**STATEMENT OF**

**WILLIAM F. KROENER, III**
**GENERAL COUNSEL**
**FEDERAL DEPOSIT INSURANCE CORPORATION**

**on**

# TITLE II OF THE GRAMM-LEACH-BLILEY ACT OF 1999

**before the**

**SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,**
**AND GOVERNMENT-SPONSORED ENTERPRISES**

**and the**

**SUBCOMMITTEE ON FINANCIAL INSTITUTIONS**
**AND CONSUMER CREDIT**

**COMMITTEE ON FINANCIAL SERVICES**
**U.S. HOUSE OF REPRESENTATIVES**

**August 2, 2001**
**Room 2128, Rayburn House Office Building**

Chairman Baker, Chairman Bachus, Ranking Members Kanjorski and Waters, and Members of the Subcommittees, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the implementation of Title II of the Gramm-Leach-Bliley Act of 1999 (GLB Act). My testimony today will discuss our view of the interim final rules promulgated by the Securities and Exchange Commission (SEC) to implement the bank broker-dealer exceptions set forth in Title II. Our view of the SEC's rules is additionally reflected in the interagency comment letter to the SEC, dated June 29, 2001, from the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the FDIC (collectively, the banking agencies).

The FDIC is heartened that the SEC recently decided to extend the deadline for compliance until May 12, 2002. We hope that the SEC will use this time to carefully study and listen to the comments of the banking agencies and the banking industry. We believe that a more open process will produce rules that are consistent with the intent and requirements of the GLB Act without imposing undue burden on the banking industry.

The FDIC is concerned that the SEC's interim final rules would force many banks that in fact satisfy the statutory exceptions in Title II of the GLB Act to move major lines of business out of the bank, i.e., “push out” the activities — the exact opposite of what the law intended. As you know, Title II was a carefully crafted legislative compromise intended to permit banks to continue certain lines of traditional bank business. The SEC’s interim rules would effectively overturn this compromise. The adverse impact of

the interim final rules would be especially painful for hundreds of community banks that do not have SEC-registered broker-dealer affiliates. These banks provide important trust and custody services to their communities. If the SEC's interim final rules stand as currently drafted, customers of community banks might lose these important services.

**Bank Broker-Dealer Exceptions in Title II**

Prior to the enactment of the GLB Act, banks were completely exempt from the definitions of "broker" and "dealer" under the Securities and Exchange Act of 1934 (Exchange Act). With the increasing involvement of banks in broader securities activities, the GLB Act eliminated this exemption, instead providing specific exceptions from the "broker" and "dealer" definitions in the Exchange Act. These exceptions were intended to permit banks to continue providing trust, custody and safekeeping, sweep accounts, asset-backed securities, and other specified traditional banking products and services in the bank itself. The Conference Report to the GLB Act notes that Congress enacted these exceptions "to facilitate certain activities in which banks have traditionally engaged." Congress also expressed concern throughout the legislative history that in implementing these exceptions the SEC "not disturb traditional bank trust activities." Based on the latest data available to the banking agencies, over 2,000 depository institutions currently engage in trust activities with more than $22 trillion of assets under administration held in 27 million accounts.

Reflecting the functional regulation imperatives in the GLB Act, Congress enacted Section 204 of the GLB Act, which directs the banking agencies to adopt

recordkeeping requirements for banks that rely on the broker-dealer exceptions. Section 204 also requires the banking agencies to provide the SEC, at its request, any records maintained by a bank pursuant to the agencies' recordkeeping regulations. Since the Congress granted no similar statutory authority to the SEC, this requirement serves as the sole method for the SEC to obtain records of banks' compliance with the broker-dealer exceptions. Section 204 states that the recordkeeping requirements established by the banking agencies "shall be sufficient to demonstrate compliance [by banks] with the terms of such exceptions and be designed to facilitate compliance with such exceptions."

**SEC's Issuance of its Interim Final Rules**

The SEC published its interim final rules implementing various bank broker-dealer exemptions in Title II in the Federal Register (66 FR 27760) of May 18, 2001, without any prior notice to the banking agencies of their form or content. In these rules, the SEC sought to clarify various statutory exceptions in Title II. However, the banking agencies believe that the SEC went further by imposing numerous burdensome conditions on the use of the exceptions by banks and added certain exemptions that included extensive conditions that minimize banks' ability to make any meaningful use of those exemptions.

In the interim final rules, the SEC imposed a compliance deadline of October 1, 2001, on all non-compensation requirements in the rules, and a compliance deadline of January 1, 2002, for the compensation requirements in the rules. On July 18, 2001, the SEC issued a press release that extended the compliance deadlines in its interim final

rules until May 12, 2002. We expect that when the SEC issues its final rules, it will provide for an effective date of at least one year after the date of the rules' publication for purposes of compliance by banks.

**Response to SEC's Interim Final Rules**

The SEC's interim final rules in effect significantly revise the statutory language in Title II and disregard Congressional intent regarding various statutory exceptions. The FDIC's principal concerns regarding various statutory exceptions in Title II covered under the interim final rules are the following:

**1. Trust and Fiduciary Exception.** Of greatest concern to the FDIC and the other banking agencies are the provisions of the SEC interim final rules that implement the statutory exemption for traditional trust and fiduciary activities of banks (the Trust and Fiduciary Exception). The FDIC believes many of these provisions conflict with the statutory language of the GLB Act and significantly interfere with the traditional trust and fiduciary activities of banks. These activities are a key component of the business of banking for most banks (including hundreds of community banks), have long been offered to bank customers without significant securities-related problems, and are already regularly examined by bank examiners for compliance with trust and fiduciary principles that provide strong customer protections.

The Trust and Fiduciary Exception broadly authorizes a bank, without registering as a broker-dealer, to effect securities transactions in a trustee capacity. The bank also

may effect securities transactions in a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. This exception is effective so long as the bank is "chiefly compensated" for the securities transactions that it effects for its trust customers on the basis of certain fees set forth in the statute (referred to as "relationship compensation" in the SEC's interim final rules). In addition, the Trust and Fiduciary Exception prohibits banks from publicly soliciting brokerage business except in conjunction with advertising its other trust activities.

The SEC's interim final rules provide that a bank meets the GLB Act's "chiefly compensated" requirement only if, on an annual basis, the amount of the relationship compensation received by the bank from <u>each</u> trust account exceeds the sales compensation received by the bank from that account. We do not believe an account-by-account calculation of compensation is consistent with the GLB Act. The plain language of the Act requires only that the bank be chiefly compensated for the securities transactions that it effects for all of its trust customers from the fees set forth in the statute. The FDIC and the other banking agencies believe the GLB Act's "chiefly compensated" condition cannot be interpreted to require a higher percentage than 50 percent of its fees, measured in aggregate terms, from its trust and fiduciary accounts from the types of revenues specified in the Act.

The FDIC is especially concerned that the provision in the SEC's interim final rules which requires banks to track the compensation received from all trust customers on

an account-by-account basis will impose significant burdens on banks. Most banks currently do not have the systems in place to track the compensation received from the trust activities on an account-by-account basis and would incur significant compliance expenses in order to meet the SEC's rules that we do not believe are required by the statute. These costs likely would be passed on to trust customers in the form of higher fees. The practical effect of the SEC's interpretation and the potentially severe consequences of noncompliance will cause many banks — especially small community banks — to discontinue providing securities services that they have long offered as part of their traditional trust operations. We do not believe the Congress intended this harsh result.

In recognition of the significant regulatory burdens that the SEC's "chiefly compensated" requirements will impose on banks, the SEC did adopt an exemption in its interim final rules (Rule 3a4-2). That exemption apparently is intended to permit banks to avoid calculating their compliance with the "chiefly compensated" requirement on an account-by-account basis. However, the exemption itself requires a bank to comply with equally burdensome conditions. For example, the bank must maintain procedures to demonstrate that the “chiefly compensated” requirement is met when compensation arrangements for the account are changed and when sales compensation received from the account is reviewed by the bank for determining any employee’s compensation. The most restrictive of these SEC-imposed conditions is a requirement that a bank relying on the exemption must ensure that during any year the sales compensation received from all trust accounts does not exceed 10 percent of relationship compensation received from

such accounts. The statute does not impose such a limitation; thus, the SEC's action would artificially constrain this revenue source.

Numerous other aspects of the interim rules appear to conflict with either the provisions of the statute or Congressional intent or both. Regarding the scope of the term "trustee capacity" as used in the Trust and Fiduciary Exception, the SEC, in its preamble to its interim final rules, asserts that there is uncertainty concerning whether banks acting as an indenture trustee, or as a trustee for ERISA plans or individual retirement accounts (IRAs), are "trustees" for purposes of the Trust Exception. The FDIC disagrees with the interpretation of the SEC that there is any ambiguity concerning the scope of that term. Congress designed the "trustee capacity" definition on the basis of a long-standing Federal regulation covering bank fiduciary activities (12 C.F.R. Part 9). The plain meaning of the term encompasses all relationships in which a banks acts as a trustee under applicable Federal and state law. A bank acts in such a capacity when it is named as trustee by written documents that create the trust relationship under applicable law. There is no indication that Congress intended to grant the SEC broad authority to review specific types of trustee services provided by banks to determine whether such relationships constitute a "trustee" relationship for purposes of the GLB Act's bank broker-dealer exceptions. The SEC's position on this matter could result in unnecessary uncertainty by bank customers involving the status of such trust relationships as self-directed personal trusts, charitable foundation trusts, insurance trusts and rabbi and secular trusts.

For purposes of qualifying under the Trust and Fiduciary Exception, the GLB Act provides that a bank acts in a "fiduciary capacity" when it acts "as an investment adviser if the bank receives a fee for its investment advice." The SEC's interim final rules, however, provide that a bank will qualify as acting in an investment advisory capacity for purposes of this Exception only if the bank provides "continuous and regular" investment advice to the customer's account that is based upon the individual needs of the customer, and owes a duty of loyalty to the customer (arising out of state or Federal law, contract, or customer agreement). The FDIC believes that there is no basis in the GLB Act for additional conditions that the SEC has imposed on its definition of "fiduciary capacity" regarding the fee-based investment adviser activities of banks. In particular, the "continuous and regular" requirement in the SEC's interim final rules is overly broad and would prevent banks from relying on the Trust and Fiduciary Exception even in circumstances where the statutory test for such investment advice is met.

The GLB Act requires that all securities transactions effected by a bank under the Trust and Fiduciary Exception be effected in the bank's trust department or in another department of the bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards. The preamble to the SEC's interim final rules provide that "all aspects" of the securities transactions conducted by a bank for its trust and fiduciary customers must be conducted in a part of the bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards. In the preamble, the SEC also suggests that such areas include any area that facilitates the execution of a securities transaction, handles customer funds and securities, or prepares

and sends confirmations for securities transactions (other than for the executing broker-dealer).

The SEC's "all aspects" test conflicts with the delegation of various functions involving fiduciary activities under state trust law. Under state trust law, banks that conduct fiduciary activities may delegate securities processing and settlement activities to a separate department or affiliate that is responsible for all of the bank's back-office securities settlement and processing tasks. Many banks, and particularly small banks, also outsource processing, settlement and other back-office functions to third parties because the bank cannot achieve the economies of scale to provide such services directly to their customers on a cost-effective basis. While these separate bank departments, affiliates or third party providers may be subject to examination by bank examiners, they do not themselves have fiduciary relationships with customers and accordingly, may not be regularly examined for compliance with fiduciary principles and standards.

As described in the June 29, 2001, comment letter from the banking agencies to the SEC, the FDIC also has various problems with the SEC's inclusion of Rule 12b-1 fees from ERISA plans, certain service fees from mutual funds, and certain finders' fees as "sales compensation" for purposes of the "chiefly compensated" standard in the Trust and Fiduciary Exception.

**2. Custody and Safekeeping Exception.** Another primary concern of the FDIC and the other Federal banking agencies involves the SEC's treatment of the GLB Act's

safekeeping and custody exception from the definition of "broker" and "dealer" in the Exchange Act (the Custody and Safekeeping Exception). The Custody and Safekeeping Exception as enacted in the GLB Act permits a bank, without registering as a "broker" under the Exchange Act, to engage in various custodial- and safekeeping-related activities "as part of its customary banking activities." The activities expressly permitted by the statute include (1) providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers; and (2) serving as a custodian or provider of other related administrative services to any Individual Retirement Account (IRA), pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan. This Exception also allows banks to engage in other activities as part of their customary safekeeping and custody operations, such as facilitating the transfer of funds or securities as a custodian or clearing agency, effecting securities lending and borrowing transactions for customers, and holding securities pledged by a customer.

The FDIC strongly disagrees with the SEC's position in the interim final rules that the Custody and Safekeeping Exception does not permit banks to accept securities orders for their custodial IRA customers, for 401(k) and benefit plans that receive custodial and administrative services from the bank, or as an accommodation to custodial customers. The SEC's interpretation is not consistent with the GLB Act, its legislative history, or the purposes of the Custody and Safekeeping Exception. As a result, the SEC's interpretation will improperly interfere with core banking activities that Congress intended to protect and will impose unnecessary costs on consumers, including securities execution services

to self-directed IRA accounts for which the bank acts as custodian. Applicable Internal Revenue Service regulations generally require that a bank serve as trustee or custodian for an IRA, and many banks offer self-directed custodial IRA services to their customers.

Banks as part of their customary banking activities effect securities trades as an accommodation to their custodial customers and generally only upon the order of the customer and on an incidental and infrequent basis. Because these services are customarily provided only as an accommodation to custodial accounts, banks typically seek to recover only the costs incurred in placing the trade for the customer.

Although the SEC's interim final rules also include two SEC-granted exemptions for custodial-related transactions, these exemptions are subject to numerous burdensome conditions that make the exemptions of little benefit. More fundamentally, these exemptions impose newly created SEC conditions on bank activities that Congress determined to be protected under the Custody and Safekeeping Exception. For example, one of the SEC-granted exemptions would allow small banks (generally defined as under $100 million in bank assets) to conduct securities order-taking under the Custody and Safekeeping Exception solely for effecting transactions in securities of SEC-registered mutual funds in an IRA account (not a 401(k) account) for which the bank acts as custodian. This small bank exemption would not cover order-taking for individual securities or bonds purchased by the bank custodian for its customers and would be subject to numerous conditions, including that (1) the bank's total compensation relating to effecting securities pursuant to this exemption would be less than three percent of its

annual revenue, (2) the bank is not associated with a broker-dealer, (3) the bank must not have a networking arrangement with a broker-dealer as expressly permitted under the Networking Exception of the GLB Act, and (4) various restrictions on advertising and bank employee compensation. The restrictions in this SEC-granted exemption would functionally prohibit a bank from advertising its permissible private placement, sweep account, municipal securities, stock purchase plan or networking activities.

Another of the SEC-granted exemptions from its prohibition on securities order-taking under this Exception also would prohibit a bank from directly or indirectly receiving any compensation for effecting securities transactions. In addition, the SEC would impose burdensome advertising and employee compensation restrictions on banks as a result of this exemption. We believe that this exemption would direct banks to provide customary banking services at a loss and would conflict with the Congressional intent to preserve securities order-taking as part of the Custody and Safekeeping Exception.

**3. Networking Exception.** The GLB Act permits banks to enter into arrangements with registered broker-dealers to offer brokerage services to bank customers provided the "networking" arrangement meets certain requirements set forth in the Act (Networking Exception). One of the requirements in the Networking Exception is that bank employees (other than employees also employed by the broker-dealer who are registered with the NASD or another self-regulatory organization) are prohibited from receiving "incentive compensation," except that a bank employee may receive

compensation for the referral of any customer "if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction."

In the SEC's interim final rules, the Commission interpreted the statutory term "nominal one-time cash fee of a fixed dollar amount" to be limited to only (1) payments that do not exceed one hour of the gross cash wages of the bank employee making the referral; or (2) 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. In addition, the SEC's interim final rules state that referral fees cannot be paid in the form of bonuses.

The FDIC and the other banking agencies are concerned that the SEC's interpretation of the statutory term "nominal one-time cash fee of a fixed dollar amount" imposes unnecessary limitations on the securities referral programs of banks that are not required by statute. In enacting this referral compensation standard in the Networking Exception, Congress relied, in part, on prior SEC precedents regarding networking arrangements by banks and savings associations which did not involve the types of restrictions on bonus programs and referral fees as those contained in the SEC’s interim final rules. The FDIC is concerned that the SEC’s excessively restrictive interpretation of the statutory referral compensation standard will inappropriately limit the discretion of

the banking agencies to apply the statutory standard on a case-by-case basis to securities or insurance sales activities of banks.

We believe that the restriction in the interim final rules that a payment not exceed one hour of the gross cash wages of the unregistered bank employee making the referral is unworkable. Banks often offer all of their employees, regardless of the level of their compensation, the same nominal award value for referring securities customers. Under the interim final rules, banks will be forced to incur increased burden because a separate referral fee calculation now will be required for each employee who makes a referral, and adjustments in an employee's salary or wages would need to be tracked. Additional administrative burden not required by the statute and not involving securities transactions would be imposed on banks through the requirement that the securities-related referral points have a value that is no greater than the points received under the system for any other product or service.

The SEC's interim final rules also provide that banks are prohibited from indirectly paying their unregistered bank employees incentive compensation for securities transactions through a branch, department, or line of business or through a bonus program related to the securities transactions of a branch, department or line of business. This language is drafted so broadly that it would appear to prevent a bank with a networking arrangement from paying any officer a bonus based on the success of a department or line of business that engages in securities transactions even in the event

that employee, department or line of business has no connection with the networking arrangement.

The interim final rules also mandate that securities referral fees may not be related to (1) the size or value of any securities transaction, (2) the amount of securities-related assets gathered, (3) the size or value of any customer's bank or securities account, or (4) the customer's financial status. This requirement is not contained in the statutory language of the Networking Exception. The statute only prohibits a nominal referral fee if it is "contingent on whether the referral results in a transaction." These additional SEC-imposed conditions have been arbitrarily established and are unnecessary given the existing "incentive compensation" standard.

**4. Other Statutory Exceptions Treated in the SEC's Interim Final Rules.**

The banking agencies' comment letter to the SEC covers various problems with the SEC's treatment of the broker exception for no-load sweep accounts, the dealer exception for asset-backed securitization activities, and the broker exception for transactions with affiliates. The FDIC continues to support the position taken in the banking agencies' comment letter to the SEC that the interim final rules' treatment of those statutory exceptions conflicts with the statutory language of the GLB Act and Congressional intent and would render those exceptions to be of no functional benefit to long-standing commercial services provided by banks for their customers.

**Conclusion**

The FDIC commends the Subcommittees for focusing attention on the significant impact of the SEC's interim final rules on the banking industry. The SEC's final interim rules as currently drafted mandate restrictions that effectively negate the intent of Congress and the statutory language designed to preserve traditional trust, fiduciary, and custodial activities of banks. If the interim final rules force traditional trust activities out of banks, customers will have fragmented relationships with their chosen trustee and a third-party broker-dealer.

We appreciate the SEC's recent press release that extended the compliance deadlines in the interim final rules until May 12, 2002. Given the profound impact of the SEC's interim final rules on the functional regulation of the securities activities of banks, we propose that the SEC provide a meaningful dialogue with the banking agencies to produce a final rule that significantly limits any unnecessary termination of traditional banking services to communities and consumers.