of the sweep services provided by the bank.

Moreover, banks offering sweep account services have incentives other than earning fees to sweep balances out of deposit accounts. Notably, sweeping allows banks to reduce the amount of assets they are required to hold in vault cash or Federal Reserve accounts, neither of which earns interest. Sweep accounts, therefore, inherently allow banks to use more of their assets to generate income.[225] They also provide a means by which a bank may direct investments into proprietary funds from which the bank or an affiliate of the bank may receive advisory fees and other revenue.

One mutual fund company[226] suggested amending the definition to reflect the fact that different classes or series of shares issued by a particular fund may be subject to different distribution-related charges. This commenter noted that many investment companies offer multiple classes or series of shares, and some, but not others, may be subject to sales loads or deferred sales loads. In response to this comment, we propose to amend the definition of ''no-load'' to refer to loads applicable to a class or series of investment company security, rather than to the securities of an investment company in general.[227] We request comment on the proposed amendment to the definition of ''no-load,'' and specifically on the provision that ''no-load'' means not subject to Rule 12b–1 fees and certain other charges of more than 25 basis points. We also invite comment on whether rate spread or retained yield fees should be counted as sales charges in determining whether money market funds in a sweep account program involving such fees should be considered ''no-load'' for purposes of the exception.

2. Interpretation of ''Program''

Counsel for banks and investment companies asked the Commission staff whether the sweep accounts exception would permit a bank to sweep deposit balances into mutual funds less frequently than daily. They also asked whether a bank could rely on the exception to effect sweep transactions only at the direction of a customer rather than automatically. In addition, one commenter asked the Commission staff whether the exception would permit a bank to effect money market mutual fund transactions for a customer of another bank.[228]

In light of the legislative history, we do not believe that the sweep accounts exception permits other than regular, automatic sweeps.[229] Moreover, we do not believe, and there is nothing in the legislative history to suggest, that this exception permits a bank to effect money market mutual fund transactions for another bank using deposits held at the other bank. Therefore, to limit potential confusion, we are clarifying that the term ''program'' in Exchange Act Section 3(a)(4)(B)(v)[230] refers to arrangements for the automatic transfer of funds on a regular basis. We also interpret the term ''program'' as referring to a bank's investment and reinvestment of deposit balances held at the bank by the bank's own customers. We request comment on our interpretation of the term ''program,'' and on whether the term should be defined by a rule.

3. Definition of ''Money Market Fund''

The Interim Rules defined the term ''money market fund'' as an open-end management investment company registered and regulated as a money market fund pursuant to Rule 2a–7 under the Investment Company Act.[231] We did not receive any comments on this definition, and we propose to leave it unchanged.[232] We request comment on whether the definition should remain unchanged.

### *D. Affiliate Transactions Exception*

Exchange Act Section 3(a)(4)(B)(vi) excepts from the definition of broker a bank that ''effects transactions for the account of any affiliate of the bank.''[233]

[222] Therefore, direct charges by banks of sweep fees would not affect the fund's status as a ''no-load'' fund. *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27779.

[223] As we explained in adopting the Interim Rules, a bank could satisfy its obligation to assure that any money market fund included in the bank's sweep program is in fact a no-load fund by using only money market funds that hold themselves out as no-load funds or by obtaining written confirmation from the money market fund that it is a no-load fund before including the fund in its sweep program. *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27779 n.169.

[224] As mentioned above, according to the ACB/ABA letter, banks often charge their sweep customers monthly, account-level fees.

[225] *See* Paul Bennett and Stavros Peristiani, *Are U.S. Reserve Requirements Still Binding*?, 8 Economic Policy Review of the Federal Reserve Bank of New York 53 (May 2002) (available at *http://www.ny.frb.org/research/epr/02v08n1/0205benn.pdf*); Remarks of Treasury Under Secretary Gary Gensler Before the House Banking and Financial Services Committee, May 3, 2000 (available at *http://www.ustreas.gov/press/releases/ls600.htm*).

[226] *See* letter dated October 2, 2002 from Steve Keen, General Counsel, Federated Investors, Inc.

[227] *See* proposed Exchange Act Rule 740(c).

[228] *See* Federated letters.

[229] Legislative history suggests the scope of the sweep accounts exception could be limited to overnight sweeps. *See* H.R. Rep. No. 106–74, pt. 3, at 167 (1999) (''Section 201 [of the GLBA] contains a limited exception for banks that 'sweep' depositors' funds on an *overnight* basis into a no-load money market account. The exception has the effect of permitting banks to continue investing depositors' funds from depository accounts into no-load money market accounts.'') (emphasis added). However, we interpret the term ''program'' to include programs that involve regular, automatic sweeps of deposit balances meeting preset levels, even if the transactions are effected on a periodic basis less frequently than daily.

[230] 15 U.S.C. 78c(a)(4)(B)(v).

[231] 17 CFR 270.2a–7.

[232] *See* proposed Exchange Act Rule 740(b).

[233] 15 U.S.C. 78c(a)(4)(B)(vi). Bank Holding Company Act Section 2(k) [12 U.S.C. 1841(k)]

The affiliate transactions exception applies to a bank effecting trades for the accounts of its affiliates, other than those affiliates that are registered broker-dealers or engaged in merchant banking. Affiliates, including operating subsidiaries and other subsidiaries of the bank, may not use the bank exceptions and exemptions from the definitions of broker and dealer. While none of the Interim Rules addressed the affiliate transactions exception, in the release adopting the Interim Rules, the Commission interpreted the exception as not covering a bank effecting trades with non-affiliated customers, even when the customer transaction also is effected as part of a trade involving an affiliate.[234]

We received two comments relating to the Commission's interpretation of this exception.[235] One of these commenters stated that the Commission's interpretation, if construed literally, would effectively negate the statutory exception by prohibiting a bank from completing a brokerage transaction with non-affiliated customers under the affiliate transactions exception.[236] The other commenter said that this exception should cover transactions with non-affiliates if one of the parties to the transaction is an affiliate of the bank.[237]

Under the interpretation of the exception that these commenters have proffered, a bank could avoid broker-dealer registration for a securities brokerage transaction if an affiliate is involved in the transaction. The Commission believes that this interpretation is contrary to the plain meaning of the GLBA. As a result, we are proposing to clarify the Commission's interpretation of this exception by defining the term ''effects transactions for the account of any affiliate.''[238] Under this proposed definition, the affiliate must be acting as a principal or as a trustee or fiduciary purchasing or selling securities for investment purposes.[239] Moreover, the affiliate may not act as a riskless principal for another person, as a registered broker-dealer, or be engaged in merchant banking.[240] Finally, the bank would be required to obtain the securities to complete the subject transaction from a registered broker-dealer, from a person acting in that capacity that is not required to register, or pursuant to another exception or exemption from Exchange Act Section 3(a)(4)(B).

We request comment on this proposed definition. In particular, commenters are invited to discuss whether this definition would enhance the clarity of the affiliate transactions exception.

### *E. Safekeeping and Custody Activities Exception*

#### 1. Background on Safekeeping and Custody Exception

Exchange Act Section 3(a)(4)(B)(viii) provides an exception from broker-dealer registration with respect to certain securities-related safekeeping and custody services that banks may perform for their customers.[241] The exception explicitly allows a bank that holds funds and securities for its customers as part of ''customary banking'' activities to perform specified securities-related functions with respect to those securities without registering as a broker.[242] In particular, a bank may, among other things, exercise warrants or other rights, facilitate the transfer of funds or securities in connection with clearing and settling customers' securities transactions, effect securities lending or borrowing transactions and invest cash collateral pledged in connection with such transactions, and hold securities pledged by a customer or facilitate the pledging or transfer of securities that involve the sale of those securities. In addition, the exception expressly permits a bank to ''serve as a custodian or provider of other related administrative services'' to IRAs, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plans without being considered a broker. The exception does not apply, however, to a bank that acts as a carrying broker or clearing broker in connection with securities transactions (other than with respect to government securities).[243]

In the release adopting the Interim Rules, the Commission provided interpretive guidance with respect to the exception. In particular, the Commission stated:

> ''custody'' or ''related administrative services'' do not include accepting orders from investors to purchase or sell securities. In particular, we do not believe that by its terms the safekeeping and custody exception covers a bank that accepts orders from investors to purchase or sell securities other than those specifically permitted in the exception, such as with respect to securities lending and borrowing or investing collateral.[244]

To mitigate unnecessary disruptions in banks' existing safekeeping and custody practices that the GLBA might have caused, the Interim Rules provided conditional exemptions to permit banks to effect transactions in securities over which they have custody. In particular, current Exchange Act Rule 3a4–5 permits all banks to effect transactions in any security for custody accounts under narrow conditions.[245] In addition, current Exchange Act Rule 3a4–4 permits small banks to effect transactions in mutual funds for tax-deferred custody accounts.[246]

We received numerous comments on the safekeeping and custody exception.[247] These comments focused

defines affiliate to mean ''any company that controls, is controlled by or that is under common control with another company.''

[234] *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27783.

[235] *See* Banking Agencies letter and ICBA letter.

[236] *See* Banking Agencies letter.

[237] *See* ICBA letter.

[238] *See* proposed Exchange Act Rule 750.

[239] The securities laws and rules, however, distinguish ''dealers'' (which buy and sell securities as part of a regular business) from ''traders'' (which buy and sell securities for investment and not as part of a regualr business). For additional information on distinguishing ''dealers'' from ''traders,'' *see* Exchange Act Release Nos. 46745 (Oct. 31, 2002), 67 FR 67496, 67498 (Nov. 5, 2002) and 47364, (Feb. 14, 2003), 68 FR 8686, 8688 (Feb. 24, 2003).

[240] The affiliate may not be a registered broker-dealer or be engaged in merchange banking because the statute contains these conditions. Exchange Act Section 3(a)(4)(B)(vi). The affiliate may not act as a riskless principal because that would effectively be acting for another person who would be a customer of the affilaite.

[241] 15 U.S.C. 78c(a)(4)(B)(viii).

[242] In the absence of an exception or exemption, holding customer funds and securities in connection with securities transactions typically would require broker registration. *See, e.g., SEC* v. *Margolin*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,025 (S.D.N.Y. 1992) (noting that evidence of brokerage activity included receiving transaction-based compensation, advertising for clients, and possessing client funds and securities). *See* letter re: *Financial Surveys, Inc.* (July 30, 1973) (persons in the business of effecting transactions in securities include persons who hold customer funds or securities in connection with securities transactions). *See also* 15 David A. Lipton, at 1.04[3] (having custody or control over funds and securities of others is a badge of being a broker).

[243] Exchange Act Section 3(a)(4)(B)(viii)(II).

[244] 66 FR at 27781.

[245] *See* 17 CFR 240.3a4–5.

[246] *See* 17 CFR 240.3a4–4. Both exemptions are subject to limits on solicitation activities, compensation, and use of bank employees. The exemptions also require banks to execute the resulting transactions pursuant to Exchange Act Section 3(a)(4)(C), which requires banks that accept orders to the extent they engage in transactions under a specified safekeeping and custody function either to transmit orders to be executed to a registered broker-dealer or internally cross those orders.

[247] *See* ABA/ABASA letters; Banking Agencies letter; BONY letter; Bank One letter; BSA letter; CSBS letter; FirstMerit letter; FirstUnion letter; Fleet letter; Frost letter; Harris Trust letter; ICBA letter; KeyBank letter; letter dated August 30, 2001 from D. Rodman Thomas, Senior Vice President and Senior Trust Officer, The Ledyard National Bank (''Ledyard letter''); Mellon letter; letter dated August 29, 2001 from Bill Beyer, President and CEO, Meredith Village Savings Bank (''Meredith Village Savings Bank''); National City letter; NYCH letter; PNC letter; Shaw Pittman letter; Roundtable letter; UMB Bank letter; Wells Fargo letter; State

Continued

primarily on the Commission's interpretation with respect to accepting orders, the general custody exemption, and the small bank custody exemption.

2. Comments on Commission's Interpretation Regarding Accepting Customer Orders

A number of commenters criticized the Commission's interpretation that the safekeeping and custody exception generally does not permit banks to accept their customers' securities orders. These commenters argued that the interpretation was contrary to the GLBA and its legislative history.[248] In particular, they contended that order taking is a customary banking activity in custody accounts and that in adopting the GLBA Congress did not intend to disturb such activities. A few commenters also opined that with respect to retirement and other benefit plans, the plain meaning of the exception and Congressional intent should expressly permit a bank to handle orders because the exception permits banks to engage in ''related administrative services'' for investors through retirement and benefit plans.[249] Moreover, two commenters stated that, whether under the trust and fiduciary exception or the safekeeping and custody exception, Congress clearly intended to allow banks to continue effecting transactions in securities for custodial IRAs.[250] Some commenters also asserted that the Commission staff has recognized that entities offering a bundle of custodial and administrative services may accept and process orders for retirement plans.[251]

Although we understand the concerns of the commenters discussed above, the Commission continues to believe that accepting orders to purchase or sell securities is a core broker-dealer function and was not intended to be permitted under the safekeeping and custody exception.[252] Therefore, we continue to believe that the combination of handling funds and securities with order taking, absent a specific exemption, requires broker-dealer registration. Although the safekeeping and custody exception generally does not provide for banks to take orders for securities, the Commission has proposed several exemptions to allow banks to accept orders from a custody account, subject to certain conditions.

3. Comments on and Proposed Amendments to the General Bank Custody Exemption

Current Exchange Act Rule 3a4–5 provides a limited exemption from the definition of ''broker'' for banks seeking to operate in the broader role of order takers for all types of securities while holding clients' funds or securities. To qualify for the exemption, however, a bank may not receive any compensation for effecting such transactions. In addition, the exemption would limit the ways in which banks: (1) Solicit orders; (2) use their employees to engage in brokerage activities; and (3) compensate their employees for the sale of securities.[253]

We received multiple comments regarding the general bank custody exemption.[254] One commenter argued that the safekeeping and custody exception is clear and unequivocal, and therefore an exemptive rule in this area is unnecessary.[255] Another explained that taking orders to execute securities transactions for its custody clients historically has been an important aspect of its custody business that it provides as an accommodation and convenience for clients rather than as a substitute for the brokerage business.[256]

Another commenter expressed concerns that a bank may not receive transaction-based compensation for placing orders for its customers and still rely on this exemption.[257] It viewed this condition as requiring banks to provide certain custodial services at a loss.

Other commenters indicated that Exchange Act Rule 3a4–5 could be misinterpreted to prohibit a bank from receiving certain fees that these commenters believed should be permissible under the exemption (*e.g.*, settlement fees, securities movement fees, or similar processing fees that do not depend on whether the bank placed an order for its customer).[258]

One commenter urged the Commission to expand the exemption so that banks may continue to be compensated for effecting securities transactions in custodial accounts where the compensation consists of Rule 12b–1 fees, shareholder servicing fees, mutual fund advisory fees, or other revenue sharing arrangements.[259]

Some commenters complained about the solicitation restrictions in Exchange Act Rule 3a4–5(a)(5), arguing, among other things, that they would prohibit banks from engaging in advertising activities that are expressly permitted by the Exchange Act.[260]

Some commenters stated that banks offering proprietary funds should not (as the rule requires) be required also to offer competitors' funds because their operational costs would increase as the number of investment options offered increased.[261]

Street letter; M&T Bank letter; Fulton Street Financial letter; Union Bank of California letter; ICBA letter; IIB letter; Wilmer, Cutler letter; Wilmington Trust letter; Regions Financial letter; TIAA-CREF letter; Virginia Bankers Association letter; and Compass Bank letter.

[248] *See, e.g.*, ABA Banking Law Committee letter; ABA/ABASA letters; Banking Agencies letter; Financial Services Roundtable letter; and IIB letter.

[249] *See, e.g.*, ABA/ABASA letters; Banking Agencies letter; and NYCH letter.

[250] *See, e.g.*, Federated letters and Mellon letter.

[251] *See, e.g.*, Banking Agencies letter; PNC letter; and TIAA-CREF letter. Commenters cited Letter re: *Universal Pensions, Inc.* (Jan. 30, 1998). Pursuant to that staff no-action letter, a third-party pension plan administrator acted in a mechanical order-taking role subject to independent supervision, could not influence the purchase of securities by plan participants, did not receive transaction-based compensation related to those purchases, was not permitted to handle funds or securities, recommend any mutual funds, or provide any other investment advice. Broker-dealers worked directly with plan sponsors and advised the sponsors in which mutual funds to invest. While the administrator could receive and invest new participant contributions for each plan according to directions from the plan fiduciary, it could not net or match orders. An independent trust company independently calculated net orders and forwarded them along with cash to settle trades. We note that banks relying on the safekeeping and custody exception could not meet the terms of the Universal Pensions letter because they handle funds and securities.

[252] *See* H.R. Rep. No. 106–74, pt. 3, at 169 (1999) (''This exception is not intended to allow banks to engage in broader securities activities.'').

Although the term ''related administrative services'' is not defined in the securities laws, in the broker-dealer industry, administrative services generally are considered to be those that are ''clerical and ministerial.'' Clerical and ministerial activities include, for example, mechanical tasks such as bookkeeping and record keeping, performing calculations, and data processing functions. Accepting general orders to buy and sell securities, however, is not a ''clerical and ministerial'' activity. *See Exchange Services, Inc.* v. *S.E.C.*, 797 F.2d 188, 189–190 (4th Cir. 1986) (court determined that the Commission was not being arbitrary and capricious when it relied, as a reason to deny an exemption, on NASD's policy that anyone taking orders from the public must register as a broker-dealer).

[253] *See* Exchange Act Rule 3a4–5(a). For example, the rule restricts banks that wish to rely on the exemption from soliciting securities transactions except through one of four means specified in the rule. *See* Exchange Act Rule 3a4–5(a)(5)(i)–(iv). A bank relying on the exemption also must comply with the order execution condition in Exchange Act Section 3(a)(4)(C). *See* Exchange Act Rule 3(a)(3).

[254] *See, e.g.*, ABA/ABASA letters; Banking Agencies letter; BONY letter; Bank One letter; BSA letter; CSBS letter; FirstMerit letter; Fleet letter; Frost letter; Harris Trust letter; ICBA letter; KeyBank letter; Ledyard letter; Mellon letter; National City letter; NYCH letter; PNC letter; Shaw Pittman letter; Roundtable letter; UMB Bank letter; and Wells Fargo letter.

[255] *See* IIB letter.

[256] *See* BONY letter.

[257] *See* Mellon letter.

[258] *See, e.g.*, NYCH letter and BONY letter.

[259] *See* NYCH letter.

[260] *See, e.g.*, Banking Agencies letter and UMB Bank letter.

[261] See, *e.g.*, BONY letter; Frost letter; Harris Trust letter; Mellon letter; NYCH letter; PNC letter; and Roundtable letter.

Several commenters objected to the employee compensation provisions in the rule because they believe that banks should be able to reward their employees for securing new custody business.[262] Some commenters asserted that the rule's prohibition on using dually licensed employees to accept orders is contrary to the Commission's view that registration provides important investor protections.[263]

One commenter complained about a provision in the rule requiring that a bank employee taking customers' securities orders primarily perform duties for the bank other than effecting transactions in securities for customers.[264] This commenter contended that this provision restricts a bank's ability to staff custody accounts in a manner that it deems most appropriate without enhancing customer protection.

*a. Modifications to General Bank Custody Exemption*

*1. Bank Compensation*

In response to comments, and based on the Commission staff's discussions with representatives of banks, bank trade groups, and staff of the Banking Agencies, we propose to amend the general custody exemption to clarify that a bank that accepts orders for securities could be compensated for effecting a securities transaction for a person with an existing custody account or for a ''qualified investor'' so long as the compensation that the bank receives for its custody services (*e.g.*, securities movement fees, annual fees, asset based fees, and processing fees) does not directly or indirectly vary based on whether the bank accepts an order to purchase or sell a security.[265]

Accordingly, the proposed amendment would conditionally permit a custodian bank to be compensated for the movement of funds and securities for ''grandfathered'' custody accounts or accounts of ''qualified investors'' when that movement results from the bank's acceptance of a securities order. We propose to limit this exemption on a going forward basis to ''qualified investors'' because their custody accounts have not typically been used extensively for execution purposes.[266] Customers that do not already have a custody relationship, other than ''qualified investors,'' would not obtain securities (other than securities covered by other exceptions or exemptions) through their bank custodian. We solicit comment on limiting this exemption to ''qualified investors'' on a going-forward basis. In particular, we solicit comment on whether there are other institutional entities that have custodial, rather than trust accounts, with banks and that have a special need for banks to take their securities orders. We request that commenters, particularly those that are custody customers, set forth the specific reasons why banks would need to have other entities included within the terms of this exemption. Please include the special circumstances that apply to these entities and why these entities do not require the comprehensive protections of the federal securities laws.

The proposed amendment articulates more clearly the accommodative and historical nature of the limited securities business that banks have customarily performed through their custody departments. The proposed amendment also would remove limitations in the Interim Final Rules that prohibited custody department employees from being compensated for securities-related custody activities, including gathering assets and moving funds and securities, if the bank accepts customer orders. While we see no difference between a bank that effects transactions in securities as a custodian and a broker-dealer,[267] we believe an exemption would be appropriate where a bank's sales efforts and sales incentives are limited. While the proposal would be more accommodative than the current exemption, it would not permit a bank to operate as an ''introducing broker'' in the custody department, which we do not believe would be consistent with Exchange Act investor protection principles.[268]

Under the proposal, banks that accept securities orders would not be permitted to adjust their compensation to reflect the additional cost of forwarding orders on behalf of customers. These costs could not be recouped in any other aspect of their customer relationships to account for the acceptance of customers' orders pursuant to this exemption.[269] To give legal certainty to banks regarding the compensation condition, the proposed amendment would specify that a bank could demonstrate that it does not receive additional compensation for effecting securities transactions by utilizing fee schedules that specify charges for the movement of funds securities and identifying similarly situated customers who pay the same price for such movements and who do not utilize the bank or its affiliates to effect securities transactions.

In addition, we propose to amend the general custody exemption to permit banks to be compensated for accepting securities orders through Rule 12b–1 or shareholder servicing fees for accounts that were opened before the date of this proposing release or for ''qualified investors.'' While Rule 12b–1 fees create the types of conflicts of interest that broker-dealer regulation is designed to address, we propose to grandfather

[262] *See, e.g.*, ABA/ABASA letters; Harris Trust letter; Mellon letter; and NYCH letter.

[263] *See, e.g.*, Fleet letter; BONY letter; Meredith Village Savings Bank letter; National City letter; NYCH letter; PNC letter; and Roundtable letter.

[264] *See* PNC letter referencing Exchange Act Rule 3a4–5(a)(2)(ii).

[265] *See* proposed Exchange Act Rule 760. The term ''qualified investor'' is defined in Exchange Act Section 3(a)(54). Banks advised the Commission that banks provide custody services to a broad range of institutional customers, including corporations, endowments, market professionals (such as mutual funds, hedge funds, and investment advisers), employer pension plans, state, local, and foreign governmental entities, other not-for-profit organizations, welfare benefit plans, union plans, Indian Tribal Nations, and partnerships and limited liability companies. Bank custodians also act as custodians for individuals, such as private banking clients, trust clients, or IRA owners. Most of these customers did not use bank custodians to execute securities transactions.

[266] *See* Banking Agencies letter (''Based on our supervisory experience, banks customarily conduct accommodation trades for custodial accounts only upon the order of the customer and on an incidental and infrequent basis.'').

[267] When brokerage is conducted through a custody account, the investor protections associated with order entry through a registered broker-dealer are not available. However, the protections associated with order execution are available because orders are forwarded to a registered broker-dealer for execution.

[268] An ''introducing broker'' arranges securities transactions for a customer but uses a ''clearing broker'' to execute the transactions and maintain securities and funds on that customer's behalf.

[269] One bank trade group informed the staff that custody fee arrangements may reflect other products or services for which the customer uses the bank. Similarly, to ensure that the whole relationship with a customer is profitable, clearing brokers do not necessarily charge uniform fees to securities customers. For example, clearing firms may charge low custody fees and split securities lending income with the customer to offset other charges. In this example, a bank could engage in securities lending pursuant to the safekeeping and custody exception or the exemption for securities lending transactions in Exchange Act Rule 15a–11. A bank's compensation from securities lending transactions involving a custody customer's securities could not, however, be used to offset or credit fees for that custody customer's securities transactions pursuant to this exemption.

A non-exhaustive list of examples of indirect compensation for order-taking may include:

(1) The bank custody department varies the fees received based on securities transaction volume;

(2) The bank custody department only charges certain custody customers for purchasing securities;

(3) The bank varies the order acceptance fee for customers who purchase another product or service, such as by giving high net worth bank customers a certain number of free trades annually or by requiring a custody customer to purchase another product or service to qualify for a particular custody fee that includes order-taking services; and

(4) The bank receives payments of sales compensation from other persons related to the sale of mutual funds to custody customers, other than payments expressly permitted pursuant to this exemption.

existing custody accounts to avoid any unnecessary disruption of this business.

In keeping with the accommodative nature of banks' custody business and partially to address the conflicts associated with Rule 12b–1 fees, we propose to condition the receipt of Rule 12b–1 and shareholder servicing fees on the bank making available any class or series of a registered investment company's securities that can be reasonably obtained by the bank for purchase or sale by customers. This condition is designed to ensure that investors have a full range of choices available when they consider whether to pay custody costs directly or to offset some of these custody costs with Rule 12b–1 fees. By making different classes of shares available, including classes that do not pay 12b–1 fees (*e.g.*, institutional class), banks will not effectively require a customer to pay Rule 12b–1 fees to obtain execution services.

We believe that the additional conditions that we propose, however, will limit banks to the type of accommodation role that commenters represent banks act in when effecting transactions in securities as custodians. We do not propose to amend the exemption to permit banks to be compensated for accepting securities orders through revenue sharing arrangements because of the conflicts that these payments create.[270] We solicit comment on these proposed amendments, including specific comments on whether we have adequately protected the interests of these current bank customers through the conditions we propose. We request comment on whether it is appropriate to grandfather existing custody customers by allowing banks to take securities orders from these customers and collect 12b–1 fees from their accounts. We request comment on whether this proposed exemption creates an unreasonable level of competitive issues for other banks or broker-dealers that should be considered by us further. If commenters think that these customers should have additional investor protections that we have not provided through these proposed conditions, please tell us what additional investor protections we should require.

2. Solicitation Restrictions

In general, we propose to tighten the solicitation conditions in the proposed amendments. Consistent with commenters' assertions that banks effect transactions purely as an accommodation to their customers, we propose to remove a provision from the current custody exemption that permits banks to solicit investors through investment company advertising and other sales material. We propose to modify the current custody exemption to permit banks to respond to investor inquiries by delivering sales literature that is prepared by an investment company that is not an affiliated person.[271] We propose to remove the condition in the current exemption that permits banks to solicit their existing customers for securities transactions in connection with solicitation of their other custody activities.

In response to a request from one commenter to limit the solicitation condition to custodian accounts,[272] we propose to clarify that the solicitation restrictions in the general bank custody exemption apply only to solicitations of securities transactions pursuant to the proposed amended exemption covering accounts for which the bank acts as a custodian. Therefore, a bank could solicit a custody business, including securities transactions that are permissible under the safekeeping and custody exception in Exchange Act Section 3(a)(4)(B)(viii) and the stock lending exemption in Exchange Act Rule 15a–11. A bank could not, however, directly or indirectly solicit securities transactions in reliance on this proposed exemption, except as permitted pursuant to the terms of this exemption. For example, a bank making referral payments to another person for the solicitation of securities transactions for the bank operating pursuant to this proposed exemption would exceed the solicitation limits in this proposed exemption.

Banks advised the Commission staff that departments of a bank other than the custody department may provide lists of recommended securities, watch lists, research reports, or other publications highlighting particular securities or groups of securities, and may provide investment advice. These activities exceed the securities solicitation limits of Exchange Act Rule 3a4–5 and the proposed exemption.[273] Except as expressly permitted, the solicitation conditions would not permit a bank to solicit through another bank department securities activities in its custody department. We solicit comment on each of these proposed changes to the solicitation restrictions. We specifically invite comment on whether these restrictions are too lax or too strict. We also invite comment on whether we should impose any other or different restrictions.

3. Employee Activities and Compensation

As suggested by commenters, we propose to eliminate a provision in current Exchange Act Rule 3a4–5(a)(2)(i) that prohibits the use of dually licensed employees to effect transactions pursuant to the general custody exemption. We also propose to eliminate the requirement that a bank employee must primarily perform duties for the bank other than effecting transactions in securities.[274] Commenters explained that eliminating these prohibitions would enhance operational efficiencies and would allow them to use the most skilled persons for processing securities transactions.

We also propose to eliminate the restriction in current Exchange Act Rule 3a4–5 (a)(2)(iii)(B) that custody employees may not receive incentive compensation for the amount of securities-related assets gathered or the size or value of any customer's securities account. This will permit compensation for a custody employee that brings assets into the bank.

We request comment on the elimination of both of these restrictions. We invite commenters to tell us if other or more tailored conditions would be

[270] The NYCH advised the Commission staff that banks acting as custodians may enter into revenue sharing arrangements with investment advisers. As the Commission noted, the development of fund "supermarkets" sponsored by broker-dealers has led to related arrangements in which a fund or its affiliates compensates broker-dealers in ways that are not generally disclosed to investors. *See* 69 FR 6438 at 6443.

[271] *See* proposed Exchange Act Rule 760(a)(3)(B).

[272] *See* NYCH letter.

[273] As we explained in Exchange Act Release No. 27017, *supra* note 86, 54 FR at 30017–18:

[T]he Commission generally views "solicitation," in the context of broker-dealer regulation, as including any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates. Solicitation includes efforts to induce a single transaction or to develop an ongoing securities business relationship. Conduct deemed to be solicitation includes telephone calls from a broker-dealer to a customer encouraging use of the broker-dealer to effect transactions, as well as advertising one's function as a broker or a market maker in newspapers or periodicals of general circulation in the United States or on any radio or television station whose broadcasting is directed into the United States. Similarly, conducting investment seminars for U.S. investors, whether or not the seminars are hosted by a registered U.S. broker-dealer, would constitute solicitation. A broker-dealer also would solicit customers by, among other things, recommending the purchase or sale of particular securities, with the anticipation that the customer will execute the recommended trade through the broker-dealer.

This release explains that providing research reports may be a form of solicitation. Providing an asset allocation model to a custody customer is another example of an affirmative effort to induce transactional business.

[274] *See* Exchange Act Rule 3a4–5(a)(2)(ii).

more likely to enhance investor protections.

4. Trustee and Fiduciary Activity Accounts

We propose to add a new provision to the general custody exemption designed to ensure that a bank would use that exemption only for those custody accounts in which it does not act in a trustee or fiduciary capacity.[275] Transactions for trust and fiduciary activity accounts would need to be effected in compliance with the trust and fiduciary exception in Exchange Act Section 3(a)(4)(B)(ii). Congress enacted the conditions that apply to that exception in recognition of certain fiduciary obligations that banks have to their trust customers. In contrast, a custody account is created through a contractual relationship that does not provide the customer with any fiduciary protections. We solicit comment on the appropriateness of this proposed new provision of the general custody exemption. We also request comment on whether activities covered by any other exceptions or exemptions should be specifically carved out of this custody exemption. We also invite comment on whether any other restrictions would offer better protection to investors.

5. Employee Benefit Plans

In light of the proposed new exemption for banks effecting transactions for employee benefit plans, we propose to add a new provision to the general bank custody exemption to clarify that the custody exemption would not be available for banks to effect transactions in securities for an employee benefit plan account described in proposed Rule 770. We invite comment on this proposed provision and whether any other restrictions should be imposed for the protection of investors.

6. Small Bank Exemption

In light of the expanded availability of the small bank custody exemption, we propose to add a new provision to the general custody exemption that would limit the availability of the general bank custody exemption to banks that do not simultaneously use the small bank custody exemption. Banks that qualify for both exemptions could choose which custody exemption to use. We invite comment on whether it is appropriate to limit the use of these exemptions in this way.

[275] *See* proposed Exchange Act Rule 760(a)(4).

7. Custody Account Definition

We propose to define an ''account for which the bank acts as a custodian'' to mean an account established by a written agreement between the bank and the customer, which, at a minimum, provides for the terms that will govern the fees payable, rights, and obligations of the bank regarding the safekeeping of securities, settling of trades, investing cash balances as directed, collecting of income, processing of corporate actions, pricing securities positions, and providing of recordkeeping and reporting services.[276] We based this definition on our understanding of what custodians do. In addition, to provide legal certainty to bank custodians accepting orders for IRAs, we specifically added such accounts to this definition of custody account. We invite comment on the extent to which custodians provide the services outlined in the proposed definition and whether there are additional services that custodians perform that should be included in this definition. We also invite comment on whether there are any other conditions or disclosure requirements that we should consider to protect investors.

8. Request for Comments

We request comment on these proposed modifications to the general custody exemption. In responding to this request for comments, please describe whether this exemption would cover most categories of custody customers from whom banks accept orders for the purchase or sale of securities. For bank commenters, with respect to each type of custody customer, please list: (1) The percentage of any type of order for the movement of funds or securities that includes an order for the purchase or sale of a security; (2) the types of securities the bank purchases or sells for these customers; (3) how the bank offers particular classes or series of mutual funds to these custody customers; (4) all of the types of compensation the bank receives in connection with its custody activities related to different types of custody customers; and (5) how the bank solicits these custody customers. We solicit comment regarding whether we should adopt disclosure requirements similar to the proposed general disclosure requirements in proposed Exchange Act Rule 776.

We request comment on whether the proposed definition of ''account for which the bank acts as a custodian'' in Rule 762(a) reflects the types of services that bank custodians typically provide. If not, please explain which of these services bank custodians typically provide. In addition, does the custody definition reflect the services that banks typically provide for investors who purchase or sell securities within individual retirement accounts?

[276] Proposed Exchange Act Rule 762(a).

9. Carrying Broker Definition

The Exchange Act generally[277] disqualifies banks that act as carrying brokers from utilizing the safekeeping and custody exception and the networking exception.[278] The applicable statutory condition defines the term ''carrying broker'' by reference to Exchange Act Section 15(c)(3) and the rules thereunder.[279] In adopting the Interim Rules, the Commission explained:

> A bank acting as a carrying broker facilitates the transfer of funds and securities associated with the clearance and settlement of securities and related margin lending on behalf of a broker-dealer and executes trades for itself and its customers. A carrying broker relationship is distinguished from a custody relationship by the fact that the bank is

[277] Exchange Act Section 3(a)(4)(B)(viii)(II) does not prohibit a bank from using the safekeeping and custody exception if the bank only acts as a carrying broker for government securities.

[278] Exchange Act Sections 3(a)(4)(B)(i)(VIII) and 3(a)(4)(B)(viii)(II). 15 U.S.C. 78c(a)(4)(B)(i)(VIII) and 15 U.S.C. 78c(a)(4)(B)(viii)(II).

[279] The legislative history indicates that the GLBA uses the terms ''carrying broker'' and ''clearing broker'' synonymously. *See* H.R. Rep. No. 106–74, pt. 3, at 169 (1999). (''The exception also will not apply to a bank that acts as a clearing broker in connection with securities transactions, except if the bank is acting in the U.S. as a clearing broker with respect to government securities.''). As the legislative history indicates:

''To ensure that an investor has SIPC protection for the securities that he or she purchases—protection that applies to the broker-dealer but not a bank—the broker-dealer that is part of a networking arrangement must carry the investor's account.'' H.R. Rep. No. 106–74, pt. 3, at 164.

There is a technical difference between a ''carrying broker'' and a ''clearing broker.'' A carrying firm knows the customer and is responsible for the underlying customer assets. A customer may clear elsewhere. As the Commission has explained, an introducing broker-dealer is one that has a contractual arrangement with another firm, known as the carrying or clearing firm, under which the carrying firm agrees to perform certain services for the introducing firm. Usually, the introducing firm submits its customer accounts and customer orders to the carrying firm, which executes the orders and carries the account. The carrying firm's duties include the proper disposition of the customer funds and securities after trade date, the custody of customer securities and funds, and the recordkeeping associated with carrying customer accounts. Exchange Act Release No. 31511 (Nov. 24, 1992), 57 FR 56973, 56978 (Dec. 2, 1992). *See also* NASD Rule 3230 regarding clearing arrangements (discussing the contractual requirements for all ''clearing or carrying agreements entered into by a member''); NYSE Rule 382 and American Stock Exchange Rule 400. As noted above, however, Congress used these terms interchangeably.

selected and its systems are utilized primarily by the broker-dealer rather than primarily by the customer. In a situation where the broker-dealer arranges for a substantial majority of its customers to use bank custody or deposit services of a bank, a carrying broker relationship may be established particularly if the bank performs clearance and settlement functions that the broker-dealer cannot perform economically or efficiently. In contrast, a bank would not be a carrying broker when it acts as custodian for a customer of a broker-dealer and responds to customer directions to deliver securities against payment or cash against receipt of securities.[280]

One commenter stated that the distinction between permissible clearing and settlement functions within the custody and safekeeping exception and impermissible ''carrying broker'' activities was not clear.[281] This commenter expressed concern about a bank's status when multiple customers may have bank accounts for which the bank provides investment management and custody services, as well as accounts with the bank's affiliated broker-dealer for which the bank is a custodian. In this commenter's view, a bank in this situation may inadvertently act as a carrying broker merely by having a large number of accounts, even if the accounts were originated primarily because of the bank's relationship with customers.[282]

A brokerage relationship can involve an introducing broker-dealer that accepts customer orders, a clearing or carrying broker-dealer that settles the customer orders,[283] and a custodian that holds the funds and securities on behalf of the carrying or clearing broker-dealer. The prohibition on banks acting as carrying brokers for registered broker-dealers predates the GLBA.[284] Only registered broker-dealers have been permitted to act as carrying or clearing brokers.[285] The statutes and rules governing securities transactions generally use the terms, ''carrying broker'' and ''clearing broker'' interchangeably.[286] Under these earlier provisions, and consistent with the Exchange Act condition on the networking and safekeeping and custody exceptions, banks are only permitted to act as carrying brokers with respect to government securities.[287] Thus the question arises as to what a carrying broker is and when would a bank be engaged in prohibited conduct.

Under the securities laws and rules, a carrying or clearing broker has higher minimum net capital requirements than a broker-dealer that does not handle customer funds and securities.[288] In addition, a carrying or clearing broker often provides securities recordkeeping, trade execution, and settlement services. A carrying or clearing broker relationship must be documented and, at a minimum, must specify the responsibilities of the introducing broker and the carrying or clearing broker.[289] Because the responsibilities of the carrying or clearing broker and the introducing broker are clearly set forth, securities customers are protected and the legal obligations of the parties can be determined in the event of a dispute.[290]

When a bank performs the back office functions of a broker-dealer, the bank is often acting as a carrying broker for the broker-dealer. A bank may be acting as a carrying broker if it also executes customers' securities transactions through a broker-dealer whose primary purpose is to support the bank, and whose back office functions reside in the bank.[291] For example, a bank could be a carrying broker by acting as a custodian, performing many back office functions for a broker-dealer, and entering into a networking arrangement on an omnibus basis with the broker-dealer.[292] In this situation, the business of the two entities would be so inextricably intertwined, and the bank would be providing so many different functions to the broker-dealer, that the bank could be said to be ''carrying'' the broker-dealer's accounts.

One bank trade group advised the Commission staff that bank custody departments typically do not open accounts with large numbers of broker-dealers. Instead, when a large bank opens an account with a broker-dealer, the broker-dealer frequently is a bank affiliate. A bank could be acting as a carrying broker if it uses an affiliated broker-dealer whose main purpose is to execute the securities transactions of the bank and the bank assumes other functions, such as clearing transactions with a clearing agency, that properly belong within the broker-dealer. The carrying broker question arises when a bank assumes more broker-dealer functions, and the broker-dealer is dependent upon the specific relationship established between the bank and the broker-dealer. Of course, a bank would not be acting as a carrying broker when a customer chooses the bank to act as custodian and the bank then uses a variety of broker-dealers to execute and clear the subsequent

[280] Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27780, n. 174.

[281] *See* PNC letter.

[282] *Id.*

[283] If a broker-dealer effects securities transactions for a customer, Exchange Act Rule 15c3–1(a)(2)(i) requires a broker-dealer to hold the customer assets and settle the securities transactions. *See also* 15 U.S.C. 78o(c)(3)(A).

[284] *See* Decision of the Comptroller of the Currency on the Application by Zions First National Bank, to Commence New Activities in an Operating Subsidiary, December 11, 1997, at n. 74. The Comptroller references a Commission comment letter on the Zions' application in this footnote, and states that the subsidiary has committed to comply with all applicable federal securities laws and regulations, including the Commission's financial responsibility regulations. In more detail than was repeated in the OCC's order, the Commission's letter stated,''[b]ecause the bank is not a broker-dealer, the Operating Subsidiary would be required to introduce to a registered broker-dealer its customers' transactions in Revenue Bonds, or to carry and clear those accounts itself in compliance with the Commission's financial responsibility regulations, including Rules 15c3–1 and 15c3–3 under the Securities Exchange Act of 1934.'' *See* letter from Jonathan G. Katz, Secretary, Commission, to Office of the Comptroller of the Currency at page 2 (Nov. 21, 1997).

[285] *See* 15 U.S.C. 78o(c)(3)(A), Exchange Act Rule 15c3–1(a)(2)(i), NASD Rule 3230, Clearing Agreements and NYSE Rule 382.

[286] *Id.*

[287] 15 U.S.C. 78c(a)(4)(B)(viii)(II).

[288] *See* Exchange Act Rule 15c3–1(a)(2)(i).

[289] *See* NASD Rule 3230, Clearing Agreements and NYSE Rule 382, which set forth the following requirements to specify the responsibility of the introducing broker and the carrying or clearing broker: (1) opening, approving and monitoring customer accounts; (2) extension of credit; (3) maintenance of books and records; (4) receipt and delivery of funds and securities; (5) safeguarding of funds and securities; (6) confirmations and statements; and (7) acceptance of orders and execution of transactions. For purposes of the financial responsibility rules and SIPC, customers are customers of the clearing broker. Furthermore, each customer whose account is introduced on a fully disclosed basis must be notified in writing upon the opening of the account or the existence of the agreement and the relationship between the introducing and the carrying broker.

One way to divide the responsibilities of an introducing and a clearing broker-dealer is to list the front office activities conducted by an introducing broker-dealer (items one and seven above) as compared to the back office activities conducted by a clearing broker-dealer (items two through six above).

[290] For example, if either party were to become insolvent, the rights and obligations of the solvent party, the Securities Investor Protection Corporation, and the customers could be determined under the terms of the written agreement. Without this kind of clear documentation, a carrying or clearing broker relationship could result in chaos if one of the parties were to become insolvent, or in the event of any dispute over their respective responsibilities and obligations. This kind of dispute or insolvency may unnecessarily harm customers, or the Securities Protection Investors Corporation.

[291] *See supra* note 289 for an explanation of ''front office'' versus ''back office'' functions.

[292] This would be especially true if that broker-dealer does not engage in business other than executing securities transactions for the bank. Exchange Act Section 3(a)(4)(B)(vii) permits banks to enter into networking arrangements with broker-dealers on the basis that all customers that receive the services are fully disclosed to the broker-dealer. A bank relying on the networking exception may not, however, act as a carrying broker.

Broker-dealers could, of course, continue to use banks to fulfill their customer segregation requirements as provided in Exchange Act Rules 15c3–3(c)(5), 15c3–3(e)(1), and 15c3–3(k)(2)(i).

securities transactions as permitted by the safekeeping and custody exception.[293]

We solicit comment on whether we should adopt a rule setting forth specific factors to clarify the distinction between a bank acting as a carrying broker and a bank acting as a custodian. Some of the factors we would consider including in a rule as indications of whether a bank is acting as a carrying broker are: (1) A bank having opening, approving and monitoring control over the broker-dealer's customer accounts; (2) a bank extending credit to the broker-dealer's customers; (3) a bank maintaining the broker-dealer's books and records; (4) the bank receiving and delivering the broker-dealer's funds and securities; (5) the bank safeguarding the funds and securities of the broker-dealer's customers; (6) the bank preparing and issuing the broker-dealer's confirmations and statements; (7) the bank accepting the customer's orders; and (8) the bank arranging for the execution of the customer's transactions. We invite comment on whether there are any other factors that should be considered in determining whether a bank is acting as a carrying broker.

4. Comments on and Proposed Amendments to the Small Bank Custody Exemption

The Exchange Act exceptions from the definition of ''broker'' apply equally to all banks. To help alleviate possible administrative burdens imposed on small banks by the GLBA, current Exchange Act Rule 3a4–4 provides a limited exemption from the definition of ''broker'' under Exchange Act Section 3(a)(4) to permit small banks to receive transaction-based compensation for effecting transactions in investment company securities held in tax-deferred custodial securities accounts, such as custody IRAs.[294]

Exchange Act Rule 3a4–4 is available to banks with less than $100 million in assets and that are not part of bank holding companies with consolidated assets of more than $1 billion.[295] Compensation from securities transactions effected under this exemption may constitute up to three percent of a small bank's annual revenue. The exemption is only available to small banks offering custody accounts that do not have affiliated broker-dealers or networking arrangements with registered broker-dealers. The exemption is also subject to restrictions on solicitation, staffing, and employee incentive compensation.

We received several comments regarding the small bank custody exemption. Commenters criticized many aspects of the exemption asserting, among other things, that its conditions limit the exemption's usefulness.[296] In particular, commenters contended that the $100 million asset limit is too low. Some commenters recommended increasing the asset limit to $250 million, noting that the Banking Agencies, for purposes of the Community Reinvestment Act, define a small bank as one with less than $250 million in assets.[297] In later discussions with Commission staff, the ICBA recommended increasing the asset limit to $500 million. Some commenters asserted that the three percent limit on annual revenue would severely constrain small banks from receiving compensation for order taking services.[298] Commenters also objected to the restriction on utilizing networking arrangements with registered broker-dealers to effect securities transactions for a bank's customers in conjunction with the exemption.[299]

In response to comments, we propose to amend Exchange Act Rule 3a4–4, which would be redesignated as Exchange Act Rule 761, to expand the exemption's usefulness to small banks while minimizing their potential compliance costs. In particular, as discussed in detail below, we propose to raise the eligibility limit from banks with $100 million in assets to banks with $500 million in assets. In addition, we propose to eliminate the exemption's staffing restrictions. We propose to retain, however, the requirement that a bank may not be affiliated with a bank holding company that has more than $1 billion in assets. We also propose to limit the availability of the exemption to banks that have less than $100,000 in annual ''sales compensation'' and that do not have affiliated broker-dealers. This proposed exemption would be available for transactions in any type of security held in an account for which the bank acts as a custodian.

The small bank exemption, with the proposal modifications, reflects a balance between making it available to more banks while also assuring that these banks' securities activities are largely effected through registered broker-dealers, consistent with the functional regulation mandate in the GLBA. The conditions are designed to permit small banks to use a limited securities sales channel without meeting the licensing, sales practices, and other requirements that apply to registered broker-dealers.

In proposing these amendments, we have evaluated the benefits to small banks against the risk to investors of not receiving protections under the Exchange Act and SRO rules. We have also considered whether the proposed conditions could tilt the level playing field between securities market participants that Congress sought to establish with functional regulation. In particular, we have considered the competitive effect the scope of this proposed exemption may have on small broker-dealers. Commenters are invited to discuss whether this proposal strikes the right balance.

*a. Bank Asset Size Limit*

We propose to increase significantly the number of banks that potentially could utilize the small bank custody exemption by amending the definition of ''small bank'' to mean a bank with less than $500 million in assets.[300] We

[293] This interpretation does not affect the ability of a bank to act as a good ''control location'' of fully-paid and excess margin securities of customers pursuant to Exchange Act Rule 15c3–3(c). A broker-dealer is deemed to have control of securities under Rule 15c3–3(c)(5), if the securities:

are in the custody or control of a bank as defined in Section 3(a)(6) of the Act, the delivery of which securities to the broker or dealer does not require the payment of money or value and the bank having acknowledged in writing that the securities in its custody or control are not subject to any right, charge, security interest, lien or claim of any kind in favor of a bank or any person claiming through the bank * * *.

Under Exchange Act Rule 15c3–3(c), only a broker-dealer may have access to the securities held at a bank that is a good ''control location.''

[294] 17 CFR 240.3a4–4.

[295] The Interim Rules use the $1 billion limit for small bank holding companies because the Federal Reserve Board has categorized these companies as ''small, noncomplex bank holding companies'' for the purposes of determining the type of supervisory review that they receive. *See* Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27782 (citing the 1999 Federal Reserve Annual Report at 122). *See also* 2003 Federal Reserve Annual Report at 87.

[296] *See* ABA/ABASA letters; ICBA letter; IIB letter, Compass letter; and Trust Financial Services Division of the Texas Bankers Association letter.

[297] *See* ICBA letter and ABA/ABASA letters. *See also* Virginia Bankers Association letter (asserting the $100 million dollar asset limit is ''too narrow'').

[298] *See* ABA/ABASA letters; Banking Agencies letter; and ICBA letter.

[299] *See, e.g.*, Banking Agencies letter and ICBA letter.

[300] The Banking Agencies have recently proposed to raise the small institution asset limit of the Community Reinvestment Act from $250 million to $500 million, without reference to holding company assets. *See* 69 FR 5729 (Feb. 6, 2004). We do not consider this proposal relevant for purposes of setting the asset limit for this exemption because of the very different legislative purposes of the Community Reinvestment Act and the Exchange Act. The asset limit increase recently proposed by the Banking Agencies addresses a bank's responsibilities under the Community Reinvestment Act, while the asset limit increase we propose addresses whether a small bank must register as a broker-dealer to effect securities transactions for its custody customers.

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propose, however, to retain the requirement that such a bank may not be an affiliate of a bank holding company or a savings and loan holding company with more than $1 billion in consolidated assets in the two prior calendar years.[301]

A $500 million asset limit would greatly expand the availability of this exemption, increasing the number of potentially eligible banks and thrifts from 4,359 (or approximately 48 percent of all banks and thrifts insured by the FDIC) to 8,021 (or approximately 88 percent of all FDIC insured banks and thrifts).[302] We solicit comment on the proposed amendment to the definition of small bank. We also solicit comment regarding whether an eligibility test based on deposits rather than assets would be better suited for an exemption targeted to small banks. Should the $500 million asset limit be adjusted for inflation? If so, what measure of inflation should be used?

*b. Annual Sales Compensation Limit*

We propose to replace the current three percent annual revenue limit with an annual ''sales compensation'' limit of $100,000 for effecting securities transactions in reliance on this exemption. Sales compensation would include compensation that a bank receives for a securities offering that the bank does not receive directly from a customer, beneficiary, or the assets of the trust or fiduciary account, such as Rule 12b–1 fees.[303] We anticipate that most sales compensation would be composed of Rule 12b–1 fees. Sales compensation could also include revenue sharing arrangements with mutual funds or commissions for securities trades that include a profit. Sales compensation, however, would not include fees for holding custody of a customer's funds and securities that do not vary based on whether orders for securities are accepted by the broker. In addition, the proposed rule provides that this $100,000 annual limit on ''sales compensation'' that the bank receives pursuant to this exemption would be adjusted for inflation so that this exemption remains useful to small banks in years to come.[304]

The $100,000 annual ''sales compensation'' limit should provide those banks that occasionally effect transactions in securities as an accommodation in their custody relationships with sufficient flexibility to continue to serve the needs of their customers without requiring the banks to register as brokers.[305] We solicit comment on the proposed $100,000 ''sales compensation'' limitation.

Commenters are invited to share information about how small banks assess custody fees. With respect to each type of customer with a custody relationship with a small bank, small banks are invited to discuss: (1) The types of securities that the bank purchases or sells for these customers; (2) all of the types of compensation that the bank receives in connection with its custody activities related to different types of such customers; (3) whether custody fees vary depending on whether small banks sell non-custody products and services to customers; and (4) whether small banks are compensated in other ways for custody accounts or relationships.

In particular, we seek comment regarding the amount of ''sales compensation'' that small banks receive for effecting transactions in securities for customers with whom they have a custody relationship. We seek comment regarding the percentage of custody revenue that small banks obtain from Rule 12b–1 fees. Commenters are invited to discuss whether small banks receive significant sales compensation outside of Rule 12b–1 fees, such as from revenue sharing arrangements for mutual funds held for custody customers or through commissions for securities trades that include a profit. Commenters should note if their answer varies depending on whether the custody accounts are for: (1) Companies; (2) market professionals; (3) individual private banking clients; or (4) clients holding IRAs. We seek comment on whether small banks would find it difficult to calculate the total amount of Rule 12b–1 fees they would receive on an annual basis in connection with this exemption.

We invite comment on whether the sales compensation limit should be set at a different level. Would a different limit on sales compensation such as $50,000 be more appropriate for an exemption designed to be used only by small banks? Should the limit be higher? Commenters that believe that this limit on sales compensation should be more than $100,000 should provide empirical data supporting this assertion. We request comment about the inflation-adjusted aspect of this condition. Is linking it to the Consumer Price Index All Urban Consumers published by the Department of Labor appropriate or should another measure of inflation be used?[306] The Commission is also interested in information regarding the types of securities transactions that a bank likely would effect at these different revenue levels.

We invite comment on whether particular types or sources of revenues should be excluded, temporarily or permanently, from the $100,000 sales compensation limit. For example, should Rule 12b–1 fees that small banks

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The Interim Rules incorporate the definition of ''small bank'' used by the Small Business Administration (''SBA'') because it was a definition determined by an independent third agency. One option would be to raise the asset limit for this exemption to $150 million because the SBA raised its size standards for small banks from $100 million to $150 million since the Interim Rules were adopted. *See* 13 CFR 121.201. *See also* Small Business Size Standards, Inflation Adjustments to Size Standards, 67 FR 3041 (Jan. 23, 2002). Increasing the asset threshold to $150 million would expand the availability of this exemption to approximately 63 percent of all banks and thrifts insured by the FDIC.

However, the ABA and the ICBA have advised the Commission staff that few banks with assets of less than $150 million actually hold custody of customers' securities. They have indicated that a $500 million standard would be more useful. Because we believe that this exemption should be one that small banks having custody of securities can use, we have adopted the suggestion of the ABA and the ICBA and propose to increase the asset threshold for the proposed Exchange Act Rule 761 to $500 million.

[301] The requirement of two prior calendar years is a condition of current Exchange Act Rule 3a4–4. We received no comments on this requirement. It is intended to preclude short-term business changes from affecting a bank's reliance on this provision.

We propose a technical amendment to add savings and loan holding companies to bank holding companies. Because a new bank, bank holding company, or a savings and loan holding company would have no assets in either one or both of the two prior calendar years, a bank would qualify for the exemption for at least the period of time in which it had no assets.

[302] A smaller percentage than 88 percent of banks and thrifts would be able to use this proposed exemption because other conditions of this proposed exemption require that these banks cannot be affiliated with a bank holding company or a savings and loan holding company with consolidated assets of more than $1 billion and cannot be affiliated with a registered broker-dealer.

[303] *See* section III.B. *supra.*

[304] As of December 1, 2003, three percent of the annual revenue of an average bank with $500 million in assets was $183,570; for an average bank with $250 million in assets it was $131,010; and for an average bank with $150 million in assets it was $97,770. The proposed revenue limitation is necessary because some banks that would qualify for the proposed exemption have extremely high revenues in relation to total assets. For example, the Commission staff reviewed Schedule RC (''Consolidated Report of Condition'') and Schedule RC–I (''Consolidated Report of Income'') (Form FFIEC 041) of a bank that has assets of approximately $354 million but revenue of approximately $493 million. Some banks with $500 million or less in assets appear to be almost exclusively in the securities business, and these banks could potentially operate a large introducing broker-dealer within the bank without an overall revenue limitation such as the one we are proposing.

[305] The $100,000 limit was selected based on information the Commission staff received from a bank trade association. This information indicated that the proposed limit should accommodate small banks' existing business.

[306] *See* proposed Exchange Act Rule 761(c).

receive as a result of mutual fund sales that took place before the date of this proposal be excluded from the $100,000 sales compensation limit? If yes, please explain why. Should there be any limitations on such excluded revenue? Should revenues received from the sale of other types of securities be excluded from the $100,000 limit? If so, why?

*c. Other Conditions*

*1. Solicitation*

We propose to simplify the solicitation restrictions in current Exchange Act Rule 3a4–4 to permit small banks effecting securities transactions pursuant to this exemption to publicly solicit brokerage business as permitted by the trust and fiduciary activities exception.[307] The trust and fiduciary exception permits small banks to solicit brokerage business by advertising that they effect transactions in securities in conjunction with advertising their other trust activities.[308] This restriction on solicitation of securities transactions for custody accounts would not apply to securities transactions that are not effected pursuant to this proposed exemption.

We request comment on this proposed amendment to the small bank custody exemption. We are particularly interested in comments regarding how small banks market custody services to potential clients. We also request comment on the extent to which small banks inform those customers with whom they have custody relationship about securities. For example, do small banks provide these customers with recommended lists, watch lists, research reports, or other publications highlighting securities or groups of securities? Do small banks offer asset allocation advice, and, if so, do they suggest possible investments to achieve asset allocation goals? Do small banks recommend specific securities—or classes of securities—to such customers? Do small banks recommend specific trading strategies to these customers? Do small banks provide investment advice to such customers? How do small banks offer particular classes or series of mutual funds to their customers with whom they maintain a custody relationship? Finally, we solicit comment regarding whether we should adopt disclosure requirements similar to the proposed general disclosure requirements in proposed Exchange Act Rule 776.

*2. Securities Networking*

Commenters criticized the provision in Exchange Act Rule 3a4–4 that excluded banks that had a networking relationship with a broker. They argued that permitting small banks to have networking arrangements with third-party broker-dealers would allow banks to offer the services of a broker to their customers (the networking arrangement), while still allowing banks to conduct some transactions in-house.[309] We propose to replace that restriction with one that restricts a small bank from affiliating with a broker-dealer. Permitting banks to have networking arrangements with registered broker-dealers will greatly increase the utility of this exemption to small banks. Banks with a registered broker-dealer affiliate, however, have demonstrated their ability to put in place the infrastructure of a regulated broker-dealer to serve their customers, which can be used for other securities activities of bank customers. Small banks that have networking arrangements with broker-dealers are particularly invited to discuss whether this provision would be workable for them, and to suggest alternative provisions that might be more workable. We request comment on the proposal to replace the networking restriction in current Exchange Act Rule 3a4–4 with a restriction on having an affiliated broker-dealer. We also solicit comment on the number of small banks that have an affiliated broker-dealer.

*3. Employee Staffing Restrictions*

Commenters criticized the provision in the Interim Rules that prohibits bank employees from also being employees of a broker-dealer, asserting that having such dual employees allows banks to better serve the investment needs of retail customers with whom bank employees come into contact while performing their banking custodial responsibilities.[310] In response to this comment, we propose to permit small banks to use dual employees with broker-dealers.

Commenters also criticized the requirement that any bank employee must primarily have duties other than conducting securities transactions, arguing that this requirement is contrary to proper internal controls.[311] This requirement was designed to prevent banks from developing dedicated securities sales forces outside of the safeguards of the sales practice rules applicable to broker-dealers. We understand, however, that it would ease small banks' compliance burdens if specialized employees could be used to effect securities transactions for bank customers in the context of this exemption. We also understand that specialized employees may improve operational economies. Therefore, we propose to permit banks to use a dedicated bank sales force to effect transactions in securities under this exemption. This dedicated sales force may consist of either unregistered personnel or registered representatives employed by both a broker-dealer and the small bank seeking to qualify for the exemption.

We solicit comment with regard to these proposed amendments to the employee staffing restrictions for the small bank custody exemption. Commenters are particularly invited to discuss how small banks utilize personnel to effect securities transactions.

*4. Employee Compensation Restriction*

Some commenters expressed concern regarding the rule's restriction on payment of incentive compensation to bank employees for the sale of securities.[312] We propose to retain this restriction but to clarify that small banks may pay their employees incentive compensation pursuant to a networking arrangement that meets the conditions of Exchange Act Section 3(a)(4)(B)(i).[313] This condition encompasses payment of incentive compensation both to unregistered employees and to employees who are registered representatives.[314]

We request comment on this proposed amendment to the small bank custody exemption. Commenters are invited to discuss how small bank employees are compensated. For example, how much incentive compensation would a typical small bank employee receive in a year from making referrals to a broker-dealer via a networking arrangement? How much could a small bank employee earn in a year from this activity if he or she made so many referrals as to be in the top one percent of employees referring customers to broker-dealers?

*5. Investment Company Shares for Tax-Deferred Accounts*

Commenters also criticized the small bank custody exemption because it only applies to transactions in investment company shares for the benefit of tax-

[307] The Commission interprets solicitation broadly in the context of securities transactions. *See* Exchange Act Release No. 27017, *supra note* 86, 54 FR 30013.

[308] *See* Exchange Act Section 3(a)(4)(B)(ii)(II).

[309] *See, e.g.*, ICBA letter and Banking Agencies letter.

[310] *See* ABA/ABASA letters.

[311] *See* ICBA letter and Frost letter.

[312] *See* ICBA letter and BSA letter.

[313] *See* proposed Exchange Act Rule 761(e).

[314] *See* section III.B. *supra.*

deferred accounts.[315] One commenter suggested that the exemption should not be limited to providing order taking services for clients seeking to purchase mutual funds, but should be expanded to include tax-deferred accounts holding corporate debt and equity securities.[316] Other commenters suggested that the Commission eliminate the requirement that banks offering proprietary mutual funds also offer nonproprietary mutual funds.[317] To provide small banks and their customers more flexibility, we propose to expand the scope of this exemption to allow small banks to effect transactions in all securities, not just shares of investment companies. In addition, we are proposing to expand this exemption to apply to custodial accounts in general by eliminating the requirement that transactions pursuant to this exemption must be for tax-deferred accounts. Finally, we propose to permit small banks to offer proprietary mutual funds without the requirement that banks also offer nonproprietary mutual funds.

We solicit comment regarding how small banks select the mutual funds they offer to their custody customers, and the extent to which they limit offerings to proprietary funds. We also invite comment regarding the effect on investor protections of this proposed expansion of the securities transactions permitted under the exemption. Moreover, we are also interested in receiving comment on this exemption for small banks in light of the proposed ERISA exemption available to all banks. Do commenters believe that exempting bank trustees and non-fiduciary administrators that effect transactions in securities of open-end companies for participants in employee benefit plans from the definition of broker eliminates the need for the amendments being proposed to the small bank custody exemption?[318] In other words, do commenters believe that the small bank custody exemption will be used for securities transactions in securities other than investment company securities or for accounts other than IRA custody accounts?

*d. Trustee and Fiduciary Activity Accounts*

A small bank that has trust and fiduciary activity accounts may use the small bank custody exemption provided that it does not rely on any other of the trust and fiduciary exemptions in the Rules.[319] In other words, banks could elect to effect transactions for trust and fiduciary activity accounts under this exemption. The sales compensation that a bank would receive from these transactions would count towards the $100,000 annual limit. If small banks elect to utilize this exemption to effect securities transactions for trust and fiduciary activity accounts, they would avoid all calculation and other requirements of the trust and fiduciary exemptions—except in particular accounts where they elect to rely on the statutory test without utilizing any safe harbors. We understand that up to 85 percent of small banks may be able to avoid any other ''chiefly compensated'' comparison by using this proposed exemption.

*e. Availability of Exemption to Non-Depository Trust Companies*

An industry group representing non-depository trust companies complained that the small bank custody exemption is not workable for its members.[320] According to this commenter, because trust companies do not earn revenue from loan payments, the three percent annual revenue limit would not permit them to continue to effect transactions in securities.[321] While we do not propose specific amendments to address non-depository trust companies, the proposal to amend Exchange Act Rule 3a4–4 to replace the three percent limit on ''annual compensation'' with an annual sales compensation limit of $100,000 should address this comment. We seek comment on whether replacing the three percent annual revenue limit with the $100,000 annual limit on sales compensation addresses any competitive disadvantages that non-depository trusts might have with regard to small banks as a result of the small bank custody exemption.[322]

*f. Request for Comments*

We solicit comment on the small bank exemption in proposed Exchange Act Rule 761. In particular, we are soliciting comments on the Commission's proposal to raise the eligibility limit from $100 million to $500 million in assets. What would the impact of such a change have on the percentage of banks that could qualify for the exception? Should the threshold be higher or lower than $500 million? Commenters should provide a detailed discussion, including data, if available, to support a higher or lower standard. We also solicit comment on whether banks anticipate effecting transactions in securities as custodians for health savings accounts and whether this proposed exemption would accommodate this business.

In addition, we are soliciting comment on whether the proposed exemption would place small broker-dealers at a competitive disadvantage vis-á-vis small banks.

*F. General and Special Purpose Exemptions*

1. General Exemption

In response to requests by some commenters that the Commission provide banks with greater flexibility to provide cash management services to their customers, we are proposing a general exemption, not tied to any of the GLBA exceptions, that would, subject to certain conditions, allow banks to buy and sell money market securities for bank customers who are ''qualified investors,'' [323] a person who directs the purchase of securities from any cash flows that relate to an asset-backed security that has a minimum original asset amount of $25,000,000, and for other customers for whom banks act in a trustee or fiduciary capacity, or in an escrow agent, collateral agent, depository agent, or paying agent capacity.

The new exemption, which would be contained in proposed Exchange Act Rule 776, is based in part on requests from some commenters on the Interim Rules that the Commission provide more flexibility with respect to the services banks could offer to their customers for whom they act in capacities such as indenture trustee, escrow agent, or paying agent.[324] Similarly, commenters and other industry representatives have indicated to Commission staff that banks desire

[315] *See* ICBA letter and ABA/ABASA letters.

[316] *See* ABA/ABASA letters.

[317] *See* Compass letter and Frost letters.

[318] *See* section III.F.2 *supra* (proposed ERISA exemption).

[319] *See* proposed Exchange Act Rule 761(d).

[320] *See* Association of Independent Trust Companies letter.

[321] This commenter stated that its trust company members typically have assets under management of between $50 million and $500 million and may, in some cases, have in excess of $1 billion in assets under management. *See id.*

[322] One commenter asked that we extend current Exchange Act Rule 3a4–4 to include small insurance agencies and insurance brokerage, arguing that these entities will be at a competitive disadvantage in the financial services marketplace if they do not also receive an exemption. *See* letter dated September 4, 2001 from Scott Sinder and Douglas S. Kantor, Counsel to the Council of Insurance Agents & Brokers. We are not proposing to extend this exemption to include these entities because, in contrast to banks, insurance agencies and insurance brokerages historically have not held customer assets, in connection with securities transactions or accepted customer orders as an accommodation to custer without using registered broker-dealers.

[323] ''Qualified investor'' is defined in Exchange Act Section 3(a)(54). 15 U.S.C. 78c(a)(54).

[324] *See, e.g.,* ABA/ABASA letters and Federated letters.

more flexibility to offer clients with particular cash management needs shares in money market funds that may pay more than 25 basis points in 12b–1 fees.

The Commission is sensitive to commenters' requests that banks be given greater flexibility in offering some of their customers a wider range of cash management services that include investing in money market funds that may include investing in money market fund shares that do not qualify as ''no-load.'' We believe that this enhanced flexibility could be granted to banks and would also be consistent with the Exchange Act investor protection principles with respect to these limited securities transactions that this proposed exemption contemplates.

Accordingly, the exemption in proposed Exchange Act Rule 776 would permit banks to make available money market funds for cash management purposes to customers that have particular cash management needs and that prefer to compensate banks for these or other services through Rule 12b–1 fees, or through a combination of Rule 12b–1 fees and other fees. For example, banks would be able to continue to provide these cash management services when the bank is acting as an indenture trustee for a municipality that needs to invest bond proceeds on a short-term basis or as escrow agent for corporations that need to invest funds pending the consummation of a corporate transaction.

We would limit the availability of the proposed exemption to certain investors. For purposes of the proposed exemption, a ''qualified investor'' would be identified as a qualified investor within the meaning of Exchange Act Section 3(a)(54). We include qualified investors because Congress already determined that investors in this category were able to engage in some transactions directly with banks that would not generally be available to other investors.[325] We would also permit a bank to use the exemption with respect to a person who directs the purchase of securities from any cash flows that relate to an asset-backed security that has a minimum original asset amount of $25,000,000. We selected a minimum $25,000,000 in original asset amount for qualifying for this exemption because we believe that it is consistent with minimum of $25,000,000 in investments found in many of the categories of qualified investor. We elected to make this $25,000,000 requirement applicable only to the original asset amount, so that the bank would not have to monitor the size of the remaining asset pool every time it entered into a sweep transaction with a person who directs the purchase of securities from any cash flows that relate to an asset-backed security. We believe that this description of the second category of persons should be broad enough to accommodate asset-backed securities issuers, such as certain small state and local governmental entities that use these kinds of sweep investments. Bank representatives suggested to Commission staff that these types of issuers of asset-backed securities be included under an exemption, such as the one found in proposed Exchange Act Rule 776, although many of these issuers may not meet the definition of qualified investors under Exchange Act Section 3(a)(54). We request comment on whether the proposed exemption is appropriate in its coverage, including the selected minimum $25,000,000 in original asset amount. If commenters believe that minimum qualifying amount should be changed, we request that commenters provide us with specific information on what the amount should be and why. We also request comment on whether the proposed exemption should be expanded to cover additional types of investors, such as commercial depositors that may not be qualified investors under Exchange Act Section 3(a)(54).

The exemption would be limited to certain, specified securities. The money market fund shares in which a bank could effect transactions in reliance on the exemption would have to belong to a ''no-load'' class or series of the fund's shares, or, alternatively, the bank would not be permitted to characterize or refer to the shares as ''no-load.'' A bank relying on the exemption to effect transactions in money market fund shares that do not qualify as ''no-load'' for customers (other than ''qualified investors'' and persons who direct the purchase of securities from any cash flows that relate to an asset-backed security that has a minimum original asset amount of $25,000,000) also would have to provide to these customers a fund prospectus and a clear and conspicuous notice disclosing payments the bank may receive in connection with the transactions from the fund's fund complex.[326] This notice would also be required to refer the customers to the fund prospectus for additional information regarding expenses. These conditions are designed to assure that a customer of a bank relying on the exemption would have sufficient information upon which to make an informed decision. We request comment on whether the proposed exemption should be conditioned on additional disclosures, and invite any commenters who believe the exemption should be expanded to cover transactions for additional types of investors to comment on whether such transactions should be conditioned on enhanced disclosures. In particular, we invite comment on whether the conditions under which banks may rely on the exemption should include disclosure obligations with respect to fees banks charge directly to their customers, such as rate spreads or retained yield fees. We also request comment on whether it is appropriate not to require that the additional disclosures for ''qualified investors'' and persons who direct the purchase of securities from any cash flows that relate to an asset-backed security that has a minimum original asset amount of $25,000,000.

We considered whether to extend the proposed exemption to cover transactions for additional types of bank customers. Most such customers, however, do not have the same specific cash management needs as the customers that we have identified. Moreover, we remain concerned that additional types of customers may be more vulnerable than the types of customers identified in the proposed exemption to being misled regarding the costs of their investments.[327] As a

[325] For example, the asset-backed transactions exception from the definition of dealer only permits a bank to issue and sell securities through a grantor trust or other separate entity to qualified investors. *See* Exchange Act Section 3(a)(5)(C)(iii). 15 U.S.C. 78c(a)(5)(C)(iii).

[326] The term ''no-load'' is defined in proposed Exchange Act Rule 740(c), which amends the definition of the term in current Exchange Act Rule 3b–17(f). Under the proposed definition, with certain exceptions, a class or series of a fund's securities would be considered no-load if it is not subject to a sales load or a deferred sales load and charges against net assets for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts do not exceed 25 basis points. The notice that would have to be provided to investors, other than qualified investors, in load money market fund shares under the proposed exemption would have to identify separately any payments to the bank that are a ''sales load'' or a ''deferred sales load,'' as those terms are defined in proposed Exchange Act Rule 740, or a fee paid pursuant to a plan under Rule 12b–1 under the Investment Company Act (17 CFR 270.12b–1).

[327] The services covered by the proposed exemption would involve fee-related issues similar to those raised by sweep accounts offered to retail investors. Sweep account fees can represent significant costs for retail investors, and sweep account customers have sued banks over excessive fees. However, cases in which investors

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result, the proposed exemption would apply only to ''qualified investors'' and certain other customers who already use a bank for trust or fiduciary services, or for the agency services identified in proposed Exchange Act Rule 776.

Bank representatives have told Commission staff that some banks have existing business practices that include investments in a broader range of securities. We request comment on whether the proposed exemption should be extended to cover funds that are not money market funds and whether extending the exemption to these other funds would accommodate existing bank practices that would not otherwise be covered by one of the proposed exemptions or exceptions. It would be particularly helpful if any such comments identified and described mutual funds, other than money market funds, that banks would be unable to continue using for customers under the other exceptions or exemptions, as well as how much the banks currently invest in these other funds on behalf of customers that would qualify for this exemption. We also ask commenters to provide us with information on whether the 12b–1 fees generated by those funds are currently offset against bank fees. Would a custodial exemption that required that fees be offset, such as that proposed for ERISA activities, be appropriate?

Finally, we request comment generally on the exemption contained in proposed Exchange Act Rule 776. Commenters are specifically invited to discuss whether the proposed exemption should be limited to particular types of money market funds or to specific types of investors within the categories described in the proposed exemption, and, if so, under what conditions. Commenters that believe the proposed exemption should be expanded should also explain why any proposed expansion of the proposed exemption would be consistent with the protection of investors.

2. Employee Benefit Plan Exemption

The Exchange Act does not specifically exclude from broker-dealer registration banks that administer employer-sponsored retirement plans.[328] While banks do not typically charge plan participants directly for the cost of plan administration, banks may be compensated through Rule 12b–1 fees and other fees that meet the ''sales compensation'' definition in current Exchange Act Rule 3b–17. Because of this compensation arrangement, banks that administer these retirement accounts often cannot meet the requirement in the trust and fiduciary activities exception to be ''chiefly compensated'' through relationship fees.[329]

We propose conditionally to exempt from the definition of broker bank trustees and non-fiduciary administrators that effect transactions in securities of open-end companies for participants in employee benefit plans. A bank relying on this proposed exemption would be required to offset or credit any compensation it received from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes to the bank. While ERISA permits banks to receive Rule 12b–1 compensation from mutual funds that they offer to plan sponsors, banks have advised the Commission staff that they offset or credit any compensation received from mutual funds against plan expenses.[330] A dollar-for-dollar offset or credit would address the conflict of interest that banks would otherwise have when choosing particular funds to offer to plan sponsors.

In addition, the exemption in proposed Exchange Act Rule 770 would require the bank to disclose clearly and conspicuously to the plan sponsor or its designated fiduciary, if any, all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex.[331] The disclosures would need to be made in a manner that permits the plan sponsor or its designated fiduciary to determine that the bank has offset or credited any fees or expenses received from a fund complex related to securities in which plan assets are invested against the fees and expenses that the plan owes to the bank.

These disclosure requirements are intended to ensure that banks relying on the exemption provide their customers with information on their compensation and offsets that makes the disclosure of fees charged more transparent and easier to compare for plan sponsors or their designated fiduciaries.[332] As we have discussed before, investors need to know about the fees associated with these investments because these fees directly affect the amount of their returns.[333] This information should be transparent to purchasers of ERISA plans so that they can make ''apples to apples'' comparisons.[334]

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unsuccessfully sued banks over excessive sweep fees indicate that retail investors do not have a private right of action for excessive sweep account fees under the federal banking laws. *See, e.g., In re Fidelity Bank Trust Fee Litigation,* 839 F. Supp. 318 (E.D. Penn. 1993). In addition, some courts have considered the anti-fraud protections of the federal securities laws inapplicable to excessive sweep account fees due to the extensive regulation of deposit accounts under the federal banking laws. *See, e.g., Simpson* v. *Mellon Bank,* 1993 U.S. Dist. LEXIS 17994 (E.D. Penn. Dec. 17, 1993).

[328] As of 2003, these plans accounted for $2.1 trillion in mutual fund assets. They, therefore, are an important vehicle through which ordinary Americans invest in securities. Investment Company Institute, 2003 Mutual Fund Fact Book at 47.

[329] For example, banks administering small plans advised the Commission staff that they often bundle their fees by offering Class C shares with one percent Rule 12b–1 fees. Banks that offer Class C shares to smaller plans do so in part to compete with insurance companies that are more prevalent in the small plan market and bundle their fees. Class B shares often carry relatively high 12b–1 fees, but may automatically convert into Class A shares (which generally carry lower 12b–1 fees) several years after purchase. Class C shares also generally carry relatively high 12b–1 fees, and usually do not automatically convert to a class of shares with lower 12b–1 fees. Because Class C shares do not automatically convert to a share class associated with lower 12b–1 fees, post-first year compensation for selling Class C shares may be particularly significant. *See, e.g.,* Release Nos. 33–8358, 34–49148, IC–26341 (Jan. 29, 2004) supra note 130, 69 FR 6438 at 6453, n. 97 and 101 (Feb. 10, 2004).

[330] Banks advised the Commission staff that they do a dollar-for-dollar offset, or credit, of the compensation they receive from the funds that they offer to plans against the fees imposed on the plans themselves. In this way, the bank avoids having a conflict of interest in selecting the funds in which plan participants invest.

This dollar-for-dollar offset practice is consistent with guidance issued by the Department of Labor (''DOL''). *See* ERISA Advisory Opinion 97–15A (available at: *http://www.dol.gov/ebsa/programs/ori/advisory97/97–15a.htm).* In that opinion, a bank acting as a directed trustee that reserved the right to add, delete, or substitute individual mutual funds or fund families within the investment menu that it made available to plans and applied the mutual fund fees received for the benefit of the plans. Because this bank applied the mutual fund fees for the benefit of the plans, either as a dollar-for-dollar offset against the fees that the plans paid for trustee and recordkeeping services, or as amounts credited to the plans, the DOL viewed the bank as not engaging in self dealing under 29 U.S.C. 406(b)(1) or (b)(3). At all times, the terms of the bank's fee arrangements with the mutual fund companies was fully disclosed to the plans. Although DOL also issued ERISA advisory opinion 97–16A (available at: *http://www.dol.gov/ebsa/programs/ori/advisory97/97–16a.htm),* no bank has advised the Commission staff that it does not apply mutual fund fees for the benefit of the plans.

[331] The term ''fund complex'' would be defined in proposed Exchange Act Rule 770(b)(1).

[332] This requirement is consistent with our proposal to increase transparency regarding mutual fund fees and expenses. *See, e.g.,* Exchange Act Release No. 49148, *supra note* 130.

[333] *Id.*

[334] It is very difficult for a plan sponsor to compare fees across plans because plan vendors have 80 different ways of charging plan fees. *See* Economic Systems, Inc, Study of 401(k) Plan Fees and Expenses (April 13, 1998) (study sponsored by the Office of Policy and Research of the Department of Labor's Pension and Welfare Benefits Administration). This may lead to fee disparities of up to 100 basis points for similar plans. A 100 basis point charge reduces the return to investors by 18 percent over 20 years. *See, e.g.,* Exchange Act Release No. 47023 (Dec.18, 2002), 68 FR 160 (Jan. 2, 2003).

Some plans allow plan participants to invest through their retirement plans in securities and funds beyond those offered in the plan menu. This is often referred to as a participant-directed brokerage account or a ''brokerage window.''[335] Bank representatives advised the Commission staff that when they offer brokerage windows to plan participants, they establish separate brokerage accounts for each participant with a broker-dealer. The proposed rule would codify this practice by requiring banks that offer brokerage windows to plan participants to continue to do so through a registered broker-dealer.

Finally, proposed Exchange Act Rule 770 would prohibit a bank that administers employee benefit plans from paying unregistered employees incentive compensation that differs based on the value of a security or the type of security purchased or sold by a plan participant. The payment of incentive compensation for securities transactions creates the type of salesman's stake the federal securities laws are designed to regulate. Banks could, of course, pay these employees nominal referral fees consistent with the terms of the networking exception for referring accounts to a broker-dealer. Banks could also register these employees as associated persons of broker-dealers for the purpose of receiving incentive compensation from the broker-dealers.

We solicit comment on all aspects of this exemption. In responding to comments, please specify the typical size of the employee benefit plan. We solicit comment regarding whether we have adequately captured the types of employee benefit plans for which banks act as pension plan administrators. If we have not listed all the types of employee benefit plans that a bank administers, please list the additional types of employee benefit plans that are not included in the proposed rule.

Please answer the following questions for employee benefit plans that are listed in the proposed rule, as well as for any additional types of employee benefit plans that a commenter believes should be added to the list. We seek bank-specific empirical data with respect to each question. In other words, a bank should answer these questions with respect to its own business and customers.

Does a bank typically act as a trustee or as a non-fiduciary recordkeeper? How does a bank determine in which capacity to act? What services does a bank provide in each different capacity in which it acts?

How does a bank's compensation differ depending on the capacity in which it acts? How does a bank's compensation differ depending on the type of compensation that it offers to plan participants? What transactional or asset-based charges does a bank earn when it acts in each different capacity? If a bank offers unaffiliated mutual funds, how is the bank compensated by these funds? If a bank is acting in a trustee or fiduciary capacity, can the bank meet the ''chiefly compensated'' comparison requirement, including the related exemptions?

Does a bank offset or credit any compensation that it receives from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes to the bank? How does a bank disclose the total compensation that it receives for acting as trustee or non-fiduciary recordkeeper? How does it disclose any offsets or credits?

3. Regulation S Transactions with Non-U.S. Persons

Persons that conduct a broker or dealer business while located in the United States must register as broker-dealers (absent an exemption), even if they direct all of their selling efforts offshore.[336] A bank industry group has requested an exemption from the broker-dealer registration requirements to permit banks to continue to sell securities that are covered by the safe harbor from U.S. registration pursuant to Regulation S to non-U.S. persons, both as agent and on a riskless principal basis.[337] The group also requested that the exemption extend to resale of Regulation S securities held by non-U.S. persons to other non-U.S. persons in transactions pursuant to Regulation S. While the group indicated that banks need this exemption primarily to sell proprietary products, such as mutual funds, to non-U.S. persons,[338] they would like the flexibility to sell other Regulation S securities to non-U.S. persons as well.[339]

In explaining the need for an exemption, the industry group expressed the view to the Commission staff that non-U.S. persons expect to deal with one private banker and that these customers would not choose to deal with a registered broker-dealer to conduct securities transactions in Regulation S securities, but would instead look to foreign banks to effect these transactions.

In response to this request, we are proposing Exchange Act Rule 771, which would provide banks with a conditional exemption to effect transactions pursuant to Regulation S with non-U.S. persons.[340] This exemption would *not* permit banks to effect transactions involving U.S. persons, other than U.S. registered broker-dealers. This exemption would permit banks to effect transactions involving offshore, non-U.S. persons on an agency or riskless principal basis. The exemption defines riskless principal for the purposes of the exemption. A bank could also resell any eligible Regulation S securities after their initial issuance by or on behalf of a non-U.S. person or to a non-U.S. person as long as the bank continues to

[335] *See* description of ''participant-directed brokerage account'' in Schedule H of the 2003 Instructions for Form 5500 (combined Internal Revenue Service, Department of Labor and Pension Benefit Guaranty Corporation Annual Report of Employee Benefit Plan).

[336] As the Commission stated when it adopted Exchange Act Rule 15a–6:

As a policy matter, the Commission now uses a territorial approach in applying the broker-dealer registration requirements to the international operations of broker-dealers.

Under this approach, all broker-dealers physically operating within the United States that effect, induce, or attempt to induce any securities transactions would be required to register as broker-dealers with the Commission, even if these activities were directed only to foreign investors outside the United States.

Exchange Act Release No. 27017, *supra* note 86, 54 FR at 30016 (footnotes omitted).

[337] *See* letter dated May 27, 2004, from Lawrence R. Uhlick, Executive Director & General Counsel, Institute of International Bankers to Catherine McGuire, Chief Counsel, Division of Market Regulation, Commission. Regulation S [17 CFR 230.901, *et seq.*] specifies the requirements for an offer or sale of securities to be deemed to occur outside the United States and therefore not subject to the registration requirements of Section 5 of the Securities Act. Regulation S permits the sale of newly issued off-shore securities and re-sales of off-shore securities from a non-U.S. person to a non-U.S. person.

[338] These mutual funds are usually specifically designed for sale offshore to avoid implicating U.S. tax laws for nonresident non-U.S. persons.

[339] Banks indicated to the Commission staff that although these products will vary depending on customer preferences and needs, among the most important products for banks are proprietary and non-proprietary offshore mutual funds structured (particularly for tax purposes) for non-U.S. investors, Euro bonds, and emerging market debt (especially debt sold to customers in the local jurisdiction—*e.g.*, Argentine debt sold to Argentine investors). To a lesser extent, banks indicated they may also sell European equity securities and emerging market equity securities (again, especially for investors in the local jurisdiction) to investors. Banks also noted they may sell tailored investment products, such as structured notes or deposits (*e.g.*, equity-or credit-linked notes), which often are customized to the individual needs of an investor and may be issued by a bank affiliate or an entity (*e.g.*, a special purpose vehicle) controlled by a bank affiliate. Banks may sell other products as well, such as offshore ''hedge funds,'' to certain investors.

[340] 17 CFR 242.771. Nothing in this proposed rule would affect the necessity of complying with Regulation S or any other requirements of or exemptions from the Securities Act of 1933.

comply with the requirements of Regulation S.[341] After the requirements of Regulation S cease to apply to an issuance, then the bank could resell the securities to another non-U.S. person or a broker-dealer without meeting the terms of Regulation S.

We are proposing this exemption with these limited conditions because we believe that non-U.S. persons will not be relying on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks.[342] While generally we believe that U.S. broker-dealers should be subject to the broker-dealer standards of conduct when dealing with non-U.S. persons, we feel that this principle is less compelling when the foreign person has chosen to deal with a U.S. bank with respect to Regulation S securities. We also understand that non-U.S. persons can purchase the same securities from banks located outside of the U.S. and would not have the protections of the U.S. law when purchasing these securities offshore. We invite comment on whether U.S. broker-dealer registration should be required with respect to transactions with these non-U.S. persons who are purchasing new offering securities offshore, or may be selling or purchasing seasoned securities.

We propose to define two other terms used in the exemption. We propose to define the term ''eligible security'' to include a requirement that the security is not being sold from the inventory of the bank or an affiliate of the bank. We request comment on whether this condition would be an appropriate safeguard against banks' financial conflicts that may disadvantage foreign investors. Within the definition of eligible security, we are also proposing to exclude from the exemption situations when the bank or an affiliate of the bank is underwriting a new issue security on a firm-commitment basis. In that instance, the bank could still sell the security using the exemption if the security is acquired from an unaffiliated ''distributor,'' that has not purchased the securities from the bank or a bank affiliate.[343] This condition is intended to prevent banks from soliciting investors, who do not have the protections of the U.S. securities laws, to purchase securities in which banks or their affiliates have an overriding financial interest as underwriters or selling group members. We understand, however, that there may be instances when a customer wants to purchase a security that is being underwritten by a bank or its affiliate. To facilitate these customer requests, a bank could sell the securities in reliance on this exemption if it obtained the securities from another distribution participant, other than an affiliate of the bank, as long as the other distribution participant did not directly or indirectly obtain the securities from the bank or its affiliate. We request comment on whether this condition would be an appropriate safeguard against banks' financial conflicts that may disadvantage foreign investors.

We also propose to define the term ''purchaser'' to mean a person that purchases a security and that is a non-U.S. person under Rule 902(k) of Regulation S.[344]

We request comment on this proposed exemption, as well as the other proposed definitions, including the definition of riskless principal that is consistent with the definition we have used previously in the bank dealer rules. We particularly request comment from non-U.S. investors on whether this exemption is necessary to serve their needs, or whether they would prefer to purchase Regulation S securities subject to the full investor protections of the U.S. federal securities laws. We also invite comment on the possible competitive effects this proposed exemption may have.

4. Redesignation and Revision of Exemptions for Savings Associations and Savings Banks

We propose to redesignate the current exemption for savings associations and savings banks found in Exchange Act Rule 15a–9 [345] as Exchange Act Rule 773.[346] As is true under the current rule, the savings associations and savings banks would be subject to all of the same conditions and definitions as are applicable to banks that utilize the exceptions from the definitions of ''broker'' and ''dealer.'' [347] We propose to extend to savings associations and savings banks the proposed money market exemption in Exchange Act Rule 776,[348] the proposed exemptions in Exchange Act Rules 720–723 [349] relating to the bank trust and fiduciary activities exception, the proposed small bank custody exemption in Exchange Act Rule 761,[350] the proposed expanded exemption for the way in which banks effect transactions in investment company securities in Exchange Act Rule 775,[351] and the current exemption for securities lending transactions in Exchange Act Rule 15a–11,[352] which we are proposing to redesignate as Exchange Act Rule 772.[353]

We are not proposing to extend to thrifts the proposed general custody exemption in Exchange Act Rule 760,[354] the proposed new ERISA exemption in Exchange Act Rule 770,[355] or the proposed Regulation S exemption in Exchange Act Rule 771, however, because we were unable to obtain sufficient information to determine whether thrifts directly engage in the types of securities activities covered by these proposed exemptions.[356] We solicit comment on whether thrifts engage in securities activities or transactions that would be covered by the excluded exemptions. We invite commenters to provide specific information about their current business models that would require them to utilize these proposed exemptions. For example, do thrifts have income that does not qualify as ''relationship compensation'' for employee benefit plan accounts and that cannot be accommodated by the small bank custody exemption? With respect to those securities activities or transactions that are not covered by the excluded exemptions, we seek empirical data from individual thrifts regarding the type and amount of compensation received for each of these securities activities. Thrift commenters are invited to answer the specific request for comments in each of the exemptions.

[341] Rule 904 of Regulation S (17 CFR 230.904).

[342] While no rules have been adopted, the exemption provided by Exchange Act Section 30(b), pertaining to foreign securities, has been held unavailable if the United States is used as a base for securities fraud perpetrated on foreigners, *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171 (2d Cir. 1976), *reh. denied*, 551 F.2d 915 (2d Cir. 1977), *cert. denied* 434 U.S. 1009. *See also* Exchange Act Release No. 27017, *supra* note 86, 54 FR at 30016.

[343] The term ''distributor'' is defined in 17 CFR 230.902(d).

[344] 17 CFR 230.902(k).

[345] 17 CFR 240.15a–9.

[346] 17 CFR 242.773.

[347] Nevertheless, savings associations and savings banks that are municipal securities dealers must register and be regulated as municipal securities dealers pursuant to Exchange Act Section 15B. Banks must also register pursuant to Exchange Act Section 15B. Exchange Act Section 3(a)(34)(A) provides that the ''appropriate regulatory agency'' of a municipal securities dealer that is a bank regulated by the OCC, the Federal Reserve, or the FDIC is the agency that already regulates the bank. Exchange Act Section 3(a)(34)(A)(iv) designates the Commission as the appropriate regulatory agency in the case of all other municipal securities dealers, which includes savings associations and savings banks that are municipal securities dealers.

[348] 17 CFR 242.776.

[349] 17 CFR 242.720 through 723.

[350] 17 CFR 242.761.

[351] 17 CFR 242.775.

[352] 17 CFR 15a–11.

[353] 17 CFR 242.772.

[354] 17 CFR 242.760.

[355] 17 CFR 242.770.

[356] 17 CFR 242.771.

5. Credit Unions

Because credit unions are not ''banks'' under the Exchange Act,[357] they cannot utilize the bank exceptions from the definitions of broker and dealer. While nine commenters indicated that some, or all, of the exceptions should be extended to credit unions, the commenters generally conceded that credit unions do not currently engage in many of the securities activities authorized for banks under the Exchange Act exceptions from the definitions of ''broker'' and ''dealer.''[358]

Based on the Commission staff's discussions with credit union representatives, we understand that credit unions are engaged in a very limited securities business today.[359] We do not propose extending all of the transaction-based bank exceptions in Exchange Act Section 3(a)(4) to credit unions for their potential future securities activities. We do, however, propose to extend three of the bank exceptions to provide a limited accommodation for credit unions. As is true under the rule for the savings associations and savings banks, credit unions utilizing this proposed exemption would be subject to all of the same conditions and definitions as are applicable to banks that utilize the exceptions from the definitions of ''broker'' and ''dealer.''

*a. Networking*

Credit unions currently may enter into networking arrangements with broker-dealers under the conditions set forth in the Chubb letter.[360] However, banks, savings banks, and savings and loan associations can network with broker-dealers under the terms of the Exchange Act Section 3(a)(4)(B)(i) exception for third-party brokerage arrangements.[361] This bifurcated system makes compliance more complicated for broker-dealers that have networking arrangements with a variety of financial institutions. It also creates an unequal playing field among financial institutions offering the same services.

We, therefore, propose Exchange Act Rule 774[362] to address these issues by simplifying the terms under which credit unions may enter into networking arrangements by exempting them from the definition of broker under the terms of the bank networking exception in Exchange Act Section 3(a)(4)(B)(i),[363] including any related interpretive and exemptive rules for banks' networking activities that the Commission may adopt. The proposed rule would subject credit unions to the same uniform networking rules that apply to banks and savings associations. This should simplify compliance for credit unions as well as for the broker-dealers that enter into networking arrangements with different types of retail depository institutions. If the Commission adopts this proposal as a final rule, the rule would supercede the staff no-action letter. We request comment on whether this is appropriate. We also request comment on whether any additional conditions or limitations should be imposed on credit unions that enter into networking arrangements with broker-dealers.

*b. Sweep Accounts*

The sweep accounts exception is a limited transactional exception that permits banks to sweep deposit funds into no-load, open-end money market funds.[364] One credit union requested a Commission exemption to engage in this activity. The Commission published this request along with a request for comment in June 2002.[365] After reviewing the credit unions' comments, we are proposing Exchange Act Rule 774 to provide an exemption for credit unions to provide sweep account services. In particular, proposed Exchange Act Rule 774 would permit credit unions to sweep deposit accounts into no-load money market funds under the terms of the bank exception in Exchange Act Section 3(a)(4)(B)(v).[366] Because the statutory exception is limited, any incentives for abuse are also limited. Thus, we believe extending this exception to credit unions would not raise investor protection concerns. Moreover, it should place financial institutions offering similar services on a more level playing field.

*c. Investment, Trustee, and Fiduciary Transactions*

The investment transactions exception in Exchange Act Section 3(a)(5)(ii) permits a bank to buy or sell securities ''for investment purposes'' for its own account or for the accounts for which it acts as a trustee or fiduciary.[367] We propose to include in Exchange Act Rule 774 an exemption for credit unions from the definition of dealer to permit credit unions to buy and sell securities for investment purposes for themselves, or for accounts for which they act as trustee or fiduciary under the terms of the bank exception in Exchange Act Section 3(a)(5)(C)(ii).[368] While credit unions may rely on the dealer-trader distinction[369] for their proprietary trading, extending this exemption to credit unions should provide them with legal certainty. With respect to transactions for trust and fiduciary account customers, we would expect credit unions' fiduciary obligations to provide these customers with sufficient protections.

*d. Scope of Credit Union Exemption*

We propose to permit all credit unions to utilize the proposed Exchange Act Rule 774 exemptions. This would include federal- and state-chartered credit unions, as well as federally insured and privately insured credit unions. We are preliminarily of the view that these transactions should be handled in the same way under one uniform set of rules for all credit unions, as well as for all banks and savings

[357] The term ''bank'' is defined in Exchange Act Section 3(a)(6).

[358] *See* ACCU letter; CUNA letter; NACUSO letter; NASCUS letter; NCUA letter; NAFCU letter; Navy Federal letter; Ohio Credit Union League letter; and U.S. Central Credit Union letter.

[359] This reflects the fact that credit unions, unlike banks, never had a blanket exception from broker-dealer registration. Therefore, credit unions that wanted to conduct a securities business always had to do so through a registered broker-dealer.

[360] *See* Chubb Letter, a staff no-action letter, *supra* note 37. The staff no-action letter sets forth the terms under which financial institutions (federal and state chartered banks, savings and loan associations, savings banks, and credit unions) may participate in the networking arrangement.

[361] As discussed throughout this release, banks, savings banks and savings associations continue to have a temporary exemption from the Exchange Act definition of ''broker.'' The networking exception in Exchange Act Section 3(a)(4)(B)(i) and proposed Exchange Act Rule 710 set forth the terms that banks and savings associations will follow when the Exchange Act's bank broker exceptions and rules are fully implemented.

[362] 17 CFR 242.774.

[363] 15 U.S.C. 78c(a)(4)(B)(i).

[364] Exchange Act Section 3(a)(4)(B)(v). 15 U.S.C. 78c(a)(4)(B)(v).

[365] *See* Notice of Application of Evangelical Christian Credit Union for Exemptive Relief Under Sections 15 and 36 of the Exchange Act and Request for Comment, Exchange Act Release No. 46069 (June 12, 2002), 67 FR 41545 (June 18, 2002) (available at *http://www.sec.gov/rules/other/*).

[366] 15 U.S.C. 78c(a)(4)(B)(v).

[367] As we noted in footnote 83 of the release in which we adopted final ''dealer'' rules for banks, [Exchange Act Release No. 47364, 68 FR 8686 (Feb. 24, 2003)], the ''dealer'' exception for trustee and fiduciary transactions only applies when the bank buys or sells securities for investment purposes for the bank, or for accounts for which the bank acts as a trustee or fiduciary. Furthermore, in giving meaning to the term ''fiduciary'' in Exchange Act Section 3(a)(5)(C)(ii), we look to the legislative history. The legislative history states that Exchange Act Section 3(a)(5) ''excepts a bank from the definition of 'dealer' when it buys and sells securities for investment purposes for the bank, or for accounts for which the bank acts as trustee or fiduciary. This mirrors existing law distinguishing between investors and dealers, and is limited to the portfolio trading of the bank and the accounts for which it makes investment decisions.'' H.R. Rep. No. 106–74, pt. 3, at 170–171 (1999).

[368] 15 U.S.C. 78c(a)(5)(C)(ii).

[369] *See* Section IV of the Dealer Release for a discussion of the Dealer/Trader distinction. Exchange Act Release. No. 47364 (Feb. 14, 2003).

associations. The proposed exemption would grant credit unions these three statutory exceptions but this exemption would not automatically give them any associated exemptions we may grant to banks in the future.

The Commission requests comment on proposed Exchange Act Rule 774.[370] In addition, the Commission specifically requests comment on whether state-charted, privately insured credit unions (which do not have a federal regulator) should be included within the scope of the exemption.[371] Commenters are requested to discuss the scope of the supervision of state-chartered, privately insured credit unions and the legal framework applicable to these entities.

*e. Additional Exemptions for Credit Unions*

Exchange Act Section 3(a)(4)(B)(viii) provides banks with an exception from the definition of broker for certain safekeeping and custody activities.[372] Under this exception, a bank is not considered a ''broker'' if, as part of its customary bank activities, it engages in certain specified types of safekeeping and custody services with respect to securities on behalf of its customers. The exception generally permits banks to hold securities, pledge securities, lend securities held in custody, and reinvest collateral.[373]

The National Credit Union Administration (''NCUA'') has indicated to the Commission staff that credit unions are authorized to hold custody of customer funds and securities in connection with securities transactions. However, the Commission staff has no evidence that credit unions engage in the activities included in the safekeeping and custody activities exception. For this reason, we are not proposing to give credit unions a custody exemption.

We invite comment on the extent to which credit unions utilize their authority to hold custody of customer funds and securities, and whether credit unions engage in any of the types of transactions enumerated in the bank safekeeping and custody exception. Do credit unions hold custody of customer funds and securities in connection with transactions other than the networking, sweep accounts, or investment transactions described above? Credit union commenters are invited to discuss any legal authority on which they currently rely to engage in any of these additional activities.[374]

Because we have no evidence that credit unions require additional exemptions for the safekeeping and custody of customer funds and securities in connection with securities transactions, we are not proposing additional exemptions at this time. Commenters that believe additional exemptions are warranted should explain why an exemption is needed and discuss how such an exemption would be in the public interest, and whether any additional conditions should be added to protect investors. In addition, we specifically invite comment on how any credit unions that need additional exemptions are regulated, both under state and federal law.

6. Exemption for the Way in Which Banks Effect Transactions in Investment Company Securities

Exchange Act Section 3(a)(4)(C) requires a bank to execute through a registered broker-dealer (or internally cross) transactions executed in the United States in securities that are publicly traded in the United States that are effected pursuant to either the trust and fiduciary activities exception, the safekeeping and custody exception, or certain stock purchase plans exception.[375] Current Exchange Act Rule 3a4–6, however, exempts from this requirement banks that process transactions in shares of investment company securities through the National Securities Clearing Corporation's (''NSCC'') Mutual Fund Services,[376] including Fund/SERV.[377]

Banks that use NSCC's Mutual Fund Services to execute transactions in investment company securities advised us that they may not use a registered broker-dealer to execute these transactions, depending on whether NSCC's arrangement is with the principal underwriter or a transfer agent that acts as agent for the investment company. Therefore, some industry representatives indicated informally to the staff that banks needed an exemption from the trade execution requirements of Exchange Act Section 3(a)(4)(C) to continue to use the NSCC's Mutual Fund Services, while complying with exceptions and exemptions from the definition of broker. Exchange Act Rule 3a4–6 was designed to allow banks to continue to execute transactions in shares of open-end investment companies through NSCC's Mutual Fund Services because NSCC's Mutual Fund Services simplify and automate the process for purchasing and redeeming investment company securities.[378] This exemption is a limited one and is only available to banks that process orders through a service of a registered clearing agency subject to the supervision and regulation of the Commission.

Commenters generally supported this exemption. However, some urged the Commission to expand the exemption to include mutual fund purchases and redemptions directed to the fund's transfer agent.[379] These commenters indicated that such an exemption would reflect banks' current practices.[380]

We, therefore, propose to expand this exemption to permit banks to process purchases and redemptions of shares of open-end investment companies directly with transfer agents that act as agents for these investment companies, provided that the transfer agents do not

[370] We also request comment on whether there are other issues or restrictions that we should consider in connection with this exemption for these three securities activities.

[371] In contrast to credit unions, all banks and savings associations have a federal regulator.

[372] 15 U.S.C. 78c(a)(4)(B)(viii).

[373] Exchange Act Section 3(a)(4)(B)(viii)(aa–ee). This exception is discussed in greater detail in Section III.E. *supra.*

[374] As part of transactions covered by the proposed exemptions for networking, sweep accounts, and investment, trustee and fiduciary transactions, a credit union would be permitted to hold customer funds and securities in connection with the securities transactions that fall within the exemptions.

[375] 15 U.S.C. 78c(a)(4)(B)(ii), (iv), and (viii).

[376] NSCC is a clearing agency registered pursuant to Exchange Act Section 17A. 15 U.S.C. 78q–1. A ''clearing agency'' is a person that acts as an intermediary in making payments or deliveries (or both) in connection with transactions in securities, or that provides facilities for comparing data with respect to the terms of securities transactions to reduce the number of settlements or the allocation of securities settlement responsibilities. *See* 15 U.S.C. 78c(a)(23)(A). A clearing agency is an SRO, and its rules of operation are subject to approval by the appropriate federal regulatory agency. *See* 15 U.S.C. 78c(a)(26), 78s(b). *See also* Investment Company Act Release No. 26288 (Dec. 11, 2003), 68 FR 70388, 70395 at n. 11 (Dec. 17, 2003).

[377] NSCC's Mutual Fund Services provide an automated system to participants to process transactions in investment company securities. Fund/SERV centralizes order entry, confirmation, registration, and settlement of purchases and redemptions of investment company securities. NSCC's Mutual Fund Services are available to investment companies, broker-dealers, banks, trust companies, and other financial institutions that have been accepted for membership in the NSCC.

[378] In light of the recent scandals involving the market timing of shares issued by certain registered open-end investment companies, this exemption could potentially allow further abuses to go undetected. Current Exchange Act Rule 3a4–6 is not an exemption from other provisions of the federal securities laws such as sections 206(1) and 206(2) of the Investment Advisers Act (15 U.S.C. 80b–6(1) and (2)) or Section 34(b) of the Investment Company Act (15 U.S.C. 80a–33(b)).

[379] *See* ABA/ABASA letters; Mellon Bank letter; BONY letter; Wilmington Trust letter; NYCH letter; PNC Bank letter; Northern Trust letter; Shaw Pittman letter; and Wells Fargo letter.

[380] In 2002, Fund/SERV processed approximately 83 million fund transactions, half of all such transactions processed that year. Transfer agents processed the others. *See* Investment Company Act Release No. 26288, *supra* note 376 at n. 64.

accept compensation paid for the distribution of the securities, including any compensation paid pursuant to any revenue-sharing arrangement or pursuant to Rule 12b–1 of the Investment Company Act.[381] The proposed exemption would only be available for securities that are distributed by registered broker-dealers or otherwise sold for sales loads that do not exceed the NASD limits for broker-distributed funds. This condition is intended to ensure that mutual fund investors will not incur higher loads for the same funds if they choose to purchase through banks, rather than through registered broker-dealers.

We propose to limit this exemption to transactions in securities of open-end investment companies that are not traded on a national securities exchange, through the facilities of a national securities association, or through an interdealer quotation system.[382] This exemption would not be necessary with regard to these securities because investors purchase or sell such shares through broker-dealers at market prices throughout the day.

We solicit comment on the proposed amendments to this exemption. We invite comment with regard to the use of omnibus accounts in the context of this proposal. In particular, we request comment about the issues raised, especially those arising from conflicts of interest associated with 12b–1 fees, and how they are disclosed by banks to custody account customers. We also seek comment regarding the number and percentage of fund share orders submitted directly to designated transfer agents.

While not specifically addressing Exchange Act Rule 3a4–6, one commenter requested guidance on the meaning of the term ''publicly traded security [in the United States]'' within the context of Exchange Act Section 3(a)(4)(C).[383] Exchange Act Section 3(a)(4)(C)(i) requires a bank to direct trades in publicly traded securities in the United States to a registered broker-dealer for execution. However, a U.S. registered broker-dealer would not necessarily provide the most liquid markets and the best prices for foreign securities, because the primary trading markets for foreign securities are located outside of the United States. Thus, if a bank customer requests a security listed or traded primarily outside of the United States, Exchange Act Section 3(a)(4)(C) gives banks the flexibility to seek the best markets for that security. In other words, Exchange Act Section 3(a)(4)(C) encourages banks to obtain best execution for securities by directing them to registered broker-dealers for U.S. transactions, but not for foreign transactions.

Publicly traded securities[384] include all securities in which at least two registered broker-dealers have indicated a willingness to quote a price, securities that are registered under Exchange Act Section 12,[385] or those from an investment company that is required to file reports under Exchange Act Section 15(d).[386] The term includes equity securities, regardless of whether they are traded through a national securities exchange, an automated quotation system sponsored by a registered national securities association, an alternative trading system, an electronic communications network, Nasdaq's Over-the Counter Bulletin Board service, or an interdealer quotation system such as the one operated by Pink Sheets LLC.[387] The term also includes debt securities and hybrid securities.[388] We solicit comment about whether the term ''publicly traded securities'' should be defined by rule.

*G. Temporary Exemptions*

1. Extension of Time and Transition Period

Commenters have indicated that banks may need as much as a year to develop compliance systems to adapt to the more limited Exchange Act bank exceptions from the definition of broker. The Commission has also stated that it does not expect banks to develop compliance systems for the broker exceptions until the Commission has adopted any amendments to the Interim Rules.

We recognize that when the bank broker exceptions are fully effective, some banks may need a transition period as they move toward statutory compliance.[389] Exchange Act Rule 15a–7 provides such a transition period, and we propose to amend that rule, which would be redesignated as Exchange Act Rule 781, to extend the transition period to one year after any amended rules are adopted. We expect banks to use this time to develop compliance systems.[390]

We request comment on the proposed amendment to this temporary exemption, and, in particular, on whether banks would need a full year to develop compliance systems. We also request comment on whether the transition period should cease at the end of a calendar year.

2. Temporary Exemption for Contracts Entered Into by Banks From Being Considered Void or Voidable

Current Exchange Act Rule 15a–8 recognizes that banks may have inadvertent, technical violations as they become accustomed to any new regulatory requirements. This exemption mitigates the unique compliance problems that banks may

[381] *See* 17 CFR 270.12b–1. Transfer agents that are not registered as broker-dealers need to consider whether the securities activities that they are undertaking are brokerage activities that require them to register as broker-dealers. Exchange Act Section 3(a)(4) defines a ''broker'' as a person engaged in the business of effecting transactions in securities for the account of others. It includes several exceptions for certain bank activities. *See* 15 U.S.C. 78c(a)(4). Exchange Act Section 15 essentially makes it unlawful for a broker or dealer ''to effect any transactions in, or induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills)'' unless the broker or dealer is registered with the Commission. *See* 15 U.S.C. 78o(a)(1). *See also* Investment Company Act Release No. 26288, *supra* note 376 at n. 7.

[382] For example, this exemption from executing trades through a registered broker-dealer would not be available for exchange-traded funds, which are investment companies that are registered under the Investment Company Act as open-end funds or unit investment trusts. Section 5(a)(1) of that Act defines an open-end fund as an investment company that is a management company, which offers, or has outstanding, any redeemable security of which it is the issuer. 15 U.S.C. 80a–5(a)(1). Section 4(2) of the Investment Company Act defines a unit investment trust as an investment company that is organized under a trust indenture or similar instrument, that does not have a board of directors, and that issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities. 15 U.S.C. 80a–4(2). *See* Investment Company Act Release No. 25258 (Nov. 8, 2001).

[383] *See* Compass letter. In that letter, the commenter asked the Commission to clarify that shares of open-end investment companies are not ''publicly traded securities'' within the meaning of Exchange Act Section 3(a)(4)(C) unless the shares are, in fact, traded on a recognized exchange.

[384] While the term ''publicly traded security'' is used in other sections of the Exchange Act for specific purposes, *see, e.g,* 15 U.S.C. 78m(h) and 78u–3(c)(3)(A)(i), the term is commonly understood to encompass a broader range of securities than these other particular uses would indicate.

[385] 15 U.S.C. 78*l*.

[386] 15 U.S.C. 78*o*(d).

[387] Pink Sheets LLC is a privately owned company that provides pricing and financial information for equity securities that are not listed on a national securities exchange or quoted on Nasdaq.

[388] Hybrid securities are securities with features common to both equity and debt securities.

[389] 17 CFR 240.15a–7.

[390] For example, if the bank broker rules were adopted by year-end 2004, then the bank broker exceptions would apply one year later, beginning January 1, 2006. Thus, banks would not have to be in compliance with the terms of the exception or exemption during 2005, but should develop compliance systems to be used beginning in 2006.

With respect to the ''chiefly compensated'' requirements, banks would need to be in compliance with the terms of the account-by-account calculation, or one of the exemptions by the end of 2006. Demonstrated compliance during 2006 would exempt a bank from risk of noncompliance with these requirements during 2007. *See* proposed Exchange Act Rule 722(a)(2).

have by eliminating the possibility that any inadvertent failures by banks could trigger rescission under Exchange Act Section 29 during this transitional period.[391] The Commission amended this exemption in the rules addressing the exceptions from the definition of ''dealer'' under the Exchange Act to provide a transitional period from rescission liability under Exchange Act Section 29 on contracts entered into by banks in a dealer capacity for a finite period until March 31, 2005.[392]

We received a few comments on Exchange Act Rule 15a–8.[393] All of these commenters supported this temporary exemption for banks. One commenter said that liability for any violation of the broker-dealer registration requirements should be limited to customers or groups of customers that received the services or were parties to the transactions.[394]

Once we adopt any final rules, or amendments to the bank broker rules, we anticipate extending the compliance date for the broker statutory exceptions and rules to provide banks with an appropriate transition period. We therefore propose to extend the exemption from rescission liability under Exchange Act Section 29 to contracts entered into by banks acting in a broker capacity until 18 months after the delayed effective date of the broker rules.

This proposed exemption, which would be codified in proposed Exchange Act Rule 780, would be limited to bank contracts being considered void or voidable by reason of Exchange Act Section 29 because a bank that is a party to the contract violated the registration requirements of Section 15(a) of the Exchange Act or any applicable provision of this Act and the rules and regulations thereunder, based solely on a bank's status as a broker or dealer when the contract was created.

We note that this proposed exemption would not relieve banks of the obligation to register as a broker or dealer if their securities activities do not fit within a specific functional exception or exemption. We also note that banks' securities activities continue to be subject to the antifraud provisions of the federal securities laws, irrespective of the bank's lack of registration or failure to comply with the provisions of the Exchange Act and the related rules that otherwise apply to banks based on their status as broker-dealers. We request comment on extending the temporary exemption from Exchange Act Section 29(b).

*H. Amendment to Exchange Act Rule 15a–6*

Exchange Act Rule 15a–6 provides a conditional exemption from U.S. broker-dealer registration for certain foreign broker-dealers.[395] Exchange Act Rule 15a–6 (a)(4)(i) allows a foreign broker-dealer, without registering in the United States, to effect transactions in securities with or for a U.S.-registered broker-dealer or bank acting ''in a broker-dealer capacity as permitted by U.S. law.'' [396] Thus, in transactions between a U.S. bank and its foreign broker-dealer affiliate, acting as principal, the U.S. bank could rely on the affiliate transactions exception in the GLBA,[397] and the foreign affiliate could rely on Rule 15a–6(a)(4)(i). As discussed in the release adopting the Interim Rules, Exchange Act Rule 15a–6(a)(4)(i), however, does not permit a foreign broker-dealer or bank to have direct contact with customers of the U.S. bank.[398] Moreover, the affiliate transactions exception would not permit the U.S. bank to effect transactions with its foreign affiliate's customers.[399] We received no comments on our discussion of the interplay between Exchange Act Rule 15a–6 and the affiliate transactions exemption and we are not proposing to change that analysis in the current proposal.

We do, however, propose a technical amendment to Exchange Act Rule 15a–6 in light of the amended definitions of ''broker'' and ''dealer.'' Currently, Exchange Act Rule 15a–6(a)(4)(i) refers to ''a bank acting in a broker or dealer capacity as permitted by U.S. law.'' As amended, however, the definitions of ''broker'' and ''dealer'' in Exchange Act Section 3(a)(4) and 3(a)(5) respectively, provide that banks engaging in the conditional exceptions in those definitions ''shall not be considered to be'' brokers or dealers. To reflect this change, we propose to amend Exchange Act Rule 15a–6(a)(4)(i) by replacing the phrase ''in a broker or dealer capacity as permitted by U.S. law'' with the phrase ''pursuant to an exception or exemption from the definition of 'broker' or 'dealer' in Sections 3(a)(4)(B) or 3(a)(5)(C) of the Act.'' [400] We request comment on this proposed amendment to Exchange Act Rule 15a–6(a)(4)(i).

## IV. Administrative Law Matters

*A. General Request for Comments*

We are soliciting comments on all aspects of these proposed new rules and rule amendments. We also request comment on the portions of the Interim Rules pertaining to banks' broker activities that we are not proposing to amend, including Exchange Act Rule15a–9,[401] which provides an exemption from the definitions of ''broker'' and ''dealer'' for savings associations and savings banks. In addition, we encourage comment on the other provisions of Exchange Act Section 3(a)(4)(B) that we did not discuss in connection with these proposals. We plan to address issues regarding issuer plans separately.[402]

Commenters should, when possible, provide us with empirical data to support their views. Commenters suggesting alternative approaches should provide comprehensive proposals, including any conditions or limitations they believe should apply. We also specifically request comment on when any final rules should become effective. Should particular rules be implemented on a more delayed schedule? If so, why? With respect to proposed exemptions that contain a grandfather clause, have we proposed the most appropriate date for such purposes? If not, why not? Commenters suggesting an alternative date should

[391] Exchange Act Section 29(b) provides, in pertinent part, that every contract made in violation of the Exchange Act or of any rule or regulation thereunder shall be void.

[392] *See* Exchange Act Release No. 47364, *supra* note 34, 68 FR 8686.

[393] *See* ABA/ABASA letters; Banking Agencies letter; NYCH letter; NASAA letter; and Regions letter.

[394] *See* NYCH letter.

[395] 17 CFR 240.15a–6. Even when the GLBA permits a bank to engage in securities-related activities without itself registering as a broker-dealer, a broker-dealer engaged in the business of effecting transactions for such bank still must register—absent an exemption or other exclusion from the broker-dealer registration requirements of the Exchange Act. For instance, a foreign broker-dealer that executes trades for a bank under Exchange Act Section 3(a)(4)(C) would need to register as a U.S. broker-dealer if it does not meet the conditions of Exchange Act Rule 15a–6, or it does not otherwise qualify for an exemption from registration. Foreign banks cannot rely on the GLBA bank exceptions because they do not fall within the definition of ''bank'' in Exchange Act Section 3(a)(6). *Cf.* U.S. branches and agencies of foreign banks can rely on the bank exceptions to the extent described in 54 FR 30013 at 30015, n. 16.

[396] 17 CFR 240.15a–6(a)(4)(i).

[397] Exchange Act Section 3(a)(4)(B)(vi).

[398] 66 FR at 27783.

[399] *Id.* A bank would, however, be permitted to sell Regulation S securities to non-U.S. persons, including customers of a foreign affiliate, as provided in the Regulation S exemption discussed at section III.F.3, *supra.*

[400] Nothing in this release should be construed as modifying the Exchange Act Section 3(a)(6) definition of ''bank'' as it applies to foreign banks. Currently, foreign banks generally would not meet this definition and would be considered broker-dealers under the U.S. securities laws. As such, foreign banks generally would be required to register as U.S. broker-dealers unless they qualify for an exemption from registration under Exchange Act Rule 15a–6.

[401] 17 CFR 240.15a–9.

[402] Exchange Act Section 3(a)(4)(B)(iv)(III).

provide reasons why they believe the alternative date would be more appropriate.

Finally, individual banks that anticipate the need for additional time to implement compliance systems for particular rules or statutory provisions are encouraged to explain their specific needs.

*B. Paperwork Reduction Act Analysis*

Certain provisions of proposed Exchange Act Rules 776, 722, and 770 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[403] The Commission has submitted them to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The collections of information under proposed Exchange Act Rules 776, 722, and 770 are new. The title for the new collection of information under proposed Exchange Act Rule 776 is ''Rule 776: Exemption for banks effecting transactions for certain investors in money market funds.'' The title for the new collection of information under proposed Exchange Act Rule 722 is ''Rule 722: Exemption for banks from determining whether they are 'chiefly compensated' on an account-by-account basis.'' The title for the new collection of information under proposed Exchange Act Rule 770 is ''Rule 770: Exemption from the definition of 'broker' for banks that effect transactions in securities in certain employee benefit plans.'' OMB has not yet assigned a control number to the new collections of information contained in proposed Exchange Act Rules 776, 722, and 770. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.[404]

1. Proposed Exchange Act Rule 776

*a. Collection of Information*

Proposed Exchange Act Rule 776(a)(2)(ii)(B) would require a bank relying on this proposed exemption to provide customers that are not qualified investors or persons that direct the purchase of securities from any cash flows relating to asset-backed issues of at least $25,000,000 with a prospectus for the securities bought or sold pursuant to the proposed exemption and a clear and conspicuous notice containing the information required by this proposed rule.[405]

*b. Proposed Use of Information*

The purpose of the collection of information in proposed Exchange Act Rule 776 is to assure that a customer of a bank relying on the exemption would have sufficient information upon which to make an informed investment decision and to learn of any potential conflicts of interest that the bank may have.

*c. Respondents*

The proposed collection of information in Exchange Act Rule 776 would apply to banks relying on the exemption provided in the proposed rule.

*d. Reporting and Recordkeeping Burden*

The Commission estimates that approximately 500 banks annually would use the exemption in proposed Exchange Act Rule 776 and each bank would deliver the prospectus and notice required by the proposed rule to approximately 1,000 customers annually. Therefore, the Commission estimates that proposed Exchange Act Rule 776 would result in approximately 500,000 responses per year. The Commission estimates further that a bank would spend approximately .10 hour per response to comply with the delivery requirement of proposed Exchange Act Rule 776. Thus, the estimated total annual reporting and recordkeeping burden for proposed Exchange Act Rule 776 is 50,000 hours. The Commission estimates that the initial reporting and recordkeeping burden for this proposed rule would be insubstantial, but we solicit comment on this point.

*e. Collection of Information Is Mandatory*

This collection of information would be mandatory.

*f. Confidentiality*

The collection of information delivered pursuant to proposed Exchange Act Rule 776 would be provided by banks relying on the exemption in this rule to customers that are not ''qualified investors,'' as defined in proposed Exchange Act Rule 776(b)(6).

*g. Record Retention Period*

Proposed Exchange Act Rule 776 would not include a record retention requirement. Banks are subject to record retention requirements promulgated by banking regulators.

2. Proposed Exchange Act Rule 722

*a. Collection of Information*

Proposed Exchange Act Rule 722(c)(2) would require banks relying on the exemption in this rule to document the reason that an account has continued not to meet the ''chiefly compensated'' condition and link the reason to its exercise of fiduciary responsibility.

*b. Proposed Use of Information*

Proposed Exchange Act Rule 722 is intended to provide banks that determine compliance with the ''chiefly compensated'' condition through an account-by-account calculation with legal certainty for one year based on their demonstrated compliance for the previous year. The purpose of the collection of information in proposed Exchange Act Rule 722 is to document the reason a bank has not met the ''chiefly compensated'' condition while still being able to rely on the exemption provided in paragraph (c) of the rule.

*c. Respondents*

The proposed collection of information in proposed Exchange Act Rule 722 would apply to banks that wish to utilize the exemption provided in this proposed rule.

*d. Reporting and Recordkeeping Burden*

Based on information available to the Commission at this time, the Commission estimates that approximately ten banks per year would use the exemption provided by proposed Exchange Act Rule 722(c) for approximately ten accounts per bank for a total of 100 responses annually. The Commission estimates that it will take each bank approximately .25 hour per response. Thus, the Commission estimates the annual reporting and recordkeeping burden for proposed Exchange Act Rule 722 to be 25 hours.

*e. Collection of Information Is Mandatory*

This collection of information would be mandatory.

*f. Confidentiality*

Banks relying on the exemption provided in proposed Exchange Act Rule 722(c) would not be required to provide the documentation required by the proposed rule to the Commission. Rather, banks would be required to make the proper documentation and maintain such documentation in compliance with existing recordkeeping requirements of banking regulators.

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[403] 44 U.S.C. 3501, *et seq.*

[404] 44 U.S.C. 3512.

[405] *See* proposed Exchange Act Rule 776(a)(2)(ii)(B) which would require, among other things, that a bank would have to disclose any payments it may receive in connection with transactions effected pursuant to the proposed rule from the fund complex to which the issuer of the securities belongs.

*g. Record Retention Period*

Proposed Exchange Act Rule 722 would not include a record retention requirement. Banks are subject to the record retention requirements promulgated by banking regulators.

3. Proposed Exchange Act Rule 770

*a. Collection of Information*

Proposed Exchange Act Rule 770(a)(2)(ii) would require banks that wish to utilize the exemption provided in this proposed rule to disclose clearly and conspicuously to plan sponsors or their designated fiduciaries all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex.

*b. Proposed Use of Information*

The purpose of the collection of information in proposed Exchange Act Rule 770 is to provide information to plan sponsors or their designated fiduciaries to enable them to determine that a bank has offset or credited any fees or expenses received from a fund complex related to securities in which plan assets are invested against the fees and expenses that the plan owes to the bank.

*c. Respondents*

The collection of information in proposed Exchange Act Rule 770 would apply to banks that administer employer-sponsored retirement plans that wish to utilize the exemption provided in the proposed rule.

*d. Reporting and Recordkeeping Burden*

Based on the information available to the Commission at this time regarding which banks might utilize the exemption in proposed Exchange Act Rule 770, the Commission estimates that approximately 100 banks would rely on proposed Exchange Act Rule 770 annually, and each bank would provide the notice required by the proposed rule to approximately 100 plan sponsors. Thus, the Commission estimates that there would be approximately 10,000 annual responses for proposed Exchange Act Rule 770. Based on discussions between Commission staff and industry participants, the Commission believes that disclosure requirements of proposed Exchange Act Rule 770 reflect current business practices of banks, and as such, banks utilizing the exemption provided in proposed Exchange Act Rule 770 would already have in place the systems and procedures to make the disclosure required by the proposed Rule. Therefore, the Commission believes that the time required for a bank to comply with the clear and conspicuous notice requirement of the proposed rule would require .10 hour per response. Thus, the Commission estimates the total annual reporting and recordkeeping burden imposed by proposed Exchange Act Rule 770 would be 1,000 hours.

*e. Collection of Information Is Mandatory*

This collection of information would be mandatory.

*f. Confidentiality*

The collection of information delivered pursuant to proposed Exchange Act Rule 770 would be provided by banks to plan sponsors or their designated fiduciaries.

*g. Record Retention Period*

Proposed Exchange Act Rule 770 would not include a record retention requirement. Banks are subject to the record retention requirements promulgated by banking regulators.

4. Request For Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

(i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information would have practical utility;

(ii) Evaluate the accuracy of the Commission's estimates of the burden of the proposed collections of information and provide the Commission with data on proposed Exchange Act Rules 770, 772, and 776;

(iii) Enhance the quality, utility, and clarity of the information to be collected; and

(iv) Minimize the burden of the collections of information on those required to respond, including through the use of automated collection techniques or other forms of information technology.

In addition to the general solicitation of comments above regarding the collections of information contained in the proposed rules, the Commission also solicits comments regarding how many banks would rely on the exemptions provided in proposed Exchange Act Rules 776, 722, and 770, and whether banks relying on such exemptions would be able to use existing systems, programs, and procedures to comply with the collections of information requirements contained in the proposed rules. Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549–0609, and refer to File No. S7–26–04. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release in the **Federal Register**. Therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–26–04, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW, Washington, DC 20549.

*C. Consideration of Benefits and Costs*

1. Introduction

Prior to enactment of the GLBA, banks were exempted from the definitions of ''broker'' and ''dealer'' in Sections 3(a)(4) and 3(a)(5) of the Exchange Act, respectively. As a result, notwithstanding the fact that banks may have conducted activities that would have brought them within the scope of the broker or dealer definitions, they were not required by the Exchange Act to register as such.[406] The GLBA replaced banks' historic exemption from the definitions of ''broker'' and ''dealer'' with fifteen functional exceptions. Eleven of these exceptions apply to broker activities and are the subject of this release.[407]

In May 2001, when the Commission adopted the Interim Rules, it analyzed their costs and benefits and noted:

> [w]hile these rules may affect how the banks' restructuring occurs, we believe that most of the restructuring will stem from the statute and not from the rules themselves. Moreover, the extent to which banks need to restructure may be limited by the way they already do business. The majority of banks conduct most of their securities activities through registered broker-dealers that are already regulated by the Commission.[408]

Given that the costs and benefits of the Interim Rules were discussed at the time they were adopted, this discussion will focus on the costs and benefits that could result from the changes the

[406] Exchange Act Release No. 44291, *supra* note 13, 66 FR at 27761.

[407] *See* Exchange Act Section 3(a)(4)(B)(i) ''(xi).

[408] 66 FR at 27790.

Commission is proposing to make through Regulation B.

2. Discussion of Proposed Regulation B

Proposed Regulation B responds to commenters' concerns that the Interim Rules are overly complex, do not provide banks with sufficient flexibility, and would be too costly to implement. The potential benefits and costs of the principal amendments the Commission is proposing are discussed below.

*a. Networking Exception*

Exchange Act Section 3(a)(4)(B)(i) excepts banks from the definition of ''broker'' if they enter into a contractual or other written arrangement with a registered broker-dealer to share revenue when the broker-dealer offers brokerage services to bank customers. This ''networking'' exception is subject to several conditions.

The section also permits banks to motivate unregistered bank employees—such as tellers, loan officers, and private bankers—to refer bank customers to their broker-dealer networking partners, through the payment of nominal referral fees.[409]

Commenters complained that provisions of the Interim Rules defining how these referral fees could be paid would impose unnecessary limits on bank networking arrangements and administrative burdens on banks.[410] As a result, the Commission is proposing to amend these provisions to allow banks to pay referral fees that do not exceed: (1) the referring employee's base hourly rate of pay; (2) $15 plus an adjustment for inflation; or (3) $25 without adjustment for inflation. Moreover, the Commission is proposing to permit banks to pay their employees non-cash referral fees under certain conditions.[411]

The Commission believes that banks will benefit in a number of ways from the proposed amendments. For example, establishing a flat fee or inflation-adjusted fee could benefit the over 8,000 smaller banks—the entities that the Commission anticipates will be most likely to take advantage of this exemption—by permitting them to pay their employees for referrals in a manner that is easy to understand and requires no complicated calculations. In addition, permitting banks to pay referral fees based on an employee's base hourly rate of pay will give banks objective and easily calculable approaches to paying their employees referrals while remaining consistent with the requirements of the GLBA that such fees be ''nominal'' in relation to the overall compensation of the referring employees.

The Commission does not anticipate that the proposed changes to the networking exception rules will impose any material additional costs to banks other than those costs that banks already would incur as a result of the GLBA and the Interim Rules. The proposed amendments discussed above are designed to provide banks flexibility while being consistent with the statutory requirements. We believe that any cost of compliance would not be significant.

We request comments generally on the costs and benefits associated with the proposed changes to the networking exception rules. We also invite banks to provide us with additional information, including data, to assist us in further evaluating the costs and benefits associated with the proposed change to the networking exception. We invite banks to include estimates of their start-up costs for updating their systems, and their annual ongoing costs for complying with the proposed changes discussed above. We invite commenters to provide us with data to assist the Commission in further evaluating these proposed rules. We specifically invite comment regarding the costs associated with proposed Exchange Act Rule 710's alternative measures of nominal referral fee value based on $15 adjusted for inflation, $25 without an adjustment for inflation, and an unregistered employee's hourly rate of pay. We also request comment on any other costs banks would likely need to incur as a result of the proposal, and ask that commenters provide us with data to support their views.

*b. Trust and Fiduciary Activities Exception*

Exchange Act Section 3(a)(4)(B)(ii) permits a bank, under certain conditions, to effect transactions in a trustee or fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for fiduciary principles and standards without registering as a broker. To qualify for the trust and fiduciary activities exception, Exchange Act Section 3(a)(4)(B)(ii) requires that the bank be ''chiefly compensated'' for such transactions on the basis of the types of fees specified in the GLBA.

The Commission believes that the proposed amendments to the Interim Rules dealing with the trust and fiduciary activities exception should provide a number of benefits to banks and their customers without imposing significant costs on either group.[412] Indeed, virtually all of the proposed amendments, discussed above, are in response to commenters' concerns that certain aspects of the Interim Rules are overly costly or burdensome to banks.

The proposed amendments to the ''chiefly compensated'' test and related exemptions should reduce banks' compliance costs and make the trust and fiduciary activities exception more useful. For example, the proposed line-of-business test should provide banks with a less costly approach for determining compliance with the trust and fiduciary activities exception. Similarly, the Commission's proposal to grandfather living, testamentary, and charitable trust accounts opened prior to a certain date should reduce banks' compliance costs by allowing them not to analyze these older accounts. In addition, the proposed exemptions for money market accounts, employee benefit plan accounts, and Regulation S accounts for non-U.S. persons, the benefits and costs of which are discussed below, should provide banks with the option of excluding from the ''chiefly compensated'' analysis compensation a bank receives from these accounts provided the accounts are in lines of business that do not contain other accounts not subject to an exemption. The proposed safe harbors should provide banks with legal certainty with respect to their compliance with the trust and fiduciary activities exception. The Commission also is proposing to amend the small bank custody exemption so that it can be used by qualifying small banks in lieu of complying with the ''chiefly compensated'' condition and the other requirements of the trust and fiduciary activities exception.

Moreover, the Commission is proposing to remove a current requirement in the Interim Rules that banks provide ''continuous and regular'' investment advice to their customers' accounts.[413] This proposed amendment to the definition of ''investment adviser if the bank receives a fee for its investment advice'' could make it easier for banks to determine that they are acting in a fiduciary capacity with respect to those accounts and thereby make it easier for banks to rely on the trust and fiduciary activities exception

[409] Exchange Act Section 3(a)(4)(B)(i)(VI) limits such referral fees to a ''nominal one-time cash fee of a fixed dollar amount'' and requires that the payment of the fees not be contingent on whether the referral results in a transaction.

[410] Exchange Act Rule 3b–17(g)(1) defines the term ''nominal one-time cash fee of a fixed dollar amount.''

[411] *See* proposed Exchange Act Rule 710(b).

[412] The trust and fiduciary exception is addressed in proposed Exchange Act Rules 720–724.

[413] Compare Exchange Act Rule 3b-17(d)(1) with proposed Exchange Act Rule 724(d)(2).

in Exchange Act Section 3(a)(4)(B)(ii).[414] In particular, in the absence of the ''continuous and regular'' requirement, banks would not be required to monitor the frequency with which their employees provide advice to determine whether they are meeting a certain continuity standard. In addition, banks would not be required to impose on their employees arbitrary requirements that they take steps to demonstrate continuity of advice, such as contacting customers, merely to satisfy the ''continuous and regular'' standard.[415]

As the Commission noted in the release adopting the Interim Rules, banks are likely to incur costs to comply with the GLBA, but ''almost all of these costs will be necessary because of the statutory change and not because of the interim final rules.''[416] The same is true with respect to the proposed amendments to the Interim Rules. None of the amendments discussed above with respect to the trust and fiduciary activities exception imposes additional requirements on banks. Indeed, for the most part, the proposed rules would increase the number of available exemptions.

Although the proposed exemptions to the ''chiefly compensated'' test should reduce banks' costs to comply with the trust and fiduciary activities exception, banks will incur costs in complying with the statutory ''chiefly compensated'' condition. The costs of compliance with the ''chiefly compensated'' condition, however, are already established by the GLBA and, to the extent they are not, they are established by current Exchange Act Rule 3a4–2. As a result, the Commission does not believe that banks would incur additional marginal costs to comply with the liberalized exemptions proposed in Exchange Act Rules 720 through 724.

We solicit comment on the costs and benefits banks expect to incur in complying with the ''chiefly compensated'' condition in the statute. We anticipate that most banks that are subject to the ''chiefly compensated'' condition will utilize the proposed line-of-business exemption, and other exemptions, such as the proposed money market account exemption, if available. To the extent that this is true, we ask that commenters attempt to provide us with data associated with complying with the ''chiefly compensated'' condition after excluding lines of business that are covered by an exemption.

In determining the costs associated with the ''chiefly compensated'' condition, we also seek comment on how banks track revenue from their trust and fiduciary business (*e.g.*, on a line-of-business basis or by type, such as assets under management fees), and whether their systems are able to distinguish revenue from various lines of business, including lines of business covered by an exemption. In addition, we seek comment on how banks track revenue they earn from mutual funds, and whether banks can separate 12b–1 fees between fiduciary and custody accounts and along lines of business in the fiduciary activity accounts.

We also seek comment on whether the ''chiefly compensated'' condition will require banks to track compensation in a manner that they have not done before, and if so, we would like information on the start-up and annual ongoing costs to update systems to track compensation in this manner. We have received preliminary estimates indicating that the costs associated with complying with the ''chiefly compensated'' condition would range from minimal to $100,000. Those banks that estimate the costs to be minimal have indicated that their systems currently are able to track compensation consistent with this condition. Other banks intend to stop receiving Rule 12b–1 fees. Those banks whose cost estimates on the high end of the range contend that their current systems would need to be reprogrammed to track compensation consistent with this condition. We solicit comment on these estimates.

*c. Safekeeping and Custody Exception*

The Interim Rules include two exemptions that permit banks to accept orders from investors for the purchase and sale of securities under limited circumstances in which the bank is acting in a safekeeping or custody capacity. These exemptions, which are in current Exchange Act Rules 3a4–4 and 3a4–5, supplement the ''safekeeping and custody activities'' exception in Exchange Act Section 3(a)(4)(B)(viii).

Current Exchange Act Rule 3a4–4 provides that small banks may effect transactions in investment company securities in customers' tax-deferred custody accounts, provided that the bank meets certain conditions. Current Exchange Act Rule 3a4–5 provides that banks may effect transactions in securities in an account for which the bank acts as custodian under Exchange Act Section 3(a)(4)(B)(viii), if, among other conditions, the bank does not receive any compensation for effecting such transactions.[417]

Commenters criticized both of these exemptions, arguing that the exemptions provide banks with less flexibility to effect securities transactions in a safekeeping or custody capacity than is provided under the GLBA.[418] In response, the Commission has decided both to simplify and expand the exemption in current Exchange Act Rule 3a4–4 (proposed to be redesignated as Exchange Act Rule 761) and to clarify and simplify current Exchange Act Rule 3a4–5 (proposed to be redesignated as Exchange Act Rule 760).

In proposed Exchange Act Rule 761, the Commission is proposing to expand the definition of ''small bank'' from the current $100 million asset limit to a $500 million asset limit, and replace the current three percent annual revenue limit with an annual sales compensation limit of $100,000. The proposed rule would also simplify the solicitation restrictions to permit small banks effecting securities transactions pursuant to this exemption to publicly solicit brokerage business as permitted by the trust and fiduciary activities exception. In addition, it would replace the broad restriction on networking with broker-dealers with a narrower restriction that only prohibits affiliation with broker-dealers. The rule would also permit dual employees and allow small banks to maintain a dedicated sales force. Moreover, the exemption would expand to include all custodial accounts not just tax-deferred accounts, and to permit transactions in all securities rather than just mutual funds. Finally, the proposed amendments would simplify the rule's restriction on payment of incentive compensation to permit banks to pay their employees incentive compensation pursuant to a networking arrangement that meets the conditions of Exchange Act Section 3(a)(4)(B)(i).

The Commission believes that the proposed amendments to the safekeeping and custody exemptions—in particular, the broadening of the exemption in current Exchange Act Rule 3a4–4—would benefit approximately 4,000 additional small banks and thrifts

[414] *See* Exchange Act Section 3(a)(4)(D) which defines ''fiduciary capacity'' for purposes of the trust and fiduciary exception to mean, among other things, ''as an investment adviser if the bank receives a fee for its investment advice.''

[415] From the perspective of the banks' customers, the removal of the ''continuous and regular'' requirement could reduce the number of unwanted contacts they receive from their banks. The removal could also decrease the likelihood that bank employees would make confusing or unnecessary securities recommendations to the banks' customers merely to ensure that the employees are providing ''continuous and regular'' investment advice.

[416] 66 FR at 27793.

[417] Exchange Act Rule 3a4–5(a)(1).

[418] *See, e.g.*, Banking Agencies letter.

by raising the asset limit for this exemption from $100 million to $500 million. As a result, many more banks would be able to rely on this exemption.

To help the Commission better assess the costs and benefits of these proposed amendments to current Exchange Act Rule 3a4–4, we invite comment from small banks. Banks should indicate their the asset size, the approximate number of their custody relationships, and the annual dollar amount of revenue that the bank receives from effecting securities transactions for custodial accounts. Small banks are also invited to estimate their start-up costs and annual ongoing costs to update their systems to track revenue that the bank receives from effecting securities transactions for its custodial accounts.

The other proposed amendments to this exemption, including permitting small banks to enter into networking arrangements with broker-dealers, have dual employees, and to expand the types of accounts and the types of securities that are covered by the exemption—will permit smaller banks to continue to perform many of the same securities activities that they perform today. As a result, up to 85 percent of small banks may not need to make material changes to their current operations, which should lower their overall costs of compliance with the GLBA. We believe that costs of compliance for qualifying small banks will not be significant. We request comment on the costs that will be incurred by qualifying small banks to comply with this proposed amended rule.

The Commission believes that the small bank exemption should provide a very useful exemption to small banks that is not also available to small broker-dealers. This may give small banks a competitive advantage over broker-dealers that might compete with those banks. That being said, the Commission believes that small banks currently provide the services that would be encompassed by proposed Exchange Act Rule 761 and, given its limited scope, should not materially impact the competitive environment between small banks and broker-dealers. Nevertheless, the Commission seeks comment on whether the proposed amendments to the small bank custody exemption as set forth in proposed Exchange Act Rule 761 place small broker-dealers at a competitive disadvantage vis-à-vis small banks. We note, however, that, according to the NASD, there are 5,304 active registered broker-dealers and that 1,284 firms, or 24.21 percent, have annual revenue of $100,000 or less. The Commission requests comment on whether the proposed amendments to the small bank custody exemption would have a cost to small broker-dealers. The Commission is particularly interested in hearing from those active registered broker-dealers that have annual revenue of $100,000 or less and whether the existence of any of the proposed bank exemptions will have a negative impact on competition. Please provide detailed information on exactly how banks and broker-dealers compete and how the particular exemptions would impact broker-dealers' business. We are also interested in the relative cost structure of these small broker-dealers as compared to banks that qualify as ''small'' under the proposed amendments to the small bank custody exemption. In these comments, please provide us with specific information on any differences in costs between banks that could use this exemption and small registered broker-dealers that could have a hidden cost that we should consider in our analysis.

We also request comment from small banks about whether they have affiliated broker-dealers or if they are affiliated with a bank holding company. Those affiliated with a bank holding company should indicate the holding company's approximate consolidated assets. Small banks are also invited to discuss whether they have a networking relationship with a registered broker-dealer, and if so, whether they have dual employees. Those with dual employees should indicate how many.

The Commission also is proposing to amend the general custody exemption, which would be codified in Exchange Act Rule 760, to permit a bank to be compensated for effecting a securities transaction for a person with an existing custody account or for a ''qualified investor'' so long as the compensation that the bank receives for its custody services (*e.g.*, securities movement fees, annual fees, asset based fees, and processing fees) does not directly or indirectly vary based on whether the bank accepts an order to purchase or sell a security. In other words, the proposed amendment would conditionally permit a custodian bank to be compensated for the movement of funds and securities for ''grandfathered'' custody accounts or accounts of ''qualified investors'' when that movement results from the bank's acceptance of a securities order. The proposed exemption also would remove limitations in the Interim Rules that prohibited custody department employees from being compensated for securities-related custody activities, including gathering assets and moving funds and securities, if the bank accepts customer orders.

We solicit comment about the costs and benefits that would be imposed by proposed Exchange Act Rule 760. In particular, we invite commenters to discuss whether banks charge their custody customers when they accept an order to purchase or sell securities, and if so, how. Banks should note whether that charge varies when they accept an order to move funds or securities without purchasing or selling securities. If the charge varies depending on the type of customer, banks should also explain the range of charges and the proportion of customers within each range.

We expect these proposed changes to ease the compliance burden on those banks that qualify for the exemption because they would permit a bank to continue to receive Rule 12b–1 shareholder servicing fees for existing custody accounts as well as for new accounts with qualified investors. While the proposed amendment to the general custody exemption could impose some limited marginal costs on banks to ensure that the compensation they receive is consistent with the exemption, we believe that, on balance, the benefits of the exemption should justify the costs of complying with it. We believe that the costs of compliance for individual banks with respect to individual accounts will not be significant. We solicit comment on the costs that individual banks will incur to comply with this proposed rule on an account basis and we ask that banks tell us how many accounts will be affected by these proposed amendments to the rule.

We solicit comment on the percentage of a bank's customers' orders to move funds and securities that also include orders to purchase or sell a security. We also solicit comment about which segment or type of customers' account for these orders, such as custody IRAs. Banks are also invited to discuss the percentage of the securities transactions they effect for custody accounts that involve the purchase or sale of mutual fund shares. In addition, we request comment on whether banks wanting to use the modified general bank custody exemption would need to code their new accounts (other than those for qualified investors) to distinguish them from old accounts and to identify qualified investors. If so, we also invite estimates of the costs associated with coding new accounts.

*d. Other Proposed Changes*

In addition to those exemptions discussed above, the Commission is proposing a number of special purpose exemptions. For example, in response to commenters' recommendations that the Commission provide more flexibility with respect to the services banks could offer to customers that utilize money market funds for cash management purposes, we are proposing a new exemption that would, subject to certain conditions, allow a bank (without registering as a broker-dealer) to effect transactions for ''qualified investors,'' trust and fiduciary activity accounts and certain agency accounts. These transactions in money market funds would not be limited to no-load funds or to transactions that are part of a sweeps program.

The proposal should benefit banks by permitting them to offer a cash management service to these customers under an exemption that has few conditions. This proposed exemption should give banks additional flexibility in structuring their business models and in accommodating the needs of their customers when the bank acts as an indenture trustee or escrow agent. Moreover, the proposed exemption should benefit the customers within the scope of the exemption by allowing them to use more financial instruments to meet their cash management needs, including money market funds, which are diversified, highly liquid, and have low transactions costs.

We do not expect banks or investors to incur any costs related to this proposed exemption. We request comment from banks on whether they will incur any costs related to this proposed exemption.

The Commission also is proposing to permit banks that are relying on the trust and fiduciary activities, safekeeping and custody, or certain stock purchase plans exceptions under the GLBA to process transactions in investment company shares through a mutual fund's transfer agent, (in addition to using a broker-dealer or Fund/SERV, which the Interim Rules currently permit), provided the banks meet certain conditions.[419] We do not expect banks to incur any costs from complying with this proposed exemption. We invite comment from banks on whether they will incur any costs related to the proposed amendments to this exemption.

The Commission is proposing a new exemption for bank trustees and non-fiduciary administrators that effect transactions in securities of open-end investment companies for participants in employee benefit plans. This proposed exemption would allow a bank to accept compensation from a fund complex as long as the bank offsets or credits any such compensation against fees and expenses that the plan owes to the bank. Since banks have advised the Commission staff that they offset or credit any compensation received from mutual funds against plan expenses, there should be no cost to banks from utilizing this proposed new exemption. We request comment on whether any banks will incur any costs as a result of this exemption. We invite any bank that believes it will incur costs as a result of this proposed exemption specifically to delineate the nature of the costs that the bank will incur.

The Commission also is proposing a new exemption that would permit banks to effect transactions pursuant to Regulation S with non-U.S. persons. We do not expect banks to incur any significant costs in connection with utilizing this proposed exemption. We request comment on whether banks will incur any costs related to this proposed exemption. The Commission is proposing to extend the cash management exemption and the exemptions from the definition of ''chiefly compensated'' relating to trust and fiduciary activity accounts to savings banks and savings and loan associations, and to extend certain GLBA bank exceptions to credit unions.[420] We do not expect savings associations, savings banks, or credit unions to incur any costs as a result of the proposed amendments to the exemptions and proposed new exemptions. We invite comment on any costs that these entities may incur related to these proposed changes. The Commission also is proposing to extend the exemption from rescission liability under Exchange Act Section 29 to contracts entered into by banks acting in a broker capacity until a date that would be 18 months after the effective date of the proposed amendments to the Interim Rules.[421] We do not expect banks to incur any costs due to the proposed amendments to this exemption. We request comment on any costs banks may incur.

The Commission believes these proposed changes could offer a number of benefits to banks, credit unions, and to their respective customers. In particular, extending the Fund/SERV exemption to mutual fund purchases and redemptions directed to the fund's transfer agent would give banks more flexibility in processing their customers' mutual fund transactions without losing a broker registration exemption.

Moreover, the proposed Regulation S exemption could help to ensure that U.S. banks that effect transactions in Regulation S securities with non-U.S. customers will be more competitive with foreign banks that offer those services. In addition, the proposed credit union exemptions should help to level the competitive playing field between banks, savings banks, savings and loan associations, and credit unions while remaining consistent with the principles of the Exchange Act. Finally, the proposed extension of the exemption from rescission liability under Exchange Act Section 29 should provide banks some legal certainty for a reasonable period of time while they become accustomed to the proposed amendments to the Interim Rules.

We estimate that the costs of the proposed exemptions would be minimal and would be justified by the benefits. For example, the Regulation S exemption could impose certain costs on banks to ensure that they remain in compliance with the conditions under the exemption. In particular, the proposed exemption would require banks to expend certain administrative costs to ensure that the proposed exemption is used only for ''eligible securities'' and for a purchaser who is outside of the U.S. within the meaning of section 903 of Regulation S. Nevertheless, the proposed exemption is an accommodation to banks that wish to effect transactions in Regulation S securities and, as a result, the compliance costs will only be imposed on those banks that believe that it is in their best business interests to take advantage of the proposed exemption. The same is true with respect to the proposed cash management exemption and the proposed exemption for credit unions. Given that Exchange Act Section 29 is rarely used as a remedy, the Commission does not anticipate that this proposed exemption will impose any costs on the industry or on investors. We request comment on whether any bank will incur any costs or will benefit as a result of this proposed exemption. Please provide any

[419] Exchange Act Section 3(a)(4)(C) requires a bank to execute through a registered broker-dealer (or internally cross) transactions executed in the United States in securities that are publicly traded in the United States that are effected pursuant to either the trust and fiduciary activities exception, the safekeeping and custody exception, or certain stock purchase plans exception. 15 U.S.C. 78c(a)(4)(B)(ii), (iv), and (viii). Current Exchange Act Rule 3a4–6 exempts from this requirement banks that process transactions in investment company securities through NSCC's Mutual Fund Services, including Fund/SERV.

[420] *See* proposed Exchange Act Rules 771 and 774, respectively.

[421] *See* proposed Exchange Act Rule 780.

supporting data with respect to such costs or benefits.

*D. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation*

Exchange Act Section 3(f) requires the Commission, whenever it engages in rulemaking, to consider or determine if an action is necessary or appropriate in the public interest, and to consider whether the action will promote efficiency, competition, and capital formation.[422] Exchange Act Section 23(a)(2) requires the Commission, in adopting rules under that Act, to consider the impact that any such rule would have on competition. This section also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[423]

The Commission has considered the proposed amendments to the Interim Rules in light of these standards and preliminarily believes that they will not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Indeed, the Commission believes that by providing legal certainty to banks that conduct securities activities, by clarifying the GLBA requirements, and by exempting a number of activities from those requirements, the proposed amendments should allow banks to continue to conduct many of the securities activities they already conduct consistent with the GLBA. As a result, the Commission believes that the proposed amendments will permit banks to continue to compete with broker-dealers in providing a wide range of securities activities, which should preserve competition and help to keep transaction costs low for investors and for companies. We note, however, that, according to the NASD, there are 5,304 active registered broker-dealers and that 1,284 firms, or 24.21 percent, have annual revenue of $100,000 or less. The Commission requests comment on whether the proposed amendments would promote efficiency, competition, and capital formation. The Commission is particularly interested in hearing from those active registered broker-dealers that have annual revenue of $100,000 or less and whether the existence of any of the proposed bank exemptions will have a negative impact on competition. Please provide detailed information and data on exactly how banks and broker-dealers compete and how the particular exemptions would impact broker-dealers' business.

*E. Consideration of Impact on the Economy*

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or ''SBREFA,'' [424] the Commission must advise the Office of Management and Budget as to whether the proposed amendments to the Interim Rules constitute a ''major'' rule. Under SBREFA, a rule is considered ''major'' where, if adopted, it results or is likely to result in:

An annual effect on the economy of $100 million or more (either in the form of an increase or a decrease);

A major increase in costs or prices for consumers or individual industries; or

A significant adverse effect on competition, investment, or innovation.

If a rule is ''major,'' its effectiveness will generally be delayed for 60 days pending Congressional review. We request comment on the potential impact of the proposed amendments on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

*F. Initial Regulatory Flexibility Analysis*

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA''), in accordance with the provisions of the Regulatory Flexibility Act (''RFA''),[425] regarding the proposed amendments to the Interim Rules.

1. Reasons for the Proposed Action

The Commission is proposing the amendments to the Interim Rules to respond to a number of concerns commenters raised about the Interim Rules and generally to make the guidance and exemptions provided in those rules more useful to the industry while preserving the investor protection principles of the GLBA.

2. Objectives

The proposed amendments are intended to improve the usefulness and clarity of the principles addressed by the Interim Rules. The Commission intends for the proposed amendments to the Interim Rules to provide legal certainty to the industry with respect to the GLBA requirements. The Commission also seeks to make the restrictions imposed by the GLBA more accommodating of current securities activities carried out by banks while preserving investor protection principles.

3. Legal Basis

Pursuant to the Exchange Act and, particularly, Sections 3, 23(a), and 36 thereof, the Commission proposes to adopt amendments to the Interim Rules.

4. Small Entities Subject to the Rule

Congress did not exempt small entity banks from the application of the GLBA. Moreover, because the Interim Rules are intended to provide guidance to all banks that are subject to the GBLA, the Commission determined that it would not be appropriate to exempt small entity banks from the operation of those Rules. Therefore, the Interim Rules generally applied to banks that would be considered small entities.

Nevertheless, in adopting the Interim Rules, the Commission recognized that small banks' customers often use banks to effect transactions in IRAs. To allow small banks to continue to offer this service, the Commission adopted Exchange Act Rule 3a4–4 (which we are proposing to amend and redesignate as Exchange Act Rule 761), which provides a limited exemption from broker-dealer registration for small banks that effect transactions in investment company securities in tax-deferred accounts.[426]

In response to comments that the scope of this exemption is too limited to be useful to small banks and their customers, as discussed above, the Commission is proposing to expand the small bank exemption. A proposed amendment to this rule would raise the limit on this exemption from $100 million to $500 million in assets. The proposed amount could greatly expand the number of banks that qualify for the exemption.[427] The Commission seeks comment on the number of banks that would qualify for the small bank custody exemption.

Moreover, the proposed amendment would expand the scope of the exemption to increase the types of securities that could be bought or sold under the exemption and the types of accounts. It would also permit a small bank to use a dedicated bank sales force

[422] 15 U.S.C. 78c(f).

[423] 15 U.S.C. 78w(a)(2).

[424] Pub. L. 104–121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

[425] 5 U.S.C. 603.

[426] 66 FR at 27781.

[427] A $500 million asset limit could greatly expand the availability of this exemption from broker registration, increasing the number of eligible entities from over 4,000 FDIC-insured banks and thrifts, or approximately 48 percent of all such entities, to over 8,000 FDIC-insured banks and thrifts, or almost 88 percent of all such entities. Given that some of these entities may be affiliated with larger holding companies or may be affiliated with registered broker-dealers, however, some of these entities presumably would not meet the proposed definition of small bank. *See* proposed Exchange Act Rules 761(a) and 762(h).

to effect transactions in securities that may consist of either unregistered personnel or registered representatives employed by both a broker-dealer and the small bank seeking to qualify for the exemption.

5. Reporting, Recordkeeping and Other Compliance Requirements

The proposed amendments would not impose any new reporting, recordkeeping, or other compliance requirements on banks that are small entities.

6. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with the proposed amendments.

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[428] the Commission must consider the following types of alternatives: (a) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the proposed rule, or any part thereof, for small entities.

As discussed above, the GLBA does not exempt small banks from the Exchange Act broker-dealer registration requirements, and the Commission does not believe that an unconditional exemption would be consistent with the investor protection principles of the GLBA. Moreover, such an exemption could place broker-dealers at a competitive disadvantage versus small banks.

The proposed amendments to the Interim Rules (which would be codified in Regulation B) are intended to clarify and simplify compliance with the GLBA by expanding exemptions in the Interim Rules and by adding additional exemptions. As such, the proposed amendments should ease compliance on banks of all sizes, including smaller entities.

The Commission does not believe that it is necessary to consider whether small entities should be permitted to use performance rather than design standards to comply with the proposed amendments because they already propose performance standards and do not dictate for entities of any size any particular design standards (*e.g.*, technology) that must be employed to achieve the objectives of the proposed amendments.

Nevertheless, as discussed above, the Commission is proposing to expand the exemption for small banks in current Exchange Act Rule 3a4–4 (which we are proposing to redesignate as Exchange Act Rule 761) by increasing the asset limit from $100 million to $500 million, as well as expanding the types of securities included under the exemption. These proposed changes should further ease the compliance burden on those small banks that qualify for the exemption.

8. Request for Comments

The Commission encourages written comments on matters discussed in the IRFA. In particular, the Commission requests comments on (a) the number of small entities that would be affected by the proposed amendments; (b) the nature of any impact the proposed amendments would have on small entities and empirical data supporting the extent of the impact; and (c) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed amendments. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule is adopted, and will be placed in the same public file as comments on the proposed rule itself. Persons wishing to submit written comments should refer to the instructions for submitting comments in the front of this release.

## V. Statutory Authority

Pursuant to authority set forth in the Exchange Act and particularly Sections 3(b), 15, 23(a), and 36 thereof (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm, respectively) the Commission proposes to (1) amend current Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 15a–8, and 15a–9 (§§ 240.3a4–2, 240.3a4–3, 240.3a4–4, 240.3a4–5, 240.3a4–6, 240.15a–8, and 240.15a–9, respectively) and redesignate them as Rules 721, 723, 761, 760, 775, 780, and 773 (§§ 242.721, 242.723, 242.761, 242.760, 242.775, 242.780, and 242.773, respectively) (2) amend Exchange Act Rule 15a–6 (§ 240.15a–6); (3) repeal Rule 3b–17 (§ 240.3b–17); and redesignate Exchange Act Rules 15a–10, and 15a–11 as 15a–7 (§ 240.15a–7), and 772 (§ 242.772).

## VI. Text of Proposed Rules and Rule Amendments

### List of Subjects

*17 CFR Part 240*

Broker-dealers, Reporting and recordkeeping requirements, Securities.

*17 CFR Part 242*

Banks, banking, Brokers, Broker-dealers, Credit unions, Savings associations, Securities.

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

## PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

**§§ 240.3a4–2 through 240.3a4–6 [Removed]**

2. Sections 240.3a4–2 through 240.3a4–6 are removed.

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**§ 240.3b–17 [Removed and Reserved]**

3. Section 240.3b–17 is removed and reserved.

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4. Section 240.15a–6 is amended by revising paragraph (a)(4)(i) to read as follows:

**§ 240.15a–6 Exemption of certain foreign brokers or dealers.**

(a) * * *

(4) * * *

(i) A registered broker or dealer, whether the registered broker or dealer is acting as principal for its own account or as agent for others, or a bank acting pursuant to an exception or exemption from the definition of ''broker'' or ''dealer'' in sections 3(a)(4)(B) or 3(a)(5)(C) of the Act (15 U.S.C. 78c(a)(4)(B) or 15 U.S.C. 78c(a)(5)(C)).

* * * * *

**§§ 240.15a–7 through 240.15a–9 [Removed]**

5. Sections 240.15a–7 through 240.15a–9 are removed.

**§ 240.15a–10 [Redesignated]**

6–7. Section 240.15a–10 is redesignated as § 240.15a–7.

[428] 5 U.S.C. 603(c).

## PART 242—REGULATIONS M, ATS, AC AND B AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

8. The part heading for part 242 is revised as set forth above.

9. The authority citation for Part 242 is revised to read as follows:

**Authority:** 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

10. Part 242 is amended by adding Regulation B, §§ 242.710 through 242.781, to read as follows:

**Regulation B—Securities Activities of Banks and Other Financial Institutions**



## Regulation B—Securities Activities of Banks and Other Financial Institutions

## Subpart A—Networking Exception: Defined Terms

### § 242.710 Defined terms relating to the networking exception from the definition of ''broker.''

When used with respect to the Third Party Brokerage Arrangements (''Networking'') Exception from the definition of the term ''broker'' in section 3(a)(4)(B)(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(i)), the following terms shall have the meaning provided:

(a) *Contingent on whether the referral results in a transaction* means contingent on any factor related to whether the referral results in a securities transaction, including whether it is likely to result in a transaction, whether it results in a particular type of transaction, or whether it results in multiple transactions, *provided, however,* that a referral fee may be contingent on whether a customer:

(1) Contacts or keeps an appointment with a registered broker or dealer as a result of the referral; or

(2) Has assets, a net worth, or income meeting any minimum requirement that the registered broker or dealer, or the bank, may have established generally for referrals for securities brokerage accounts.

(b) *Nominal one-time cash fee of a fixed dollar amount* means a payment:

(1) Having a value that does not exceed the greater of:

(i) The employee's base hourly rate of pay;

(ii) Twenty five dollars; or

(iii) A dollar amount that does not exceed the whole dollar amount nearest to fifteen dollars in 1999 dollars adjusted by the cumulative annual percentage change in the Consumer Price Index All Urban Consumers—(CPI–U) published by the Department of Labor that was reported on June 1 of the preceding year;

(2) Paid to a bank employee no more than one time for each customer referred by that employee;

(3) That, to the extent any portion of the fee is paid other than in cash:

(i) Is paid in units of value with a readily ascertainable cash equivalent;

(ii) Has, together with any portion of the fee paid in cash, a total cash value that meets the conditions of paragraph (b)(1) of this section; and

(iii) Is paid under an incentive program that covers a broad range of products and that is designed primarily to reward activities unrelated to securities; and

(4) Having a set value that a particular employee making a referral would receive for any referral to a registered broker or dealer, and that does not vary based on factors such as the financial status of a customer the employee refers, the identity of the registered broker or dealer to which the customer is referred, the number of referrals the employee makes, or whether the customer expresses an interest in a particular type of securities product.

(c) *Referral* means the action taken by a bank employee to direct a customer of the bank to a registered broker or dealer for the purchase or sale of securities for the customer's account.

## Subpart B—Trust and Fiduciary Activities Exception: Exemptions and Defined Terms

### § 242.720 Exemption from the ''chiefly compensated'' condition for banks with existing living, testamentary, or charitable trust accounts.

(a) A bank relying on the exception from the definition of the term ''broker'' under section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)) is exempt from meeting the ''chiefly compensated'' condition in section 3(a)(4)(B)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)(I)) to the extent that it effects transactions in securities for a living, testamentary, or charitable trust account opened, or established before July 30, 2004, in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities

Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)), if the bank:

(1) Meets the other conditions for the exception from the definition of the term ''broker'' under sections 3(a)(4)(B)(ii) and 3(a)(4)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(C)); and

(2) Does not individually negotiate with the accountholder or beneficiary of such account to increase the proportion of sales compensation as compared to relationship compensation after July 30, 2004.

(b) For purposes of this section, a testamentary trust may be deemed to be established as of the date of the will that directed that the trust be established.

**§ 242.721 Exemption for banks from determining whether they are ''chiefly compensated'' on a line of business basis.**

(a) A bank relying on the exception from the definition of the term ''broker'' under section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)) is exempt from meeting the ''chiefly compensated'' condition in section 3(a)(4)(B)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)(I)) to the extent that it effects transactions in securities for any account in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)) in any year in which the bank:

(1) Meets the other conditions for the exception from the definition of the term ''broker'' under sections 3(a)(4)(B)(ii) and 3(a)(4)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(C));

(2) Can demonstrate that during the preceding year its ratio of sales compensation to relationship compensation was no more than one to nine;

(3) Maintains procedures reasonably designed to ensure that, before opening or establishing an account for which it will act in a trustee or fiduciary capacity, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation than sales compensation with respect to that account; and

(4) Maintains procedures reasonably designed to ensure that, after opening or establishing an account for which it will act in a trustee or fiduciary capacity, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of sales compensation as compared to relationship compensation, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation than sales compensation with respect to that account.

(b) A bank that fails to meet the ratio requirement in paragraph (a)(2) of this section may nonetheless continue to rely on the exemption in paragraph (a) of this section for one year if it:

(1) Meets the other requirements in paragraph (a) of this section;

(2) Can demonstrate that during the preceding year its ratio of sales compensation to relationship compensation was no more than one to seven; and

(3) Did not rely on the safe harbor in paragraph (b) of this section during any of the five preceding years.

(c) A bank may use this section for all accounts for which the bank acts in a trustee or fiduciary capacity on a bank-wide basis, or a bank may use this section for one or more individual lines of business provided that the sales compensation and relationship compensation from all accounts for which the bank acts in a trustee or fiduciary capacity, or all accounts established before a single date certain for which the bank acts in a trustee or fiduciary capacity, within a particular line of business is used to determine whether the bank meets the requirement in paragraph (a)(2) or (b)(2) of this section.

**§ 242.722 Exemption for banks from determining whether they are ''chiefly compensated'' on an account-by-account basis.**

(a) A bank relying on the exception from the definition of the term ''broker'' under section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)) is exempt from meeting the ''chiefly compensated'' condition in section 3(a)(4)(B)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)(I)) to the extent that it effects transactions in securities for an account in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)) in any year in which the bank:

(1) Meets the other conditions for the exception from the definition of the term ''broker'' under sections 3(a)(4)(B)(ii) and 3(a)(4)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(C));

(2) Can demonstrate that it met the ''chiefly compensated'' condition with respect to such account during the preceding year;

(3) Maintains procedures reasonably designed to ensure that, before opening or establishing an account for which it will act in a trustee or fiduciary capacity, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation than sales compensation with respect to that account; and

(4) Maintains procedures reasonably designed to ensure that, after opening or establishing an account for which it will act in a trustee or fiduciary capacity, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of sales compensation as compared to relationship compensation, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation than sales compensation with respect to that account.

(b) Except as provided in paragraph (d) of this section, a bank that fails to meet the requirement in paragraph (a)(2) of this section with respect to an account may nonetheless continue to rely on the exemption in paragraph (a) of this section with respect to such account for one year if it:

(1) Meets the other requirements in paragraph (a) of this section; and

(2) Did not rely on the safe harbor in paragraph (b) of this section with respect to such account during any of the five preceding years.

(c) Except as provided in paragraph (d) of this section, a bank that fails to meet the requirements in paragraphs (a)(2) and (b)(2) of this section with respect to an account may nonetheless continue to rely on the exemption in paragraph (b) of this section with respect to such account if it:

(1) Meets the other requirements in paragraph (a) of this section;

(2) Has documented the reason that such account continued not to meet the ''chiefly compensated'' condition and linked that reason to its exercise of fiduciary responsibility; and

(3) Has no more than the lesser of 500 or one percent of the total number of accounts for which it acts in a trustee or fiduciary capacity that did not meet the requirement in paragraph (b)(2) of this section.

(d) A bank may not rely on the safe harbors in paragraphs (b) and (c) of this section if more than ten percent of the total number of accounts for which it acts in a trustee or fiduciary capacity did not meet the ''chiefly compensated'' condition.

**§ 242.723 Exemption from the definition of ''broker'' for banks effecting transactions as an indenture trustee in a no-load money market fund.**

A bank that meets the conditions for the exception from the definition of the term ''broker'' under section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)), except for the ''chiefly compensated'' condition in section 3(a)(4)(B)(ii)(I) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)(I)), is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions as an indenture trustee in a no-load money market fund.

**§ 242.724 Defined terms relating to the trust and fiduciary activities exception from the definition of ''broker.''**

For purposes of this subpart and sections 3(a)(4)(B)(ii) and 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(D)), the following terms shall have the meaning provided:

(a) *Chiefly compensated* means that during the preceding year, the bank received more relationship compensation than sales compensation from an account for which the bank acts in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)).

(b) *Flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers* means a fee that is no more than the amount a broker-dealer charged an account for which the bank acts in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)) for executing the transaction, plus the direct marginal cost of any resources of the bank that are used for transaction execution, comparison, or settlement for accounts for which the bank acts in a trustee or fiduciary capacity if the bank makes a precise and verifiable allocation of these resources according to their use.

(c) *Indenture trustee* means any trustee for an indenture to which the definition in section 303 of the Trust Indenture Act of 1939 (15 U.S.C. 77ccc) applies, and any trustee for an indenture to which the definition in section 303 of that Act would apply but for an exemption from qualification pursuant to section 304 of that Act.

(d) *Investment adviser if the bank receives a fee for its investment advice* in section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)) means a bank that has a fiduciary relationship with the advised customer in which the bank:

(1) Owes the customer duty of loyalty, including an affirmative duty to make full and fair disclosure of all material facts and conflicts of interest; and

(2) Has an ongoing responsibility to provide investment advice based upon the customer's individual needs that includes selecting or making recommendations regarding specific securities and, if the customer accepts such selections or recommendations, a responsibility to direct the purchases or sales to a registered broker or dealer for execution.

(e) *Line of business* means an identifiable department, unit, or division of a bank organized and operated on an ongoing basis for business reasons with similar types of accounts and for which the bank acts in a similar type of fiduciary capacity as listed in section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)).

(f) *Money market fund* has the same meaning as in § 242.740.

(g) *No-load* has the same meaning as in § 242.740.

(h) *Relationship compensation* means any compensation a bank receives directly from a customer or beneficiary, or directly from the assets of an account for which the bank acts in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)), that consists solely of:

(1) An administration or annual fee (payable on a monthly, quarterly, or other basis);

(2) A fee based on a percentage of assets under management;

(3) A flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers; or

(4) Any combination of such fees.

(i) *Sales compensation* means any compensation a bank receives in connection with activities for which it relies on an exception under section 3(a)(4)(B)(ii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)) that is:

(1) A fee for effecting a securities transaction that exceeds the fee defined in paragraph (b) of this section;

(2) Compensation that if paid to a broker or dealer would be payment for order flow, as defined in 17 CFR 240.10b-10;

(3) A finders' fee received in connection with a securities transaction or account, except a fee received pursuant to section 3(a)(4)(B)(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(i));

(4) A fee paid for an offering of securities that the bank does not receive directly from a customer or beneficiary, or directly from the assets of an account for which the bank acts in a trustee or fiduciary capacity, which fee may be allocated to each account by dividing the number of shares of each class of an investment company's securities (or class of a series of an investment company's securities) held in each account on the last business day of the preceding year by the aggregate number of shares of the same class held by the bank in a trustee or fiduciary capacity on the same day, and multiplying the resulting number by the aggregate dollar amount of these fees the bank received in connection with that class during the preceding year, or by using another method of allocation that fairly and consistently measures the amount of sales compensation attributable to each account during the preceding year;

(5) A fee paid pursuant to a plan under 17 CFR 270.12b–1, which fee may be calculated for each account by multiplying the number of shares of each class of a registered investment company's securities (or class of a series of an investment company's securities) held in each account on the last business day of the preceding year by the net asset value per share for that class of securities for such day by the annual Rule 12b–1 fee rate applicable to that class of securities, or by using another method of allocation that fairly and consistently measures the amount of sales compensation attributable to each account during the preceding year; or

(6) A fee paid by an investment company, other than pursuant to a plan under 17 CFR 270.12b–1, for personal service or the maintenance of shareholder accounts, which fee may be allocated to each account by dividing the number of shares of each class of an investment company's securities (or class of a series of an investment company's securities) held in each account on the last business day of the preceding year by the aggregate number of shares of the same class held by the bank in a trustee or fiduciary capacity on the same day, and multiplying the resulting number by the aggregate dollar amount of these fees the bank received in connection with that class during the preceding year, or by using another method of allocation that fairly and consistently measures the amount of sales compensation attributable to each account during the preceding year. For purposes of this section, charges for the following will not be considered charges for personal service or for the maintenance of shareholder accounts:

(i) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(ii) Aggregating and processing purchase and redemption orders for investment company shares;

(iii) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(iv) Processing dividend payments for the investment company;

(v) Providing sub-accounting services to the investment company for shares held beneficially;

(vi) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

(j) *Year* means a calendar year or other fiscal year consistently used by the bank for recordkeeping and reporting purposes.

## Subpart C—[Reserved]

## Subpart D—Sweep Accounts Exception: Defined Terms

### § 242.740 Defined terms relating to the sweep accounts exception from the definition of "broker."

For purposes of section 3(a)(4)(B)(v) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(v)), the following terms shall have the meaning provided:

(a) *Deferred sales load* has the same meaning as in 17 CFR 270.6c–10.

(b) *Money market fund* means an open-end company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) that is regulated as a money market fund pursuant to 17 CFR 270.2a–7.

(c)(1) *No-load,* in the context of an investment company or the securities issued by an investment company, means, for securities of the class or series in which a bank effects transactions, that:

(i) That class or series is not subject to a sales load or a deferred sales load; and

(ii) Total charges against net assets of that class or series of the investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually and are disclosed in the investment company's prospectus.

(2) For purposes of this definition, charges for the following will not be considered charges against net assets of a class or series of an investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts:

(i) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(ii) Aggregating and processing purchase and redemption orders for investment company shares;

(iii) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(iv) Processing dividend payments for the investment company;

(v) Providing sub-accounting services to the investment company for shares held beneficially;

(vi) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

(d) *Open-end company* has the same meaning as in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–5(a)(1)).

(e) *Sales load* has the same meaning as in section 2(a)(35) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(35)).

## Subpart E—Affiliate Transactions Exception: Defined Terms

### § 242.750 Defined terms relating to the affiliate transactions exception from the definition of "broker."

For purposes of section 3(a)(4)(B)(vi) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(vi)), the term *effects transactions for the account of any affiliate* means effecting a securities transaction as agent for an affiliate of the bank as defined in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(k)), provided that:

(a) The affiliate is:

(1) Acting as a principal; or

(2) Acting as a trustee or fiduciary purchasing or selling for investment purposes; and

(b) The affiliate is not:

(1) Acting as a riskless principal for another person;

(2) Registered as a broker or dealer; or

(3) Engaged in merchant banking as described in section 4(k)(4)(H) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)(4)(H)); and

(c) The bank obtains the security or securities to complete the transaction from a registered broker or dealer, from a person that is acting in the capacity of a broker or dealer that is not required to register as such, or pursuant to another exception or exemption from section 3(a)(4)(B) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)).

## Subpart F—Safekeeping and Custody Activities Exception: Exemptions

### § 242.760 Exemption from the definition of "broker" for banks effecting transactions in securities in a custody account.

(a) A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) to the extent that it accepts orders to effect transactions in securities in an account for which the bank acts as a custodian under section 3(a)(4)(B)(viii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(viii) for a person with an account that was opened before July 30, 2004, or for a qualified investor if:

(1) The bank can demonstrate that it does not charge for or receive any compensation for effecting such transactions that directly or indirectly varies based on whether the bank accepts an order to purchase or sell a security other than:

(i) A fee paid pursuant to a plan under 17 CFR 270.12b–1; or

(ii) A fee paid by a registered investment company, other than pursuant to a plan under 17 CFR 270.12b–1, for personal service or the maintenance of shareholder accounts;

(2) Any bank employee effecting such transactions does not receive compensation from the bank, the executing broker or dealer, or any other person related to the size, value, or completion of any securities transaction effected pursuant to this exemption;

(3) The bank does not directly or indirectly solicit such securities transactions except through responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser of the security; *provided, however,* that the content of such responses is limited to:

(A) Information contained in a registration statement for the security filed under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*); and

(B) Sales literature prepared by the principal underwriter that is a registered broker or dealer or prepared by a registered investment company that is not an affiliated person of the bank;

(4) The bank does not effect securities transactions in reliance on this section for an account for which the bank acts in a trustee or fiduciary capacity within

the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D));

(5) The bank does not effect securities transactions in reliance on this section for an account described in § 242.770(a)(1);

(6) The bank does not effect transactions in reliance on § 242.761;

(7) The bank complies with section 3(a)(4)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(C)); and

(8) If the bank accepts an order to effect transactions in securities of a registered investment company for compensation as described in paragraph (a)(1)(i) or (a)(1)(ii) of this section, the bank does so on the same terms for any class or series of securities of such registered investment company that can reasonably be obtained by the bank for purchase or sale by bank customers.

(b) A bank may demonstrate that it does not receive compensation for effecting securities transactions that varies based on whether the bank accepts an order to purchase or sell a security by:

(1) Utilizing fee schedules that specify charges for the movement of funds and securities; and

(2) Identifying similarly situated customers who pay the same price for such movements and who do not utilize the bank or its affiliates to effect securities transactions.

(c) For purposes of this section, the term *qualified investor* has the same meaning as in section 3(a)(54)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(54)(A)).

**§ 242.761 Exemption from the definition of "broker" for small banks effecting securities transactions in a custody account.**

A small bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) to the extent that it accepts orders to effect transactions in securities in an account for which the bank acts as custodian under section 3(a)(4)(B)(viii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(viii)) if:

(a) The bank is not a person associated with a broker or dealer;

(b) The bank does not publicly solicit such securities transactions except by soliciting brokerage business as permitted under section 3(a)(4)(B)(ii)(II) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(ii)(II));

(c) The annual sales compensation the bank receives for effecting transactions in securities pursuant to this exemption does not exceed $100,000 in 2004 dollars adjusted by the cumulative annual percentage change in the Consumer Price Index All Urban Consumers—(CPI–U) published by the Department of Labor that was reported on June 1 of the preceding year;

(d) The bank does not effect securities transactions in reliance on this section for an account for which the bank acts in a capacity described in section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)) unless it does not rely on any exemption under § 242.720, § 242.721, or § 242.722 in the year following the year in which this exemption is utilized in connection with such an account;

(e) The bank does not pay its employees any incentive compensation related to any brokerage transaction effected under this section except pursuant to a networking arrangement that meets the conditions of section 3(a)(4)(B)(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(i)); and

(f) The bank complies with section 3(a)(4)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(C)).

**§ 242.762 Defined terms relating to the safekeeping and custody activities exception from the definition of "broker."**

For purposes of this subpart, the following terms shall have the meaning provided:

(a) *Account for which the bank acts as a custodian* means an account established by a written agreement between the bank and the customer, which at a minimum provides for the terms that will govern the fees payable, rights, and obligations of the bank regarding:

(1)(i) Safekeeping of securities;

(ii) Settling trades;

(iii) Investing cash balances as directed;

(iv) Collecting income;

(v) Processing corporate actions;

(vi) Pricing securities positions; and

(vii) Providing recordkeeping and reporting services; or

(2) An individual retirement account for which the bank acts as a custodian.

(b) *Affiliate* has the same meaning as in the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

(c) *Affiliated person* has the same meaning as in section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)).

(d) *Bank holding company* has the same meaning as in the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

(e) *Principal underwriter* has the same meaning as in section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29)).

(f) *Sales compensation* has the same meaning as in § 242.724.

(g) *Savings and loan holding company* has the same meaning as in section 10(a)(1)(D) of the Home Owners' Loan Act (12 U.S.C. 1467(a)(1)(D)).

(h) *Small bank* means a bank that:

(1) Had less than $500 million in assets as of December 31 of both of the prior two calendar years; and

(2) Is not, and since December 31 of the third prior calendar year has not been, an affiliate of a bank holding company or a savings and loan holding company that as of December 31 of both of the prior two calendar years had consolidated assets of more than $1 billion.

## Subpart G—Special Purpose Exemptions

**§ 242.770 Exemption from the definition of "broker" for banks effecting transactions in securities in certain employee benefit plans.**

(a) A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions in securities of an open-end company in an account for a plan that is qualified under section 401(a) of the Internal Revenue Code of 1986 (26 U.S.C. 401(a)) or a plan described in sections 403(b) or 457 of the Internal Revenue Code of 1986 (26 U.S.C. 403(b) or 26 U.S.C. 457) for which the bank acts as a trustee or a custodian; or offers participants a participant-directed brokerage account, if:

(1) The bank offsets or credits any compensation that it receives from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes to the bank;

(2) The bank provides a clear and conspicuous disclosure to the plan sponsor or its designated fiduciary, if any, that includes all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex in a manner that permits the plan sponsor or its designated fiduciary, if any, to determine that the bank has offset or credited any compensation received from a fund complex related to securities in which plan assets are invested or to be invested against the fees and expenses that the plan owes to the bank;

(3) The bank offers the participant-directed brokerage account through a registered broker or dealer;

(4) The bank does not pay any incentive compensation to a natural person that is not qualified pursuant to

the rules of a self-regulatory organization that differs based on the value of a security or the type of security purchased or sold by an account or a person who exercises control over the assets of such account; and

(5) The bank complies with section 3(a)(4)(C) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(C)).

(b) *Definitions.* For purposes of this section:

(1) *Fund complex* means the issuer of the security (including the sponsor, depositor or trustee), the issuer of any other security that holds itself out to investors as a related company for purposes of investment or investor services, any agent of such issuer, any investment adviser of such issuer, and any affiliated person (as defined in section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)) of such issuer or any such investment adviser.

(2) *Open-end company* has the same meaning as in § 242.740.

(3) *Participant-directed brokerage account* means an account that is carried by a broker or dealer on a basis in which each participant that receives any brokerage services is fully disclosed to the broker or dealer.

**§ 242.771 Exemption from the definitions of ''broker'' and ''dealer'' for banks effecting transactions in securities issued pursuant to Regulation S.**

(a) A bank is exempt from the definitions of the terms ''broker'' and ''dealer'' under sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4) and 15 U.S.C. 78c(a)(5)), to the extent that, as agent or as a riskless principal, the bank:

(1) Effects a sale of an eligible security to a purchaser who is outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903;

(2) Effects a resale of an eligible security after its initial sale within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a person who is not a U.S. person under 17 CFR 230.902(k) to a purchaser or a registered broker or dealer, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904; or

(3) Effects a resale of an eligible security after its initial sale within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a registered broker or dealer to a purchaser, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904.

(b) *Definitions.* For purposes of this section:

(1) *Distributor* has the same meaning as in 17 CFR 230.902(d).

(2) *Eligible security* means a security that:

(i) Is not being sold from the inventory of the bank or an affiliate of the bank; and

(ii) Is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank.

(3) *Purchaser* means a person who purchases an eligible security and who is not a U.S. person under 17 CFR 230.902(k).

(4) *Riskless principal transaction* means a transaction in which, after having received an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer.

**§ 242.772 [Reserved]**

**§ 242.773 Exemption from the definitions of ''broker'' and ''dealer'' for savings associations and savings banks.**

(a) Any savings association or savings bank that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811 *et. seq.*), and is not operated for the purpose of evading the provisions of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), is exempt from the definitions of the terms ''broker'' and ''dealer'' under sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4) and 15 U.S.C. 78c(a)(5)), to the extent that the savings association or savings bank acts as a broker or dealer on the same terms and under the same conditions that banks are excepted, provided that if a savings association or savings bank acts as a municipal securities dealer, it shall be considered a bank municipal securities dealer for purposes of the Securities Exchange Act of 1934 and the rules thereunder, including the rules of the Municipal Securities Rulemaking Board.

(b) Any savings association or savings bank that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811 *et seq.*), and is not operated for the purpose of evading the provisions of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), is exempt from the definitions of the terms ''broker'' and ''dealer'' under sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4) and 15 U.S.C. 78c(a)(5)) to the extent that the savings association or savings bank acts as a broker or dealer on the same terms and under the same conditions that banks are exempted pursuant to §§ 242.720 through 242.723, § 242.761, § 242.772, § 242.775, § 242.776, § 242.780 and § 242.781.

**§ 242.774 Exemption from the definitions of ''broker'' and ''dealer'' for credit unions.**

Any federal or state-chartered credit union that is not operated for the purpose of evading the provisions of the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) is exempt from the definitions of the terms ''broker'' and ''dealer'' under sections 3(a)(4)(B)(i) and (v) and 3(a)(5)(C)(ii) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(B)(i) and (v) and 15 U.S.C. 78c(a)(5)(C)(ii)), to the extent that the credit union acts as a broker or dealer on the same terms and under the same conditions that banks are excepted under those sections of the Securities Exchange Act of 1934.

**§ 242.775 Exemption from the definition of ''broker'' for the way banks effect excepted or exempted transactions in investment company securities.**

(a) A bank that meets the conditions for an exception or exemption from the definition of the term ''broker'' except for the condition in section 3(a)(4)(C)(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(C)(i)), is exempt from such condition to the extent that it effects transactions in securities issued by an open-end company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system, provided that:

(1) Such transactions are effected through the National Securities Clearing Corporation's Mutual Fund Services or directly with a transfer agent acting for the open-end company; and

(2) With respect to such transactions:

(i) The transfer agent, if any, does not accept compensation paid for the distribution of the securities, including any compensation paid pursuant to any revenue-sharing arrangement and compensation paid pursuant to a plan under 17 CFR 270.12b–1; and

(ii)(A) The securities are distributed by a registered broker or dealer; or

(B) The sales charge is no more than the amount a registered broker or dealer may charge pursuant to the rules of a securities association registered under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3) adopted pursuant to section 22(b)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–22(b)(1)).

(b) *Definitions.* For purposes of this section:

(1) *Interdealer quotation system* has the same meaning as in 17 CFR 240.15c2–11.

(2) *Open-end company* has the same meaning as in § 242.740.

**§ 242.776 Exemption for banks effecting transactions for certain investors in money market funds.**

(a) A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions on behalf of a customer in securities issued by a money market fund, provided that:

(1)(i) The customer has obtained from the bank a financial product or service not involving securities and is a qualified investor as defined in section 3(a)(54)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(54)(A)), or a person that directs the purchase of securities from any cash flows that relate to an asset-backed security as defined in proposed 17 CFR 229.1101(c)(1) of Regulation AB, which has a minimum original asset amount of $25,000,000;

(ii) The bank effects the transactions in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)(D)); or

(iii) The bank effects the transactions as escrow agent, collateral agent, depository agent, or paying agent; and

(2)(i) The class or series of securities is no-load; or

(ii)(A) The class or series of securities is not no-load, and the bank does not characterize or refer to the class or series of securities as no-load; and

(B) If the customer is not a person described in paragraph (a)(1)(i) of this section, the bank provides the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities and a clear and conspicuous notice that:

(*1*) Discloses any payments the bank may receive in connection with the transactions from the fund complex to which the issuer of the securities belongs;

(*2*) Separately identifies any such payments that are sales loads, deferred sales loads, or fees paid pursuant to a plan under 17 CFR 270.12b–1; and

(*3*) Indicates that the customer should carefully review the prospectus for the securities for additional information regarding expenses.

(b) *Definitions.* For purposes of this section:

(1) *Deferred sales load* has the same meaning as in § 242.740.

(2) *Fund complex* has the same meaning as in § 242.770.

(3) *Money market fund* has the same meaning as in § 242.740.

(4) *No-load* has the same meaning as in § 242.740.

(5) *Open-end company* has the same meaning as in § 242.740.

(6) *Sales load* has the same meaning as in § 242.740.

## Subpart H—Temporary Exemptions

**§ 242.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.**

(a) No contract entered into before January 1, 2003, shall be void or considered voidable by reason of section 29 of the Securities Exchange Act of 1934 (15 U.S.C. 78cc) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(a)), any other applicable provision of that Act, or the rules and regulations thereunder based solely on the bank's status as a broker or dealer when the contract was created.

(b) No contract entered into before March 31, 2005, shall be void or considered voidable by reason of section 29 of the Securities Exchange Act of 1934 (15 U.S.C. 78cc) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(a)), any other applicable provision of that Act, or the rules and regulations thereunder based solely on the bank's status as a dealer when the contract was created.

(c) No contract entered into before [insert date 18 months after effective date of the final rule], shall be void or considered voidable by reason of section 29 of the Securities Exchange Act of 1934 (15 U.S.C. 78cc) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(a)), any other applicable provision of that Act, or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created.

**§ 242.781 Exemption from the definition of ''broker'' for banks for a limited period of time.**

A bank is exempt from the definition of the term ''broker'' under Section 3(a)(4) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)) until January 1, 2006.

Dated: June 17, 2004.

By the Commission.

**J. Lynn Taylor,**

*Assistant Secretary.*

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