TESTIMONY OF
LAURA S. UNGER, ACTING CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE FUNCTIONAL REGULATION PROVISIONS OF THE GRAMM-LEACH-BLILEY ACT

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES AND THE SUBCOMMITTEE ON FINANCIAL INSITUTIONS AND CONSUMER CREDIT OF THE COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

August 2, 2001

Chairmen Baker and Bachus, Ranking Members Kanjorski and Waters, and Members of the Subcommittees:

I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission ("SEC" or "Commission") regarding the Gramm-Leach-Bliley Act's ("GLBA" or "Act") functional exceptions to the definitions of "broker" and "dealer" contained in the Securities Exchange Act of 1934 ("Exchange Act") and the Commission's rules that provide guidance on these exceptions and grant additional exemptions from broker-dealer registration to banks and other financial institutions.

We recognize that a variety of issues have been raised about the Commission's rules. We are paying attention. The Commission has been engaged in a constructive dialogue with the banking industry and regulators to understand their concerns. Discussions to date have narrowed some of the issues and provided useful guidance for amending some of the rules. We remain committed to adopting rules that faithfully uphold the plain meaning of the GLBA and the intent of Congress in enacting the legislation.

I. Brief Overview

The GLBA repealed the blanket exception of banks from the definitions of “broker” and “dealer” in the Exchange Act. In its place, the GLBA amended the Exchange Act to provide a number of functional exceptions to the definitions of “broker” and “dealer.” As a result, banks that engage in securities activities either must conduct those activities through a broker-dealer or assure that their securities activities meet the conditions of a functional exception.[1] The GLBA’s amendments to the Exchange Act became effective on May 12, 2001.

Prior to the May 12 effective date, the Commission received requests for guidance on the new functional exceptions. To better understand what guidance was needed, the Commission staff met with representatives of the banking industry and banking regulators. Based on these discussions and letters from the banking industry, the Commission, on May 11, 2001, issued rules (“Rules”) defining certain key terms used in the new functional exceptions to the definitions of “broker” and “dealer.”[2] The Rules also granted banks and other financial institutions additional exemptions from the definitions of “broker” and “dealer.” Significantly, the Rules do not impose new obligations in addition to those created by the GLBA. The Commission’s goal was to adopt rules that are consistent with the language and Congressional intent of the GLBA and the Commission’s mandate to protect investors. The Commission solicited comment on the Rules.

To give banks additional time to adjust to the requirements of the GLBA and the guidance provided by the Rules, one exemption extended the effective date of the GLBA’s

---

1 As a practical matter, it is unlikely that a bank would register as a broker-dealer.

2 See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Release No. 34-44291 (May 11, 2001), 66 FR 27760 (May 18, 2001).

amendments to the definitions of “broker” and “dealer” to October 1, 2001. In response to requests from commenters on the Rules, the Commission recently issued an Order further extending the time for banks to comply with the requirements of the GLBA until May 12, 2002. The Order also gave notice that the Commission expects to amend the Rules, and that it does not expect banks to develop compliance systems for the provisions of the GLBA discussed in the Rules until after the Rules are amended. The Commission also stated that it expects to extend the date for compliance with the GLBA yet again when it adopts amended rules.

Banks, bank trade groups, and banking regulators have raised a variety of issues about the Rules. The Commission is sensitive to the concerns of the banking industry and will explore opportunities to permit greater flexibility and to alleviate practical concerns. To that end, the Commission staff has been meeting frequently with industry representatives and seeking specific factual information relating to the banking industry’s practices, including compensation arrangements. These meeting have been very productive, and we hope to continue this dialogue as we amend the Rules.

II. Background on the Gramm-Leach-Bliley Act and the Commission’s Rules

A. Gramm-Leach-Bliley Act

In seeking to modernize the law of financial services, Congress was faced with a simple but vexing question – when banks act like brokers, how should they be regulated? The answer to that question ultimately determines the kind of consumer protection that investors receive. The Commission supported functional regulation to ensure that all customers purchasing securities receive the protections of broker-dealer regulation, whether they are customers of a bank or a registered broker-dealer, and that broker-dealer activities are consistently regulated.

The GLBA reflects Congress' endorsement of functional regulation of bank securities activities by the SEC, as well as its desire to provide "certain limited exemptions to facilitate certain activities in which banks have traditionally engaged."[3] The statute replaces the blanket exception of banks from the definitions of "broker" and "dealer" with 11 functional exceptions to the definition of "broker" and four functional exceptions to the definition of "dealer."

The GLBA functional exceptions are complex and highly negotiated provisions. Like many difficult compromises that Congress has to make, the Act and its exceptions did not completely satisfy everyone. The Commission, as the agency charged with administering the federal securities laws, supported passage of the Act, including the functional exceptions, because it believed that investors would remain protected under the Act.[4]

B. The Commission's Rules

1. The Commission's Rules Responded to Requests for Guidance

The GLBA provided an 18-month transition period between the date of adoption of the statute and the effective date of the new definitions of "broker" and "dealer" to give banks time to adapt to the new statutory scheme. The GLBA did not require the Commission to engage in rulemaking in this area, and the Commission originally anticipated that rulemaking would not be necessary. Rather, the Commission expected that difficulties in implementing the statute would

---

3 H.R. Conf. Rep. No. 106-434, 164 (1999).

4 As then-Chairman Levitt wrote to Senator Gramm days before passage of the Act:

> As you know, the Securities and Exchange Commission has long supported financial modernization legislation that provides the protections of the securities laws to all investors. I believe that the changes to the securities laws contained in the proposed amendments to the Chairmen's Mark that we agreed upon today will significantly strengthen the investor protections of the bill.
>
> With the approval of those amendments, which I understand you are distributing now, I enthusiastically support the securities provisions contained in the Mark.

See Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Senator Phil Gramm, Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate (Oct. 14, 1999).

be isolated, mainly involving issues of specific interest to individual banks. Those types of issues could be addressed readily through individual exemptions tailored to a particular bank's circumstances, and would not necessarily implicate the banking industry as a whole.

As the transition period progressed, however, the Commission staff became increasingly aware, through contacts with representatives of the industry and banking regulators, of the areas of uncertainty in the industry about the scope of the new statutory exceptions. The Commission received several requests to delay the effective date of the GLBA provisions applicable to banks, as well as for general guidance in interpreting some of the terms used in specific functional exceptions.

We concluded that rulemaking was necessary for three reasons. First, rules would provide predictability, thereby helping banks plan their ongoing business operations. Second, the Commission staff was told that banks are more familiar with implementing standards imposed by formal regulations rather than by interpretive guidance. Third, the rapidly approaching statutory deadline, coupled with the level of industry uncertainty, strongly suggested that it would be best to provide prompt and definitive guidance on issues needing clarification.

2. The Commission Received Substantial Input from the Banking Community and the Rules Reflect This Input

The Commission issued its Rules only after receiving substantial input from the banking community, including its trade organizations and regulators. In the months prior to the effective date of the GLBA amendments to the Exchange Act, the Commission received a number of letters asking how some of the key terms in the new definitions of "broker" and "dealer" should be interpreted.[5] Several of the letters asked the Commission to delay implementing the GLBA amendments to the definition of "broker" and "dealer."[6] Commission staff also engaged in a dialogue with representatives of the banking community to solicit their input on the GLBA amendments.

Many of the Rules' definitional provisions respond directly to interpretive questions raised by banks during this period. Other rules create new exemptions that the banking industry requested, such as the rule exempting thrifts from broker-dealer registration on the same terms and conditions as banks and the rule granting an exemption to allow banks to process mutual fund trades through a facility of the National Securities Clearing Corporation ("NSCC"), which is a registered clearing agency.[7]

Commission staff also met with representatives of the Federal Reserve Board ("Fed"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") prior to issuing the Rules. While there was disagreement on certain

---

5 See, e.g., Letter from Melanie L. Fein, Counsel, Federated Investors, Inc., to Robert L.D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 30, 2001). Letter from Melanie L. Fein, Counsel, Federated Investors, Inc., to Robert L.D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 13, 2001). Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 13, 2001); Letter from Senator Phil Gramm, U.S. Senate Committee on Banking, Housing, and Urban Affairs, to Arthur Levitt, Chairman, Commission (Feb. 6, 2001).

6 See, e.g., Letter from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers, to Robert L.D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission, (Mar. 15, 2001); Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 2001); Letter from Robert M. Kurucza, General Counsel, Bank Securities Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 12, 2001); Letter from Sarah A. Miller, Director, Center for Securities, Trusts, and Investments, American Bankers Association, to Laura S. Unger, Acting Chairman, Commission (Feb. 28, 2001).

7 Letter from Scott M. Albinson, Managing Director, OTS, to Annette L. Nazareth, Director, Division of Market Regulation, and Paul F. Roye, Director, Division of Investment Management, Securities and Exchange Commission (March 20, 2001); Letter from Sarah A. Miller, American Bankers Association, to Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Securities and Exchange Commission (November 7, 2000).

substantive issues, it is fair to say that our rulemaking was informed by the input and insights we received during these discussions. The Commission adopted three exemptions to address issues raised by the banking regulators. First, the Commission created an alternative aggregate compensation calculation so that many banks would not have to do an account-by-account calculation to decide whether they were "chiefly compensated" by the fees enumerated in the Act. The Commission set the compliance limit for the alternative computation at a level that industry participants told the Commission staff would avoid triggering the account-by-account calculation in the "chiefly compensated" requirement.

Second, the Fed, the OCC, and the FDIC expressed concern that investors could void securities transactions if banks inadvertently exceeded the "chiefly compensated" calculation. Although experience for the past 70 years shows that investors have seldom voided securities transactions, particularly because doing so is an equitable remedy imposed by courts, the Commission created a temporary exemption from the application of investors' rescission rights.

Third, the FDIC expressed concern that the statutory exceptions could be unduly burdensome for small banks. Although it had been subject to negotiations at one point, the Act did not contain a small bank exception. In response to the FDIC's concerns, the Commission added a small bank custody exemption so that small banks that did not have ready access to broker-dealers could continue to provide this service to their clients on an accommodation basis.

In addition, the Fed expressed concern about how the chiefly compensated calculation would be applied to account clusters. The Commission specifically sought comment on how such a calculation could be applied in that situation.

3. <u>The Commission Issued the Rules as Interim Final Rules and Solicited Comment</u>

The Commission issued the Rules as interim final rules, a rulemaking procedure that also was used by the banking regulators in several of their GLBA rulemakings. Because banks were asking for our guidance, we believed that it was important to provide banks with legal certainty as quickly as possible, given the May 12, 2001 statutory date. We were particularly concerned about an open-ended extension of a statutorily mandated effective date. Through interim final rules we also could grant immediate relief to banks from certain of the provisions of the statute. At the same time, we could afford an opportunity for substantive comment by delaying the effectiveness of the GLBA amendments and soliciting comment on the Rules and a number of the other issues and approaches. The Commission indicated a willingness to change the Rules, as appropriate, in light of those comments.

Use of interim final rules also seemed appropriate because the Rules do not impose new obligations in addition to those created by the GLBA. Instead, the Rules provide guidance as to the meaning of certain provisions of the Act or provide exemptive relief consistent with the intent of those provisions.

4. The Commission Extended the Statutory Deadline Further

Based on the comments the Commission received on the Rules and recent discussions with banks and banking regulators, the Commission determined that the temporary exemption that it granted banks from the definitions of "broker" and "dealer" might not provide banks with sufficient time to adapt to the new statutory scheme of the GLBA.

In addition, in light of the continuing dialogue between the Commission and industry participants, the Commission recognized that some of the Rules in their current form will need to be amended. As such, banks would be faced with the challenge of complying with the new statutory scheme based on the guidance (and exemptions) provided under the current Rules only to have that guidance (and exemptions) change when the Rules are amended. Consequently, several commenters requested that the Commission extend the temporary exemption from the definitions of “broker” and “dealer,” thereby extending the date for compliance with the new statutory scheme. The Commission responded to these concerns by issuing an Order extending the temporary exemption of banks from the GLBA’s amended definitions of “broker” and “dealer” until May 12, 2002.

The Commission’s Order also gave notice that it expected to amend the Rules and to extend further the temporary exemption from the definitions of “broker” and “dealer,” as appropriate, so that banks would have a sufficient transition period to bring their operations into compliance with the new statutory scheme based on the amended Rules. The Commission also stated that it does not expect banks to develop compliance systems for the provisions of the GLBA discussed in the Rules until after the Rules are amended. At the same time it issued the Order extending the temporary exemption of banks from the definitions of “broker” and “dealer,” the Commission extended the comment period on the Rules to September 4, 2001.

III. The Commission’s Rules Define Terms and Provide Exemptions Consistent with Congressional Intent

Two of the Commission’s Rules, Rules 3b-17 and 3b-18, define key terms used in several of the functional exceptions from the definitions of “broker” and “dealer.” These exceptions apply when banks enter into networking arrangements with broker-dealers, act in a trustee or fiduciary capacity, sweep funds into no-load money market funds, and hold funds and securities for investors. The Rules were designed to clarify the boundaries of these new statutory exceptions and to promote the clear Congressional intent to prevent banks from running full-scale brokerage operations outside the protections of the federal securities laws. These exceptions and the Rules interpreting these exceptions are discussed below.

In addition to the definitional provisions, the Rules provide banks with eight additional exemptions from broker-dealer registration. One of these exemptions grants banks a temporary reprieve from the operation of the GLBA by exempting banks from the amended definitions of "broker" and "dealer" until October 1, 2001, which has now been extended to May 12, 2002. The Commission granted other exemptions to enable banks to continue to conduct many of their current securities activities that do not raise significant sales practice concerns. The Commission did this because, although the negotiations leading up to the passage of the GLBA lasted many years, the statute imposed some requirements that would have created serious operational and practical problems for banks. These problems were inevitable in a statute that applies to an entire industry that has developed multiple business models over a long period of time.[8]

A. Networking Exception

1. <u>The Statutory Language</u>

Under the Exchange Act, banks that contract with broker-dealers to provide brokerage services to their customers, known as broker-dealer "networking" arrangements, may be excepted from broker-dealer registration. A bank is not considered a broker if it "enters into a contractual or other written arrangement" with a registered broker-dealer through which the broker-dealer "offers brokerage services on or off the premises of the bank."[9] The conditions to the exception address separation of brokerage and banking services, compliance with advertising conditions, functions and compensation of bank employees, full disclosure of customers' accounts to broker-dealers, and restrictions on banks acting as carrying brokers.

8 For example, banks typically process mutual fund orders through a facility of the NSCC. Because the GLBA generally prohibits banks from executing securities trades except through a registered broker-dealer, banks would have had to discontinue processing mutual funds orders through the NSCC. In response to a request from the American Bankers Association, the Commission adopted a rule to allow banks to process mutual fund orders through the NSCC.

The networking exception specifically provides that bank employees (other than employees who are associated persons of a broker-dealer and are qualified pursuant to the rules of a self-regulatory organization) may not receive:

> incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the <u>referral</u> of any customer if the compensation is a <u>nominal one-time cash fee of a fixed dollar amount</u> and the payment of the fee is not contingent on whether the <u>referral</u> results in a transaction (emphasis added).[10]

2. <u>The Rules Provide Flexibility to Banks to Compensate Employees</u>

The Rules sought to keep Congress' limit on incentive compensation in mind in interpreting two terms in this provision. The Rules define the term "referral" to mean a bank employee arranging a first securities-related contact between a registered broker-dealer and a bank customer. The term "referral," and therefore the activity for which a referral fee may be paid, is limited and does not extend to any activity beyond arranging that first securities-related contact (including any part of the account opening process) that is related to effecting transactions in securities.[11]

In addition, the Rules provide two alternative definitions of the term "nominal one-time cash fee of a fixed dollar amount." First, the Rules provide that a nominal one-time cash fee of a fixed dollar amount may be a payment that does not exceed the gross cash wages that the unregistered bank employee making the referral receives for one hour of work. Second, the Rules provide that a nominal one-time cash fee of a fixed dollar amount may be a payment in the form of points in a system or program that covers a range of bank products and non-securities

---

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

10 Exchange Act Section 3(a)(4)(B)(i)(VI) [15 U.S.C. 78c(a)(4)(B)(i)(VI)].

related services, where the points count toward a bonus. However, the points awarded for referrals involving securities may not be greater than the points awarded for products or services not involving securities. Banks may use either alternative in setting nominal payments.

The Rules provide the two alternatives to give banks the flexibility of compensating their employees for securities referrals based either on their current wages or on what the banks pay for referrals of other products and services. The Act does not provide for banks' use of a point system to pay for securities-related referrals. Nevertheless, the Commission adopted a point system alternative based on discussions between the Commission staff and banks about industry practice. By creating two alternative standards, the Rules seek to allow banks to develop a market-based approach to employee compensation, consistent with the compensation limitation in the networking exception.

The Rules include a definition of these terms in response to requests for guidance from industry participants. In addition, they are intended to give substance to Congressional limits on compensation that otherwise could induce bank employees to encourage customers to trade securities. Because payments can create conflicts of interest, the exception is intended to limit the size of these payments to "nominal amounts."

A bank certainly may give bonuses to its employees based on the overall profitability of the bank regardless of the specific contribution of the employees receiving the bonus. However, to rely on the networking exception, banks cannot indirectly pay their employees through a bonus program related to the securities transactions of a branch, department, or line of business. We solicited comment on practical ways to draw this line.

---

[11] The "account opening process" commences at the point of first contact between a broker-dealer and a customer. See NASD Notice to Members 97-89 (1997), at Question 7.

Some commenters have expressed concerns about the difficulty of paying "nominal" referral fees on the basis of hourly wages for banking employees with many different pay structures across the breadth of the country. To determine whether a more flexible approach is feasible and appropriate, we are discussing with banks their current compensation arrangements.

B. The Trust and Fiduciary Activities Exception

1. The Statutory Language

The trust and fiduciary activities exception in the Act is limited to banks that act as trustees or in one of eleven fiduciary capacities, including acting as an investment adviser if the bank receives a fee for its investment advice, and acting in any capacity in which the bank possesses investment discretion on behalf of another. Under the terms of this exception, a bank will not be considered a "broker" if it: (1) effects transactions in a trustee or fiduciary capacity; (2) effects such transactions in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards; (3) is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing such securities transactions or any combination of such fees; and (4) does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.[12]

[12] Exchange Act Sections 3(a)(4)(B)(ii)(I) and (II) [15 U.S.C. 78c(a)(4)(B)(ii)(I) and (II)]. A bank also must execute such transactions through a registered broker-dealer or in a cross trade if using the trust and fiduciary activities exception. Exchange Act Section 3(a)(4)(C) [15 U.S.C. 78c(a)(4)(C)].

This exception recognizes that banks traditionally have held securities in trust accounts, and Congress directed the Commission not to disturb banks' traditional trust business when interpreting this exception.[13] Congress, however, indicated that the Commission should interpret the exception so that banks could not run a full-scale brokerage operation in their trust departments without the appropriate investor protections provided under the federal securities laws.[14] There is a tension between these two directives, and our Rules sought to be faithful to both.

2. The Rules Provide Certainty on the Conditions of the Exception

The Rule's interpretation of the statutory conditions to the trust and fiduciary activities exception sought to address these two conflicting goals.

a. Trustee and Fiduciary Capacities

As stated previously, a bank may use the trust and fiduciary activities exception only if it is effecting transactions as a trustee or in one of the enumerated fiduciary capacities. The statute unequivocally addressed trustees, which are subject to the strongest of fiduciary duties. Questions were raised with the Commission staff, however, regarding indenture trustees, ERISA trustees, and IRA trustees, because of the legal uncertainty as to whether these three capacities are subject to the same fiduciary duties and obligations as "traditional" trustees. The Commission believed it important to provide certainty for banks acting in these capacities that wanted to use the trust and fiduciary activities exception. Therefore, the Rules provide a definitional exemption for banks acting as indenture, ERISA, and IRA trustees that makes clear that they qualify for this exception, irrespective of questions regarding their fiduciary status.

---

[13] H.R. Conf. Rep. No. 106-434, 164 (1999).

[14] H.R. Rep. No. 106-74, pt. 3, at 164 (1999).

Another fiduciary status addressed under the Rules was "fiduciary capacity" for banks acting as an investment adviser if the bank "receives a fee for its investment advice" or "possess[es] investment discretion on behalf of another."[15] Questions arose in the situation where a bank provides both investment advisory services and brokerage to a non-discretionary advisory account for a fee. In particular, should a fee be considered payment for investment advice if the bank provides an occasional, impersonal research report and unlimited brokerage?

To give banks guidance in these situations, the Rules provide that when banks give both non-discretionary investment advice and brokerage services to an account for a fee, the bank must be providing "continuous and regular investment advice . . . that is based on the individual needs of the customer" in order for it to be clear that the fees paid are for investment advice, rather than for brokerage. The guidance seeks to give effect to Congress' intent, as discussed earlier, that a bank not be permitted to offer full scale brokerage services absent the investor protections of the federal securities laws. We are considering comments that indicate there are other meaningful forms of investment advice that are provided for a fee.

b. <u>Examination for Fiduciary Principles and Standards</u>

Another requirement for banks using the trust and fiduciary activities exception is that banks must effect their transactions in the trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. Congress believed that this requirement would provide customers with "some basic protections" to mitigate the lack of federal securities law protections.[16]

---

[15] Exchange Act Sections 3(a)(4)(D)(i) and (ii) [15 U.S.C. 78c(a)(4)(D)(i) and (ii)].

[16] H.R. Conf. Rep. No. 106-434, 164-65 (1999).

The Rules deferred to bank regulators in determining whether a particular bank's activities are conducted in an area that is regularly examined by bank examiners for compliance with fiduciary principles. The Rules noted that the condition in the statute was not limited to particular portions of the securities transaction. We are willing to explore aspects of handling transactions, like post-trade processing, that may not need the protections of the fiduciary department.

c. Chiefly Compensated

Another condition banks must meet to rely on the trust and fiduciary activities exception is that they must be "chiefly compensated" for securities transactions by certain enumerated fees. Banks sought guidance on how this new condition should apply.

Congress stated that this provision should limit a bank's ability to conduct a full-scale brokerage operation in its trust department and that the Commission should not disturb traditional trust activities. Clearly, "chiefly compensated" was designed to be a meaningful condition, and the Rules sought to apply it as intended.

With these considerations in mind, the Rules look to the compensation of each account to determine whether that account is chiefly a brokerage account. An account-by-account calculation is consistent with assuring the protection of each investor, reflects the fact that bank trust departments typically charge for securities transactions at the account level, and is consistent with determinations that trustees must make under state trust law. If we adopted a business line approach, a bank potentially could operate a full-scale brokerage business within its trust department as long as it was combined with a larger non-brokerage trust business.

For purposes of the chiefly compensated calculation, the Rules separate the fees to be used in the calculation into the categories inherent in the statute, labeled in our Rules as “relationship compensation,” “sales compensation,” and “unrelated compensation.” Consistent with the statute, “relationship compensation” must exceed “sales compensation” on an account basis.

To reduce the potential costs of compliance, the Rules exempted bank trust departments that receive small amounts of sales compensation from the requirement to consider when an account is “chiefly compensated” from the enumerated fees. This exemption was intended to reduce calculation burdens on bank trust departments that do not receive a large percentage of sales compensation.

The comments received to date have emphasized the difficulties of account-by-account calculations of compensation for existing accounts, and the limited utility of the exemptive rule designed to alleviate these difficulties. We recognize these concerns are significant, and we are considering, and discussing with the banking industry, how best to address these matters.

The comments also highlighted problems under the “chiefly” calculation and other compensation limits for bank-administered 401(k) and other employer accounts that invest primarily in mutual funds. These comments raise valid concerns, and we are discussing with the banking industry ways to address the problems while also achieving the purposes of the statute.

The Commission recognizes that this new statutory provision is complicated and that banks may, in good faith, try to meet the “chiefly compensated” condition, but inadvertently violate it. At the same time, however, the Commission believes that it is important that banks strive for full compliance with the statute. With these considerations in mind, the Commission looks forward to working with banks, the banking regulators, and the industry to craft a cure period or safe harbor.

C. Sweep Accounts Exception

1. The Statutory Language

Under the statutory exception, a bank is not considered a broker if it "effects transactions as part of a program for the investment or reinvestment 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."[17] The sweep accounts exception is intended to allow banks to sweep funds into no-load money market funds without having to register as broker-dealers.

2. The Rules Provide Definitional Clarity

The term "no-load" is not defined in the GLBA or in the federal securities laws. Historically, the term "no-load" was viewed as meaning that neither investors in the fund, nor the fund itself, bore the costs of distributing the fund's shares, including making payments to broker-dealers.[18] The Commission's adoption in 1980 of Investment Company Act Rule 12b-1, which for the first time permitted funds to use their assets to finance distribution expenses, created some confusion as to the meaning of the term.[19] To address this confusion, the National Association of Securities Dealers, Inc. ("NASD") adopted Rule 2830(d)(4), which describes what a "no-load" investment company is. Rule 2830(d)(4) allows an NASD member broker-dealer to describe an investment company as being "no-load" or as having "no sales charge" if the investment company does not have a front-end or deferred sales charge, and if its total charges against assets to provide for sales related expenses and/or service fees do not exceed 0.25 of 1% of average net assets per year.[20]

---

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

18 See Investment Company Act Release No. 15431 (June 13, 1988), 53 FR 23258.

19 Investment Company Act Release No. 11414 (Oct. 28, 1980), 45 FR 73898 (Nov. 7, 1980).

20 NASD Rule 2830(d)(4) specifically states that a member broker-dealer may not "describe an investment company as being 'no-load' or as having 'no sales charge' if the investment company has a front-end or deferred sales charge or its total charges against net assets to provide for sales related expenses and/or

The Rules provide that a mutual fund is "no-load" if: (1) purchases of the investment company's securities are not subject either to a front end or deferred sales load; and (2) its total charges against net assets that provide for sales or sales promotion expenses and for personal services or the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually and are disclosed in the mutual fund's prospectus.[21] The Rules reflect current industry and public understanding of what the term "no-load" means. Nonetheless, we acknowledge the comments on the impact of this condition on bank sweep account programs and believe that there are grounds to consider exemptions from the statutory requirement under appropriate circumstances.

D. Safekeeping and Custody Exception

1. <u>The Statutory Language</u>

Banks also may be excepted from broker-dealer registration for certain safekeeping and custody activities.[22] Under the exception, a bank will not be considered a "broker" because, as part of customary bank activities, it engages in certain specified types of safekeeping and custody services with respect to securities on behalf of its customers.[23]

<u>service fees exceed .25 of 1% of average net assets per annum</u>." (emphasis added). <u>See</u> Exchange Act Release No. 30897 (July 7, 199), 57 FR 30985-02 (July 13, 1992). NASD Rule 2830(d)(4) was formerly classified as Article III, Section 26(d)(3) of the NASD Rules of Fair Practice. <u>See</u> Exchange Act Release No. 36698 (Jan. 11, 1996), 61 FR 1419 (Jan. 19, 1996).

21 Rule 3b-17(f) provides, however, that certain charges a money market fund makes against fund assets will not be considered charges for personal service or the maintenance of shareholder accounts. In particular, charges against a money market fund's assets for transfer agent and subtransfer agent services for beneficial owners of the fund shares; aggregating and processing purchase and redemption orders; providing beneficial owners with statements showing their positions in the investment companies; processing dividend payments; providing subaccounting services for fund shares held beneficially; and forwarding shareholder communications, such as proxies, shareholder reports, dividend and tax notices, updating prospectuses to beneficial owners; and receiving, tabulating, and transmitting proxies executed by beneficial owners will not count toward the 0.25 of 1% limit in Rule 3b-17(f)(2).

22 15 U.S.C. 78c(a)(4)(B)(viii).

23 Exchange Act Section 3(a)(4)(B)(viii)(aa - ee).

The safekeeping and custody exception explicitly allows banks that hold securities, on behalf of their customers, to exercise warrants or other rights, facilitate the transfer of funds or securities in connection with the clearance and settlement of the customers' transactions, effect securities lending or borrowing transactions when the securities are in the custody of the bank, invest cash collateral pledged in connection with securities lending or borrowing transactions, and facilitate the pledging or transfer of securities that involve the sale of those securities. Moreover, banks may provide custody and related administrative services to IRAs, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plans without being considered a broker.

This exception provides legal certainty to banks holding funds and securities, because holding funds and securities traditionally has been a contributing factor in determining broker-dealer status. In addition, the exception explicitly covers executing securities transactions, such as investing cash collateral. Thus, the safekeeping and custody exception provides banks legal certainty that they would not be required to shift their custody business to broker-dealers just because they held funds and securities and conducted the specified securities activities.

However, the safekeeping and custody exception does not include any language that would permit banks generally to take orders for custody accounts. Accordingly, the Commission views order-taking for custody accounts where not specifically provided as outside the custody exception. Otherwise, banks could offer brokerage accounts merely by labeling them "custody" accounts. The Commission's view is consistent with Congressional intent not to permit a full-scale brokerage operation to operate in a bank without the investor protections provided under the federal securities laws.

Moreover, the safekeeping and custody exception, in particular, must be considered in light of the other broker-dealer exceptions. For trust and fiduciary accounts, which unlike custody accounts are subject to fiduciary principles,[24] the statute imposed five conditions to prohibit banks from running a full-scale broker-dealer through those accounts. Stronger conditions would be needed for custody and safekeeping accounts if full-scale brokerage were allowed through those accounts.

2. The Rules Accommodate Some Order-Taking Activity

Nonetheless, to enable banks to take orders as an accommodation to custody customers without involving a broker-dealer, the Rules provide two limited exemptions. These exemptions are designed to permit banks to take orders under conditions that limit the concerns for which the Commission regulates broker-dealers, but are not designed to let them run full-scale brokerage operations outside of the federal securities laws.

First, the Commission adopted a small bank custody exemption to allow a small bank that is not in a networking relationship to take orders for mutual funds from customers in tax-deferred accounts and to be compensated for those sales. Second, the Commission adopted an exemption to allow any bank to take orders for any security from its custody customers, so long as the bank only passes along the broker-dealer's charges for executing the transactions.

Banks that want to offer transaction services to custody customers and charge additional amounts over the broker-dealer's charges for those services may do so by arranging for a broker-dealer to take and execute orders under the networking exception, while still holding the customers' funds and securities in the custody account. We will carefully weigh the comments

[24] In fact, the OCC does not treat nondiscretionary custodial activities as fiduciary. See Fiduciary Activities of National Banks; Rules of Practice and Procedure, 61 FR 68543, 68545 n. 4 (Dec. 30, 1996).

on the scope and workability of these exemptions, to seek to reduce burdens on banks while maintaining investor protections.

IV. Concluding Remarks

In enacting the GLBA, Congress drew lines reflecting a compromise between functional regulation and a desire not to disrupt certain traditional bank activities. In some cases, those lines will require banks to restructure their securities operations. It is not the role of regulators to redraw those lines. Nevertheless, in amending the Rules, the Commission will explore ways to minimize the business impact of the rules it adopts consistent with the language and intent of the GLBA and the Commission's mandate to protect investors.

In conclusion, we want to emphasize that the Commission will do everything in its power to ease the conversion process required by the GLBA consistent with our mandate. The Commission is eager to continue its discussions with banks and the bank regulators about their concerns. Discussions to date have narrowed some of the issues raised by commenters and provided useful guidance for amending some of the Rules.

The Commission appreciates your continuing interest in this issue and the important role that you have played in modernizing the nation's financial services industry.

Thank you.