Testimony of

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On behalf of the

INDEPENDENT COMMUNITY BANKERS OF AMERICA

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HOUSE FINANCIAL SERVICES COMMITTEE

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Chairman Bachus, Chairman Baker, Ranking Member Waters, Ranking Member Kanjorski, members of the Committee, it is a privilege to be here to present the views of our nation's independent community banks on the SEC's interim final rule to implement Title II of the Gramm-Leach-Bliley Act. Title II addresses exceptions for banks from being defined as brokers or dealers. My name is K. Reid Pollard, and I am president and CEO of Randolph Bank and Trust Company, a $186 million community bank located in Asheboro, North Carolina. I serve on the Federal Legislation Committee of the Independent Community Bankers of America (ICBA)[1], on whose behalf I appear today.

Mr. Chairman, we wish to thank you for holding this hearing to examine one of the more controversial rulemaking proposals pursuant to the Gramm-Leach-Bliley Act. We believe the rule in its present form is incompatible with congressional intent and would impose unworkable and burdensome requirements that would disrupt many of the activities traditionally conducted in banks that involve securities transactions, such as trust, fiduciary and custodial activities

Many of our concerns are shared by Members of Congress and representatives of the federal banking agencies who were instrumentally involved in the negotiations and drafting of the Title II provisions. Notable among those expressions of concern, Mr. Chairman, is your letter of July 19, co-signed by Chairman Oxley and the chairman of every Subcommittee of this Committee, as well as a separate letter sent on the same date by Ranking Member LaFalce.

It is importantly to remember that, as the House Banking Committee in the last Congress, this committee had primary jurisdiction over the Gramm-Leach-Bliley Act. Clearly, this committee knows what Congress intended when it passed the Gramm-Leach-Bliley Act.

In addition, on June 29, a joint comment letter was filed by the Federal Reserve Board, the FDIC and the OCC, similarly critical of the SEC's rulemaking.

SEC Response

Like you, Mr. Chairman, we very much welcome and appreciate the SEC's announcement on July 17 that the compliance date and comment period for this rule would be extended and that amendments to the rule would be made. We would ask the SEC to take it one step farther, however, and issue a substantially revised rule for another round of public comment. We believe that it would be an error for the SEC to try to fix this rule and proceed immediately to a final rule based on comments it has received on the existing interim final rule. Rather, a new proposal is needed based on the input the

[1] ICBA is the primary voice for the nation's community banks, representing 5,500 institutions at nearly 16,700 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than $491 billion in insured deposits, $589 billion in assets and more than $344 billion in loans for consumers, small businesses and farms. They employ nearly 232,000 citizens in the communities they serve. For more information, visit www.icba.org.

agency has received and with an opportunity for the public to provide input on a new proposal. The ICBA also believes that it is critical that the SEC should defer compliance for at least 12 months after a final rule is published to allow banks the time to adapt systems, procedures and products and services.

Summary of Concerns

On July 17, the ICBA filed an extensive comment letter on the interim final rule, which is attached to this testimony for the permanent hearing record. The ICBA comment letter describes the concerns of independent community bankers in substantial detail. For the sake of brevity, I will summarize several of our principal concerns in this testimony, and urge Members to review our entire comment letter.

Exceptions Critical to Community Banks

Prior to enactment of the Gramm-Leach-Bliley Act, banks enjoyed a blanket exemption from registration as brokers or dealers under the 1934 Securities and Exchange Act. Gramm-Leach-Bliley removed the blanket exemption, but recognizing that banks have long offered customers certain securities services without problem, instituted a series of exceptions for certain traditional banking activities, such as trust and fiduciary activities.

These statutory exceptions are extremely important for community banks and our customers. Registering as brokers or dealers or establishing a broker-dealer affiliate is simply not an option for most small banks. The capital required and the compliance and reporting systems that small banks would have to implement to register as broker-dealers are not commensurate with the potential income streams for these banks. The business case would not justify registration.

Furthermore, many community banks operate in rural areas where it would be difficult to recruit and retain experienced licensed personnel to staff such an operation. Therefore, practical and useful applications of the statutory exceptions are critical to continue to provide these services and to make them available to investors. In fact, without these exceptions, in some rural areas, customers might not have personal access to any financial institution that offers these services if their local bank discontinues them.

Rule is Incompatible with Congressional Intent, Would Add to Regulatory Burden

Title II of the Gramm-Leach-Bliley Act was designed to ensure that traditional banking activities involving securities transactions, such as fiduciary activities and custodial functions, are not disturbed, and that banks are able to continue to provide services to customers as they have for many years. However, the rule as written would impose unworkable and burdensome requirements that would, in fact, disrupt trust and fiduciary activities, and essentially nullify the congressional exceptions. The rule fails to take into account the extensive fiduciary requirements that other laws impose on bank trust and fiduciary activities and overlooks the existing supervisory framework that the federal banking agencies have established to supervise these activities.

For example, the SEC interim final rule would allow the SEC to assess what constitutes acting as a fiduciary. This is unnecessary and would lead to confusion and uncertainty. Many states have adopted laws that govern the activities and responsibilities of banks acting as fiduciary. In addition, the common law in most states further defines these responsibilities. There is no need for the SEC to evaluate what constitutes acting as a fiduciary when state law already establishes this.

Furthermore, the banking agencies have extensive examination procedures that closely review bank fiduciary activities, including the appropriateness of investments, whether they are compatible with law and the governing instrument, and so forth. It is unnecessary for the SEC to institute additional controls.

"Push Out" Would be Costly to Customers

The interim final rule will disrupt long-standing fiduciary and trustee activities, and increase costs and impose burden and inconvenience on bank customers. For example, if a bank is required to "push-out" the securities activities of a trust account to a registered broker-dealer, customers will be forced to have one account with a bank and a separate brokerage account with a broker-dealer to conduct securities transactions. State laws govern what entities may serve as trustee and while banks may generally serve as a corporate trustee, a broker-dealer may not, mandating this dual account situation and unnecessarily driving up costs for trust customers.

Chiefly Compensated Definition Flawed

To prevent banks from using trust services to engage in a full-brokerage operation, the Gramm-Leach-Bliley Act requires that banks be "chiefly compensated" for trust and fiduciary activities on the basis of non-brokerage related fees. However, the SEC interpretation creates a complex and unworkable definition of compensation, and inappropriately requires the bank to monitor and analyze each individual trust account in order to comply with the rule. This would require unworkable and unduly burdensome calculations. The alternative "safe harbor" proposed by the SEC to allow banks to avoid the account-by-account calculation is also unworkable and therefore useless. The ICBA believes that the analysis should be done on the entire trust operations of the bank and not on each individual account.

Safekeeping and Custodial Functions Jeopardized

The interim final rule also would severely disrupt bank safekeeping and custody arrangements by taking an overly narrow view of what activities are acceptable and by determining that securities transactions are generally impermissible. For example, the interim final rule would not allow a bank to accept orders to purchase and sell securities when serving as custodian. This interpretation makes little sense and defeats the purpose of the statutory exception. If a bank cannot accept orders from a customer on the disposition of securities the bank holds as custodian, including orders to purchase and

sell, then there is little reason for a bank to serve as custodian. The SEC interpretation makes the bank custodial role little more than one of corporate safety deposit box.

The Gramm-Leach-Bliley Act clearly intended that these activities be allowed to continue, but the interim final rule would make it virtually impossible for banks to continue to serve customers as they have for many years.

Exemptions

Perhaps recognizing this, the SEC has proposed two special exemptions to the limitation, for small banks and accommodation trades. But the exemptions are so complex and restrictive as to be of negligible value.

The first exemption would be for small banks. To qualify for the small bank exemption, the interim final rule would require that a bank have less than $100 million in assets and not be affiliated with a holding company with more than $1 billion in consolidated assets. This cap is much too low. The ICBA believes a higher figure would be much more appropriate for this exemption, and there are precedents for a higher figure. For example, the federal banking agencies have streamlined CRA examination procedures for "small banks," defined as having less than $250 million in assets. And the Gramm-Leach-Bliley Act permits "small banks" of under $500 million in assets unqualified eligibility for membership in the Federal Home Loan Bank System.

If this exemption is retained (we believe it would be unnecessary under a proper interpretation of the statute), we recommend that the SEC revise the definition of small bank at least to one with $250 million in assets, and perhaps even higher, to be more in keeping with existing banking industry guidelines and the realities of the present world of mergers and consolidations.

A second exemption, "the accommodation exemption," would allow banks to engage in certain securities transactions on behalf of a restricted category of safekeeping and custody customers, such as those with self-directed IRAs and other tax-deferred accounts. Currently, banks can offer a full range of investment products to their self-directed IRA customers, from CDs to stocks and bonds. However, under the SEC's interim final rule, banks would be limited to offering investments strictly in SEC-registered mutual funds. This restriction would put banks at an unfair competitive advantage in relation to other financial service providers. Since this restriction is not mandated under the Gramm-Leach-Bliley Act, it should be eliminated.

If the agency had simply followed the plain language of the statute to exempt custody and safekeeping activities, these two special exemptions would be unnecessary. Therefore, the ICBA recommends the agency adopt a much broader interpretation of what is permissible under the custody and safekeeping exception, one more in keeping with the Gramm-Leach-Bliley Act.

Networking Arrangements Restricted, Referral Fee Caps Unrealistic

Many community banks rely on networking arrangements with third-party broker-dealers to serve their customers. Under the Gramm-Leach-Bliley Act, if a bank contracts with a third-party to offer brokerage services to the bank's customers, the bank will not be considered a broker subject to SEC broker registration requirements and regulation. Under this "networking" exception, bank employees may not receive incentive compensation for any brokerage transaction, although the statute provides that they may receive referral fees that are nominal one-time cash payments of a fixed dollar amount that is not contingent on whether the referral results in a sale.

The interim final rule would impose new and unrealistic restrictions on referral fees, inappropriately interjecting the SEC into bank employee compensation programs. For example, the gross hourly wage cap that the interim final rule imposes is unrealistic and implementation of this restriction raises employee privacy concerns. Because of the impracticalities and burdens of using an hourly wage level as a cap for the referral fee, the ICBA strongly opposes its use. We believe that bank compensation is a matter more appropriately supervised by banking regulators.

***De Minimis* Exception Important to Small Banks**

The Gramm-Leach-Bliley Act contains an important exception from registration for a bank that conducts no more than 500 securities transactions in a calendar year. Under this provision, transactions excepted under one of the other Gramm-Leach-Bliley Act provisions (e.g., trust and fiduciary activities, safekeeping and custodial transactions, etc.) are not included when calculating the 500 transaction limit.

This *de minimis* exception is extremely important to small banks. The statutory language is plain and straightforward on this exception. However, the interim final rule contains a provision that confuses the plain meaning of the statute. The SEC interim final rule would count certain transactions twice – once as a sale and once as a purchase. This double counting is illogical and incompatible with plain English. We urge the SEC to define a transaction solely as the transfer of a security from one owner to a new owner and only counted once.

Asset Securitization Limited

The interim final rule also proposes unrealistic and unworkable rules for a bank to qualify for an exception from dealer requirements for asset securitization. Under the Gramm-Leach-Bliley Act, banks can underwrite and sell asset-backed securities if the underlying obligations were primarily originated by the bank, an affiliate, or through a syndicate of which the bank is a member.

However, in order for a bank to qualify for this exception under the SEC's interim final rule, "predominantly"means that at least 85 percent of the value of the obligations in the pool must have been originated by the bank, one of its non-broker dealer affiliates, or a

syndicate of which the bank is more than an insignificant member. The rule also says that to be considered as having originated the underlying obligations, the bank must have initially made and funded the obligation.

The ICBA believes that the 85 percent threshold set by the SEC is too high. While smaller community banks are unlikely to take the lead in putting together the pool of assets that are securitized, for many small banks, the ability to sell loans into the market is critical for liquidity and to be able to meet credit needs by funding new loans. Sales of loans to institutions that securitize them is one way that small banks obtain new funding. However, by making it difficult for larger banks to incorporate loans that they themselves do not originate, the SEC erects a barrier to small banks selling these loans into the market. We believe the 85 percent threshold should be dropped. A simple majority – 51 percent – would be sufficient to carry out the intent of Congress. And, it would ensure that securitizations continue to serve as a source of funding for banks.

Second, the SEC definition of a syndicate will make many existing arrangements ineligible for the securitization exception. Because the interim final rule's interpretation is so narrow, many syndications will no longer qualify, making it more difficult for banks to use this successful tool to continue to serve low- and moderate-income borrowers.

Need for a Cure Mechanism

One of the points raised by the federal banking agencies with which the ICBA strongly concurs is the need for a cure mechanism for inadvertent errors. If a bank is operating in good faith and making reasonable efforts to comply with the requirements, yet inadvertently falls out of compliance, the bank should be able to rectify the error without having to suddenly register as a broker-dealer or without allowing customers to void transactions, as would be possible if the bank were defined as a broker-dealer that had not registered. The ICBA believes that any final rule should include a cure mechanism to address this issue.

Conclusion

We believe that the SEC's interpretations in the interim final rule governing the Gramm-Leach-Bliley Act exceptions from the definition of broker and dealer are unduly and unnecessarily narrow, complicated and qualified. The net effect of the restrictions and conditions is to nullify the statutory exceptions. This is neither in keeping with the spirit nor the express language of the Gramm-Leach-Bliley Act.

Congress clearly intended that banks continue to be able to provide services to their customers that they have offered successfully for many years. Banks have offered these services, including securities transactions, as part of their traditional banking activities without problem. These activities are subject to strict fiduciary standards and closely supervised by the various banking agencies. Congress recognized all this when it established the exceptions under Title II of the Gramm-Leach-Bliley Act. Banks should

be allowed to continue providing traditional services to their customers without sustaining or passing on to their customers prohibitive costs to comply.

Therefore, the ICBA has urged the SEC to substantially revise and reissue for public comment a proposed rule that gives effect to Congress' intent and that addresses all the exceptions provided in the statute.

Thank you for this opportunity to testify.

Enclosure