BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 12, 2006

To: Board of Governors

From: Governor Bies, Chairman
Committee on Supervisory and Regulatory Affairs

Subject: Proposed Rules Implementing the "Broker" Exceptions for Banks Adopted as Part of the Gramm-Leach-Bliley Act of 1999

The attached item has been reviewed by members of the Committee on Supervisory and Regulatory Affairs. The item is now ready for Board consideration.

December 12, 2006

TO: Board of Governors

FROM: Staff[1]

SUBJECT: Proposed Rules Implementing the "Broker" Exceptions for Banks Adopted as Part of the Gramm-Leach-Bliley Act of 1999

ACTION REQUESTED: Approval to seek public comment for a period of 90 days on the attached proposed rules that would implement the so-called "push-out" provisions of the Gramm-Leach-Bliley Act of 1999 ("GLB Act"). These proposed rules would help define the scope of securities brokerage activities that banks may conduct in providing banking services to their customers without registering with the Securities and Exchange Commission ("SEC") as a securities broker or complying with the SEC's rules governing securities brokers. The proposed rules would be issued and published jointly by the Board and the SEC, as required by the recently enacted Financial Services Regulatory Relief Act ("Regulatory Relief Act").

As discussed below, the proposed rules are designed to allow banks to continue to effect securities transactions for customers as part of their customary trust and fiduciary, custodial and other banking functions without disruption, consistent with the purposes of the GLB Act. A summary of the GLB Act's "broker" exceptions for banks is attached as Appendix A (p. 20). The proposed joint rules are attached as Appendix B (p. 22) and the accompanying Federal Register notice is attached as Appendix C (p. 51).

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[1] Messrs. Alvarez, Fallon and Miller and Ms. Tokheim (Legal Division), and Messrs. Cole, Embersit and Schoenfeld and Ms. Walker (Division of Banking Supervision and Regulation).

BACKGROUND:

A. GLB Act and Prior SEC Rulemakings

Prior to the GLB Act, banks enjoyed a blanket exception from the definition of "broker" in the Securities Exchange Act of 1934.[2] This allowed banks to engage as agent in any securities activity that was permissible under the Federal banking laws and applicable state law without registering with the SEC as a broker-dealer and without complying with the SEC's rules (including net capital requirements) applicable to registered broker-dealers.

In connection with the decision to allow banks to affiliate broadly with securities brokers and dealers, Congress in the GLB Act removed this blanket exception and replaced it with 11 exceptions covering broad categories of bank securities "broker" activities. These activity-focused exceptions were designed and intended to allow banks to continue to effect securities transactions for customers as part of their normal trust and fiduciary, custodial, deposit "sweep" and other banking functions without disruption.[3] At the same time, the new exceptions were intended to prevent financial firms from moving a full-scale brokerage operation into a bank to evade SEC regulation.[4]

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[2] As a general matter, a "broker" acts as an agent for a customer and a "dealer" acts as a principal in a securities transaction.

[3] See, e.g., H.R. Rep. No. 106-434 at 163-64 (1999) (Conference Committee Report); S. Rep. No. 106-44 at 10 (1999).

[4] The GLB Act also removed the blanket exception that banks previously had from the definition of "dealer" in the Securities Exchange Act and replaced it with four activity-focused exceptions for bank "dealer" activities. See Appendix A. The "dealer" exceptions for banks have been less controversial than the bank "broker" exceptions. In 2003, the SEC adopted final rules implementing the bank "dealer" exceptions and the proposed joint rules would not address or implement these "dealer" exceptions.

Under the GLB Act, the new "broker" exceptions for banks were to become effective in May 2001. The SEC, however, has delayed the effective date of these new exceptions—and correspondingly extended the blanket exception for banks—through a series of orders while it has sought to develop rules to implement the new exceptions.[5] The first set of these implementing rules was issued for public comment by the SEC in May 2001. After reviewing the broad range of comments received on this proposal and meeting with representatives of the banking industry and the Federal banking agencies, the SEC, in June 2004, requested comment on a new set of revised proposed rules (referred to as "Regulation B") to implement the bank "broker" exceptions.

As a general matter, Regulation B, as well as the rules initially published in 2001, took a narrow view of some of the most important statutory "broker" exceptions for banks, including the exceptions that were designed to allow banks to continue to engage in securities transactions in connection with their trust and fiduciary activities and custodial activities. The Board, OCC and FDIC jointly submitted comment letters to the SEC on these previous rules explaining why the agencies believed the rules were inconsistent with the language and purposes of the GLB Act and would significantly disrupt the operations and customer relationships of banks.[6]

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[5] The most recent of these extensions is scheduled to expire on December 31, 2006, but the SEC is expected to extend this date again on December 13th when it acts on the attached joint proposed rules.

[6] See Letter from Chairman Alan Greenspan, FDIC Chairman Donald Powell, and Comptroller of the Currency John D. Hawke, Jr. to the SEC, dated October 8, 2004; Letter from Chairman Alan Greenspan, FDIC Chairman Donna Tanoue, and Comptroller of the Currency John D. Hawke, Jr. to the SEC, dated June 29, 2001.

B. Development of Joint Proposed Rule

In 2006, SEC Chairman Cox and Governor Bies convened meetings of the principals and staff of the SEC, Board, OCC and FDIC to discuss the agencies' views concerning the bank "broker" exceptions and potential new approaches to implementing these exceptions. During the course of these discussions, the Regulatory Relief Act of 2006 was enacted. Section 101 of that Act requires the Board and SEC jointly to issue "a single set" of proposed rules to implement these exceptions within 180 days of the Act's enactment (April 11, 2007). In addition, the Act requires the Board and SEC, after consulting with the OCC, FDIC and OTS,[7] jointly to adopt "a single set" of final rules to implement these exceptions and provides that these joint final rules will supersede any other proposed or final rules previously issued by the SEC to implement the bank "broker" exceptions.

DISCUSSION AND ANALYSIS OF JOINT PROPOSED RULES:

Consistent with these efforts and mandate, Board and SEC staff—with the active participation of Chairman Cox and Governor Bies—have developed the attached proposed rules to implement the most important "broker" exceptions for banks. In particular, the proposed rules would implement the statutory exceptions related to bank trust and fiduciary, custodial and deposit "sweep" services, as well as the exception that allows banks to refer customers to a SEC-registered broker-dealer as part of a "networking" arrangement.

[7] The Regulatory Relief Act also granted, for the first time, federal savings associations and FDIC-insured state savings associations the same exceptions from the definitions of "broker" and "dealer" previously available only to banks. Accordingly, the term "bank" as used in the proposed rules includes national and state banks, the U.S. branches and agencies of foreign banks, as well as insured savings associations.

Principals and staff of the OCC, FDIC and OTS were consulted extensively and were active participants in developing the proposed rules.

The proposed joint rules are significantly more flexible, simple and accommodative than the previous proposals on this subject. In this regard, the proposed rules would provide important guidance to banks on the types of activities permissible under these statutory exceptions and include a number of key administrative exemptions related to bank securities activities. These administrative exemptions are designed to help ensure that the proposed rules would not disrupt the securities brokerage activities conducted by banks in providing banking services, consistent with the purposes of the GLB Act. Staff believes that the package of proposed rules, taken as a whole, represents a reasonable potential approach to implementing the "broker" exceptions addressed by the rules. Importantly, as the Federal Register notes, the proposed administrative exemptions would be part of the "single set" of rules jointly proposed by the Board and the SEC and, if adopted, would be joint rules of the SEC and the Board.

The following describes the key aspects of the proposed joint rules.

A. Trust and Fiduciary Exception

One of the GLB Act's most important "broker" exceptions is the trust and fiduciary exception.[8] This exception allows a bank to effect securities transactions for its trust and fiduciary customers so long as, among other things, the bank is "chiefly compensated" for these transactions by (i) administration fees, (ii) annual fees (payable on a monthly, quarterly or other basis), (iii) fees based on a percentage of assets under management, (iv) flat or capped per order processing fees that do not exceed the bank's cost

[8] See 15 U.S.C. § 78c(a)(4)(B)(ii).

for executing the transactions, or (v) any combination of these fees.[9] These fees are referred to collectively as "relationship compensation" in the proposed rules The purpose of the test is to ensure that banks are not principally compensated for the securities transactions they conduct for trust and fiduciary customers by per-transaction fees (i.e., brokerage commissions) in excess of the bank's related costs.

The statutory trust and fiduciary exception also provides that a bank operating under the exception may not publicly solicit brokerage business other than in conjunction with advertising its trust and fiduciary activities. This advertising restriction, which was not addressed in previous SEC rulemakings, provides important protections against a bank operating in its trust department a securities brokerage operation devoid of bona fide trust or fiduciary services. The joint proposed rules address both the "chiefly compensated" condition and the advertising restriction.

1. Chiefly Compensated Test

The proposed rules provide banks two alternative methods of monitoring their compliance with the statute's "chiefly compensated" condition—a bank-wide methodology and an account-by-account methodology. Under either approach, a bank's compliance with the "chiefly compensated" test would be based on a two-year rolling average of the bank's compensation attributable to its trust and fiduciary accounts. Using a two-year rolling average of compensation would permit banks to experience normal fluctuations in their trust and fiduciary compensation, either in an individual

[9] The GLB Act's definition of a "fiduciary" is based on the OCC's rules and, thus, includes acting as a trustee, executor, or guardian, as well as acting as an investment advisor if the bank receives a fee for its investment advice.

account or on a bank-wide basis, without falling out of compliance with the statutory test.[10]

Under the bank-wide alternative, which likely will be used by the vast majority of banks, a bank would meet the "chiefly compensated" test if the aggregate amount of relationship compensation the bank received from all of its trust and fiduciary accounts on a bank-wide basis during the preceding two years equals or exceeds 70 percent of the total compensation attributable to all of the bank's trust and fiduciary accounts during those years (after the annual ratio for both years are averaged together).[11] In mathematical terms, a bank would meet this test if:

$$(RC_{Y\text{-}1} / TC_{Y\text{-}1}) + (RC_{Y\text{-}2} / TC_{Y\text{-}2}) / 2 \geq 0.70$$

RC = Relationship compensation attributable to all trust and fiduciary accounts
TC = Total compensation attributable to all trust and fiduciary accounts
Y-1 = Immediately preceding year
Y-2 = Year immediately preceding Y-1

The account-by-account alternative is structured similarly, except that a bank must separately compare the relationship compensation and total compensation attributable to each trust or fiduciary account individually, rather than on a bank-wide basis. If a bank decides to follow this approach,

[10] For similar reasons, the proposed rules also would allow a bank to exclude accounts open for only a short period, or that recently were acquired as part of a business combination, in determining its compliance with the chiefly compensated test under either the bank-wide or account-by-account approach.

[11] Regulation B as previously proposed contained a similar exemption except that it required relationship compensation to equal or exceed 89 percent of the bank's trust and fiduciary compensation at the end of each year and excluded several forms of traditional trust and fiduciary compensation either from relationship compensation or the calculation entirely.

the relationship compensation attributable to each trust or fiduciary account must represent 50 percent or more of the bank's total compensation from the account. Thus, in exchange for the more rigorous and detailed computation required by this approach, banks are permitted to receive a higher proportion of securities-related fees.

Importantly, the proposed rules also broadly define "relationship compensation" to include a wide range of fees customarily received by banks as compensation for trust or fiduciary services. For example, the term would include all Rule 12b-1, shareholder servicing and sub-accounting fees received from a mutual fund and attributable to the bank's trust or fiduciary accounts, as well as fees paid by trust and fiduciary customers for personal services, tax preparation, real estate settlement and other administrative services.

2. <u>Advertising Restriction</u>

The proposed rules also provide guidance concerning the statute's advertising restriction. In particular, the proposed rules provide that a bank would comply with this restriction if advertisements by or on behalf of the bank—

- Do not advertise that the bank provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services; and
- Do not advertise the securities brokerage services that the bank provides to its trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to these accounts.

An "advertisement" is defined for these purposes to include only materials published or issued in public media, such as newspapers, magazines or television or radio broadcasts. Banks would remain free in sales literature that is not distributed through public media to describe fully and independently the securities brokerage services provided to trust and fiduciary customers.

B. Safekeeping and Custody Exception

The safekeeping and custody exception in the GLB Act permits banks to engage in a variety of securities activities in connection with their customary custody and safekeeping activities such as, for example, clearing and settling securities transactions and exercising warrants and other rights associated with securities held in custody.[12] The most important issue raised with respect to this exception in the SEC's prior rulemakings was whether, or under what conditions, banks could continue to accept orders for securities transactions directly from their custodial customers. For many years banks have accepted securities orders for custodial employee benefit plan and individual retirement account ("IRA") customers as a regular part of their business and have accepted orders for other custodial customers as an accommodation to the customers.

The proposed rules include an exemption that allows banks to accept securities orders from all types of custodial accounts subject to certain conditions. Consistent with the customary practices of banks, the principal conditions applicable under the exemption vary based on the type of custodial account involved.[13]

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[12] See 15 U.S.C. § 78c(a)(4)(B)(viii).

[13] Besides complying with the applicable conditions discussed below, a bank accepting securities orders for any type of custodial account must, as a general matter, send the trade to a broker-dealer for execution and may not acting as a "carrying broker" for a registered broker-dealer. In addition, a bank may not accept securities orders for a trust or fiduciary account under the custody exemption, but may do so under the trust and fiduciary exception discussed above.

1. Employee Benefit Plans and IRAs.

The proposed rules expressly permit a bank, acting as a custodian, to accept securities orders for a wide range of employee benefit plan accounts and IRAs[14] provided that the bank complies with two restrictions. First, employees of the bank may not receive compensation that is based on whether a securities transaction is executed for the account or that is based on the quantity, price or identity of the securities purchased or sold by the account. This limitation is designed to reduce the incentive a bank employee may have to provide advice or recommendations to custodial customers about securities. It would not, however, restrict the types of compensation that the bank may receive for accepting securities orders for employee benefit plan accounts and IRAs.[15]

Second, advertisements by or on behalf of the bank may not (i) advertise in public media that the bank accepts securities orders for employee benefit plan accounts or IRAs except as part of advertising the other custodial services the bank provides, or (ii) advertise in the public media that such accounts are "securities brokerage accounts" or that the bank's custodial services are a substitute for a securities brokerage account. An additional advertising restriction would apply to IRAs (but not employee benefit plans) due to the retail nature of these accounts. Specifically, a bank's

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[14] The proposed rules broadly define the term "employee benefit plan" to include both tax-qualified plans (such as 401(k) plans) and non-qualified plans (such as so-called rabbi and secular trusts). In addition, Roth IRAs, health savings accounts and education savings accounts are treated as IRAs for purposes of the exemption.

[15] In addition, this restriction would not prevent bank employees from receiving compensation under the types of traditional, discretionary bonus plans described below under the "Networking Exception."

advertisements <u>and</u> sales literature for custodial IRAs may not describe the bank's order-taking services more prominently than other aspects of the bank's custodial services. As noted above, "advertisements" are defined as material published in the public media; "sales literature" would be defined for these purposes as other communications that are generally distributed or made available to customers, such as marketing brochures.[16]

2. <u>Other Custodial Accounts</u>.

The proposed custody exemption also allows banks to continue to accept securities orders from other types of custodial accounts subject to certain conditions designed to help ensure that banks provide these services on an unsolicited basis as an accommodation to customers. Thus, in contrast to the modest restrictions on advertising order-taking in connection with employee benefit plans ("EBPs) and IRAs, the rule provides that, in the case of non-EBP and non-IRA custody accounts, a bank may not advertise in the public media that it accepts securities orders from these types of custodial accounts. It also prohibits the sales literature of a bank from describing the bank's order-taking services for these accounts independently of, or more prominently than, the bank's other custody services. In addition, if a bank accepts securities orders from a custodial account (other than an employee benefit plan or IRA), the bank may not—

- Provide investment advice or recommendations concerning securities to the account or solicit securities transactions from the account;

[16] The exemption also would permit a bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan to accept orders from the plan if the bank and the bank acting as custodian for the plan comply with the conditions discussed above <u>and</u> the bank acting as administrator or recordkeeper does not execute cross-trades or net orders for the plan except with respect to shares of mutual funds.

- Pay its employees the types of transaction-contingent compensation described above with respect to employee benefit plans and IRAs (that is, compensation based on whether a securities transaction is executed for the account or that is based on the quantity, price or identity of the securities purchased or sold by the account); or

- Charge or receive fees that vary based on whether the bank accepted the securities order or that vary based on the quantity or price of the securities bought or sold by the account (thus, for example, the bank must charge the same securities movement fee for transferring securities into or out of the custody account regardless of whether the customer places the securities order with the bank or a securities broker).[17]

Importantly, the rule would not prevent banks from responding to inquiries from a custodial customer about the customer's account or the bank's products and services, provided that the bank does not provide investment advice or recommendations concerning securities to the customer in doing so.

C. Networking Exception

The statutory "networking" exception permits bank employees to refer customers to a broker-dealer subject to several conditions that are designed, among other things, to help ensure customers receive adequate disclosures concerning the uninsured nature of securities products offered by the broker-dealer and to prevent unqualified bank personnel from providing investment advice or engaging in other inappropriate securities sales activities.[18] For example, one of these conditions generally prohibits a bank employee that

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[17] Unlike fees paid to a bank employee, however, the securities movement fee that a bank charges its custodial customers may, consistent with current practice, vary based on the identity or type of security bought or sold (e.g., government debt, corporate equity or foreign securities).

[18] 15 U.S.C. § 78c(a)(4)(B)(i).

refers a customer to a securities broker from receiving "incentive compensation" for a securities brokerage transaction other than a "nominal" one-time cash fee for making the referral that is not contingent on whether the referral results in a securities transaction. In addition, the bank employee may not provide advice or recommendations to the customer concerning securities, but may describe in general terms the types of investments available from the securities broker.

The proposed rule defines permissible "nominal" referral fees in several ways. It also includes an exemption that allows banks to pay higher-than-nominal, contingent referral fees for referrals involving institutional or high net worth customers. In addition, the proposed rules include provisions that are designed to ensure that the "incentive compensation" and nominal referral fee restrictions in the networking exception do not disrupt traditional bank bonus and similar plans.

1. "<u>Nominal" Referral Fees</u>.

The proposed rules provide that a referral fee would be considered "nominal" if it meets any one of three alternative standards. Specifically, a referral fee would be considered nominal under the rules if it does not exceed:

- Twice the average of the minimum and maximum hourly wage established by the bank for the employee's job family (e.g., tellers, loan officers, etc.);[19] <u>or</u>

- Twice the employee's actual base hourly wage; <u>or</u>

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[19] If the pay range for a particular job family is based on annual salaries (rather than hourly wages), then the referral fee would be considered nominal if it did not exceed 1/1000th of the minimum and maximum annual base salary established by the bank for the employee's job family.

• $25, which would be adjusted periodically for inflation.

These alternatives should provide banks of all sizes, and in differing locations, important flexibility in structuring their referral programs.

Under the rule, referral fees paid for securities referrals must be paid in cash. Moreover, the amount of an individual referral fee may not vary based on the number of referrals made by the employee. These restrictions may require some banks to restructure their referral programs if these programs award trips or other gifts in lieu of cash for securities referrals or pay higher referral fees as the number of securities referrals made by the employee increases. The nominal fee requirement and these restrictions would not, however, apply to referrals made by bank employees to the bank's trust and fiduciary department or for bank products, such as loans or CDs.

2. Referrals of Institutional and High Net Worth Customers.

The proposed rules also include an exemption that would permit a bank, subject to certain conditions, to pay employees a higher-than-nominal, contingent fee for referrals of an institutional or high net worth customer to a broker-dealer. This exemption should provide banks additional flexibility in paying relationship managers and others for referrals of sizable corporate customers and private banking clients. In this regard, the rules would define an "institutional customer" as a company or other non-natural person that has at least $10 million in investments or $40 million in assets.[20] A "high net worth customer" would be defined as a natural person that has at least

[20] In order to facilitate the ability of smaller businesses to access the capital markets, this asset threshold would drop to $25 million if the referral is for underwriting or other investment banking services.

$5 million in net worth (either individually or together with the person's spouse), excluding the person's primary residence and associated liabilities. Each of these dollar thresholds would be adjusted periodically for inflation.

In order to take advantage of this exemption, the bank would, among other things, be required to provide certain disclosures to the high net worth or institutional customer concerning the employee's potential financial interest in the referral. In addition, the written agreement between the bank and the broker-dealer must obligate the broker-dealer to perform either a "suitability" analysis of the securities transactions conducted by the customer with the broker-dealer or a "sophistication" analysis of the customer being referred.

Specifically, if the bank employee's referral fee is contingent on whether the customer engages in a securities transaction with the broker-dealer, then the broker-dealer must determine that each securities transaction on which the fee is contingent is "suitable" for the customer under the NASD's suitability rules even if the broker-dealer did not recommend the transaction to the customer.[21] For non-contingent referral fees, the broker-dealer must either (i) perform a "suitability" analysis for any securities transaction requested by the customer contemporaneously with the referral, or (ii) determine that the customer has the ability to evaluate investment risk and make independent decisions and is exercising independent judgment in connection with a potential investment. This latter and more limited "sophistication" analysis is similar to the analysis that broker-dealers may perform under NASD Rules when they make recommendations to institutional

[21] Normally under the NASD's rules a broker-dealer must determine that a transaction is suitable for the customer only if the broker-dealer recommended the transaction.

customers.[22] Regardless of what test is applicable, a bank that has an agreement requiring the broker to conduct this analysis would not lose its exemption if its broker-dealer partner failed to perform the proper analysis in a particular case.[23]

3. Bank Bonus Plans.

One of the major concerns voiced by banks in connection with the previous networking-related rules was that they would interfere with general bank bonus programs. To help address these concerns, the proposed rules expressly provide that they do not affect traditional, discretionary bonus plans of banks that are based on multiple factors or variables so long as (i) these factors or variables include significant factors or variables that are not related to securities transactions conducted at a broker-dealer and (ii) the number of securities referrals made by an employee or other person is not a factor in determining payments under the plan. In addition, the rules expressly provide that nothing in the rules shall be deemed to prevent a bank from compensating its employees based on any measure of the overall profitability of the bank or any of its operating units. Thus, the rules would not prevent a bank from considering the total value of the relationship between a particular institutional customer or high net worth individual and the bank and its affiliates in determining the bonus for the customer's relationship manager under a traditional multi-factor bonus plan.

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[22] See NASD IM-2310-3 (Suitability Obligations to Institutional Customers).

[23] In addition to the conditions discussed above, the proposed rules would require that the bank employee making the referral (i) encounter the customer in the ordinary course of the employee's assigned duties for the bank, (ii) not be a registered representative of a broker-dealer, and (iii) not previously have been disqualified under the Federal securities laws from working for a broker-dealer.

D. Sweeps Exception

The proposed rules also implement the sweeps exception, which allows banks to sweep deposit funds into a no-load money market fund.[24] Consistent with the NASD's definition of a "no-load" fund, the proposed rules provide that a money market fund will be considered "no-load" if it does not charge a front-end or back-end sales load and does not charge more than 0.25 basis points in asset-based fees for sales expenses or personal services. In addition, the proposal includes an exemption that would allow banks to invest customer funds in any money market fund so long as the customer has some other banking relationship with the bank and, if the fund does not meet the NASD's definition of a no-load fund, the bank does not characterize the fund as being no-load and provides the customer a prospectus for the fund at or before the time when the customer authorizes the transaction.

E. Other Significant Aspects of Proposed Rules

The proposal also includes several additional rules that are designed to provide banks an adequate time to transition to the new rules, reduce potential customer liability concerns, and provide banks additional operational flexibility. For example, the proposal would—

- Allow banks until at least July 1, 2008, to comply with the GLB Act's "broker" exceptions and any implementing rules ultimately adopted by the Board and SEC;

- Protect banks that act in good faith and have reasonable policies and procedures to comply with the GLB Act's exceptions from potential customer suits to rescind their securities contracts with the bank if the

[24] See 15 U.S.C. § 78c(a)(4)(B)(v).

bank inadvertently fails to comply with the GLB Act's "broker" exceptions or related rules;[25] and

• Allow banks, consistent with current business practice, to effect trades involving mutual fund securities directly with the fund's transfer agent or through the National Securities Clearing Corporation's Mutual Fund Services.

F. Requests for Comment and Next Steps

The attached draft Federal Register notice requests public comment on all aspects of the proposed rules and on numerous specific issues associated with the proposed rules. For example, the notice requests comment on whether the proposed language relating to bonus plans is consistent with the structure of existing bank bonus arrangements, and whether the advertising restrictions in the rules relating to trust and fiduciary and custodial activities are appropriate. In addition, the notice seeks comment on whether the Board and SEC should adopt rules to implement the other statutory "broker" exceptions for banks that are not addressed in the proposed rules.[26]

Going forward, staff of the Board, SEC, and the other banking agencies expect to continue working on several matters related to the proposed rules. For example, staff expects to continue discussions with the other agencies and the NASD concerning the NASD's Rule 3040, which governs the supervision and regulation of persons that are employed by both a broker-dealer and another entity, including a bank (so-called "dual employees"). In addition, as required by the GLB Act, the Board and the other banking agencies, in

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[25] Section 29(b) of the Securities Exchange Act generally provides that contracts made in violation of the Securities Exchange Act, including the broker registration requirements of the Act, or any rule or regulation thereunder may be declared void by a court of law. See 15 U.S.C. § 78cc(b).

[26] See Appendix A for a description of these other exceptions.

consultation with the SEC, will develop recordkeeping rules for banks to help banks comply with the new "broker" exceptions and related rules.[27] Finally, the Federal banking agencies expect to develop supervisory guidance to help ensure that banks have adequate policies, procedures and systems in place to conduct their securities brokerage activities in a safe and sound manner and to help prevent evasions of the GLB Act's "broker" exceptions and implementing rules.

CONCLUSION: For the reasons discussed above, staff recommends that the Board approve the attached proposed rules and jointly request comment on the rules with the SEC for a period of 90 days. Staff also requests authority to make minor and technical changes to the draft proposed rules and Federal Register notice prior to publication to ensure proper formatting and consistency with the documents adopted by the SEC.

Attachments

[27] See 12 U.S.C. § 1828(t).

APPENDIX A

GLB Act "Broker" and "Dealer" Exceptions for Banks

A. "Broker" Exceptions

The GLB Act's "broker" exceptions permit banks to engage in the following securities activities without registering as a broker with the SEC. The key conditions related to these exceptions are noted below. The proposed rules would implement the first four exceptions, which are the most important "broker" exceptions.

1. **Trust and Fiduciary**. Allows a bank to buy and sell securities for its trust or fiduciary customers accounts so long as the bank:
   - Is chiefly compensated for such transactions on the basis of administration fees, annual fees, fees based on a percentage of assets under management, flat or capped per order processing fees that do not exceed the bank's processing costs, or any combination of these fees; and
   - Does not publicly solicit brokerage business other than by advertising that it effects securities transactions in connection with advertising its other trust activities.

2. **Safekeeping and Custody**. Allows a bank, as part of its customary banking activities, to provide safekeeping and custody services with respect to securities, which includes:
   - Facilitating the clearance and settlement of customer securities transactions; and
   - Serving as a custodian or provider of other related administrative services to employee benefit plans, IRAs and other similar accounts.

3. **Networking**. Allows a bank to establish networking arrangements with broker-dealers under which bank customers are referred to the broker-dealer. Under the exception, bank employees:
   - May not receive incentive compensation for referring a customer to the broker-dealer, but may receive a nominal one-time cash fee for a referral if the fee is not contingent on whether the referral results in a transaction; and
   - May perform only clerical functions in connection with securities transactions, although the bank employee may describe in general terms the investment products available from the broker-dealer under the networking arrangement.

4. **Sweeps**. Allows a bank to sweep customer deposits into a "no-load" money market mutual fund.

5. **Permissible Securities Transactions**. Allows a bank to buy or sell U.S. government securities, commercial paper, bankers acceptances, and certain other types of securities for customers.

6. **Stock Purchase Plans**. Allows a bank to buy or sell, as transfer agent, securities of a company as part of a pension, profit-sharing, bonus, dividend reinvestment or issuer purchase plan.

7. **Affiliate Transactions**. Allows a bank to buy or sell securities for an affiliate (other than a broker-dealer or an affiliate engaged in merchant banking activities).

8. **Private Placements**. Allows a bank to privately place securities, subject to certain size of issue limits, so long as the bank is not affiliated with a broker-dealer that underwrites or deals in corporate debt or equity securities.

9. **Identified Banking Products**. Allows a bank to engage in transactions in "identified banking products," which include, among other things:

- Loan participations sold to qualified investors or to other financially sophisticated investors who have been provided appropriate information;
- Equity swaps that are sold to qualified investors; and
- Any other individually negotiated derivative instrument that is based, in whole or in part, on commodities, securities, currencies, interest rates, or other rates, indices or assets.

10. **Municipal Securities**. Allows a bank to buy or sell municipal securities for customers.

11. **De Minimis Transactions**. Allows a bank to engage in up to 500 securities transactions per year for customers that are not otherwise covered by one of the foregoing exceptions.

B. "Dealer" Exceptions

The "dealer" exceptions for banks in the GLB Act, which are not addressed by the proposed rules at all, allow banks to engage in the following activities for their own account:

1. **Permissible Securities Transactions**. Buy and sell U.S. government securities, commercial paper, banker acceptances and certain other types of securities.

2. **Investment, Trustee and Fiduciary Transactions**. Buy and sell securities for investment purposes for the bank or for accounts for which the bank acts as a trustee or fiduciary.

3. **Asset-Backed Transactions**. Issue or sell to qualified investors securities backed by assets that were predominantly originated by the bank, an affiliate of the bank (other than a broker or dealer), or, in some cases, by a syndicate of banks that includes the bank.

4. **Identified Banking Products**. Buy and sell the types of "identified banking products" listed above.