

**PROPOSED RULE TEXT**

The common rules that are proposed to be adopted by the Commission as Part 247 of Title 17, Chapter II of the Code of Federal Regulations and by the Board as Part 218 of Title 12, Chapter II of the Code of Federal Regulations follow:

**§ \_\_.100      Definition.**

For purposes of this part the following definition shall apply: Act means the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.).

**§ \_\_.700      Defined terms relating to the networking exception from the definition of “broker.”**

When used with respect to the Third Party Brokerage Arrangements (“Networking”) Exception from the definition of the term “broker” in section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i)) in the context of transactions with a customer, the following terms shall have the meaning provided:

(a) Contingent on whether the referral results in a transaction means dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker or dealer; whether the referral results in a transaction involving a particular type of security; or whether it results in multiple securities transactions; provided, however, that a referral fee may be contingent on whether a customer:

(1) Contacts or keeps an appointment with a broker or dealer as a result of the referral; or

(2) Meets any objective, base-line qualification criteria established by the bank or broker or dealer for customer referrals, including such criteria as minimum assets, net worth, income, or marginal federal or state income tax rate, or any requirement for citizenship or residency that the broker or dealer, or the bank, may have established generally for referrals for securities brokerage accounts.

(b) (1) Incentive compensation means compensation that is intended to encourage a bank employee to refer potential customers to a broker or dealer or give a bank employee an interest in the success of a securities transaction at a broker or dealer. The term does not include compensation paid by a bank under a bonus or similar plan that is:

(i) Paid on a discretionary basis; and

(ii) Based on multiple factors or variables and:

(A) Those factors or variables include significant factors or variables that are not related to securities transactions at the broker or dealer;

(B) A referral made by the employee is not a factor or variable in determining the employee's compensation under the plan; and

(C) The employee's compensation under the plan is not determined by reference to referrals made by any other person.

(2) Nothing in this paragraph (b) shall be construed to prevent a bank from compensating an officer, director or employee on the basis of any measure of the overall profitability of:

(i) The bank, either on a stand-alone or consolidated basis;

(ii) Any of the bank's affiliates (other than a broker or dealer) or operating units;

or

(iii) A broker or dealer if:

(A) Such profitability is only one of multiple factors or variables used to determine the compensation of the officer, director or employee; and

(B) The factors or variables used to determine the compensation of the officer, director or employee include significant factors or variables that are not related to the profitability of the broker or dealer.

(c) Nominal one-time cash fee of a fixed dollar amount means a cash payment for a referral in an amount that meets any of the following standards:

(1) The payment does not exceed:

(i) Twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee; or

(ii) 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee; or

(2) The payment does not exceed twice the employee's actual base hourly wage;

or

(3) The payment does not exceed twenty-five dollars (\$25), as adjusted in accordance with paragraph (f) of this section.

(d) Job family means a group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank, or a separate

unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation.

(e) Referral means the action taken by a bank employee to direct a customer of the bank to a broker or dealer for the purchase or sale of securities for the customer's account.

(f) Inflation adjustment.

(1) In general. On April 1, 2012, and on the 1<sup>st</sup> day of each subsequent 5-year period, the dollar amount referred to in paragraph (c)(3) of this section shall be adjusted by:

(i) Dividing the annual value of the Employment Cost Index For Wages and Salaries, Private Industry Workers (or any successor index thereto), as published by the Bureau of Labor Statistics, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(ii) Multiplying the dollar amount by the quotient obtained in paragraph (f)(1)(i) of this section.

(2) Rounding. If the adjusted dollar amount determined under paragraph (f)(1) of this section for any period is not a multiple of \$1, the amount so determined shall be rounded to the nearest multiple of \$1.

**§ \_\_.701      Exemption from the definition of “broker” for certain institutional referrals.**

(a) General. A bank that meets the requirements for the exception from the definition of “broker” under section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i)), other than section 3(a)(4)(B)(i)(VI) of the Act (15 U.S.C. 78c(a)(4)(B)(i)(VI)), is exempt from the conditions of section 3(a)(4)(B)(i)(VI) of the Act solely to the extent that a bank employee receives a referral fee for referring a high net worth customer or institutional customer to a broker or dealer with which the bank has a contractual or other written arrangement of the type specified in section 3(a)(4)(B)(i) of the Act, if:

(1) Bank employee.

(i) The bank employee is:

(A) Not qualified or otherwise required to be qualified pursuant to the rules of a self-regulatory organization;

(B) Predominantly engaged in banking activities, other than making referrals to a broker or dealer; and

(C) Not subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; and

(ii) The high net worth customer or institutional customer is encountered by the bank employee in the ordinary course of the employee’s assigned duties for the bank.

(2) Bank determinations and obligations.

(i) Disclosures. Prior to or at the time of the referral, the bank provides the customer with the information set forth in paragraph (b) of this section.

(ii) Customer qualification.

(A) In the case of a customer that is not a natural person, the bank determines, before the referral fee is paid to the bank employee, that the customer is an institutional customer.

(B) In the case of a customer that is a natural person, the bank, prior to or at the time of the referral, either:

(1) Determines that the customer is a high net worth customer; or

(2) Obtains a signed acknowledgment from the customer that the customer meets the standards to be considered a high net worth customer.

(iii) Employee qualification information. Before the referral fee is paid to the bank employee, the bank provides the broker or dealer the name of the employee and such other identifying information that may be necessary for the broker or dealer to determine whether the bank employee is associated with a broker or dealer or is subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section.

(iv) Good faith compliance and corrections. A bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of this section shall not be considered a “broker” under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely because the bank fails to comply with the provisions of this paragraph (a)(2) with respect to a particular customer if the bank:

(A) Takes reasonable and prompt steps to remedy the error (such as, for example, by promptly making the required determination or promptly providing the broker or dealer the required information); and

(B) Makes reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for the referral that does not, following any required remedial action, meet the requirements of this section and that exceeds the amount otherwise permitted under section 3(a)(4)(B)(i)(VI) of the Act (15 U.S.C. 78c(a)(4)(B)(i)(VI)) and § \_\_\_\_ .700.

(3) Provisions of written agreement. The written agreement between the bank and the broker or dealer provides for the following:

(i) Customer and employee qualifications. Before the referral fee is paid to the bank employee:

(A) The bank and broker or dealer must determine that the bank employee is not subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; and

(B) The broker or dealer must determine that the customer is a high net worth customer or an institutional customer.

(ii) Suitability or sophistication determination by broker or dealer.

(A) Contingent referral fees. In any case in which payment of the referral fee is contingent on completion of a securities transaction at the broker or dealer, the broker or dealer must, before such securities transaction is conducted, perform a suitability analysis of the securities transaction in accordance with the rules of the broker or dealer's applicable self-regulatory organization as if the broker or dealer had recommended the securities transaction.

(B) Non-contingent referral fees. In any case in which payment of the referral fee is not contingent on the completion of a securities transaction at the broker or dealer, the broker or dealer must, before the referral fee is paid, either:

(1) Determine that the customer:

(i) Has the capability to evaluate investment risk and make independent decisions; and

(ii) Is exercising independent judgment based on the customer's own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations; or

(2) Perform a suitability analysis of all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the broker or dealer's applicable self-regulatory organization as if the broker or dealer had recommended the securities transaction.

(iii) Notice. The broker or dealer must promptly inform the bank if the broker or dealer determines that:

(A) The customer is not a high net worth customer or institutional customer, as applicable;

(B) The bank employee is subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; or

(C) The customer or the securities transaction(s) to be conducted by the customer do not meet the applicable standard set forth in paragraph (a)(3)(ii) of this section.

(b) Required disclosures. The information provided to the high net worth customer or institutional customer pursuant to paragraph (a)(2)(i) of this section shall clearly and conspicuously disclose:

(1) The name of the broker or dealer; and



(2) That the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and payment of this fee may be contingent on whether the referral results in a transaction with the broker or dealer.

(c) Receipt of other compensation. Nothing in this section prevents or prohibits a bank from paying or a bank employee from receiving any type of compensation that would not be considered incentive compensation under § \_\_\_\_\_.700(b)(1) or that is described in § \_\_\_\_\_.700(b)(2).

(d) Definitions. When used in this section:

(1) High net worth customer means any natural person who, either individually or jointly with his or her spouse, has at least \$5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse.

(2) Institutional customer means any corporation, partnership, limited liability company, trust or other non-natural person that has at least:

(i) \$10 million in investments; or

(ii) \$40 million in assets; or

(iii) \$25 million in assets if the bank employee refers the customer to the broker or dealer for investment banking services.

(3) Investment banking services includes, without limitation, acting as an underwriter in an offering for an issuer; acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction; providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments; serving as placement agent for an issuer; and engaging in similar activities.

(4) Referral fee means a fee (paid in one or more installments) for the referral of a customer to a broker or dealer that is:

(i) A predetermined dollar amount, or a dollar amount determined in accordance with a predetermined formula (such as a fixed percentage of the dollar amount of total assets placed in an account with the broker or dealer), that does not vary based on:

(A) The revenue generated by or the profitability of securities transactions conducted by the customer with the broker or dealer; or

(B) The quantity, price, or identity of securities transactions conducted over time by the customer with the broker or dealer; or

(C) The number of customer referrals made; or

(ii) A dollar amount based on a fixed percentage of the revenues received by the broker or dealer for investment banking services provided to the customer.

(e) Inflation adjustments.

(1) In general. On April 1, 2012, and on the 1<sup>st</sup> day of each subsequent 5-year period, each dollar amount in paragraphs (d)(1) and (d)(2) of this section shall be adjusted by:

(i) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(ii) Multiplying the dollar amount by the quotient obtained in paragraph (e)(1)(i) of this section.

(2) Rounding. If the adjusted dollar amount determined under paragraph (e)(1) of this section for any period is not a multiple of \$100,000, the amount so determined shall be rounded to the nearest multiple of \$100,000.

**§ \_\_.721 Defined terms relating to the trust and fiduciary activities exception from the definition of “broker.”**

(a) Defined terms for chiefly compensated test. For purposes of this part and section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)), the following terms shall have the meaning provided:

(1) Chiefly compensated—account-by-account test. Chiefly compensated shall mean the relationship-total compensation percentage for each trust or fiduciary account of the bank is greater than 50 percent.

(2) The relationship-total compensation percentage for a trust or fiduciary account shall be the mean of the yearly compensation percentage for the account for the immediately preceding year and the yearly compensation percentage for the account for the year immediately preceding that year.

(3) The yearly compensation percentage for a trust or fiduciary account shall be equal to the relationship compensation attributable to the trust or fiduciary account during the year divided by the total compensation attributable to the trust or fiduciary account during that year, with the quotient expressed as a percentage.

(4) Relationship compensation means any compensation a bank receives that consists of:

(i) An administration fee, including, without limitation, a fee paid for personal services, tax preparation, or real estate settlement services, or a fee paid by an investment

company for personal service, the maintenance of shareholder accounts or any service described in paragraph (a)(4)(iii)(C) of this section;

(ii) An annual fee (payable on a monthly, quarterly or other basis);

(iii) A fee based on a percentage of assets under management, including, without limitation:

(A) A fee paid by an investment company pursuant to a plan under 17 CFR 270.12b-1;

(B) A fee paid by an investment company for personal service or the maintenance of shareholder accounts; or

(C) A fee paid by an investment company based on a percentage of assets under management for any of the following services:

(1) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(2) Aggregating and processing purchase and redemption orders for investment company shares;

(3) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(4) Processing dividend payments for the investment company;

(5) Providing sub-accounting services to the investment company for shares held beneficially;

(6) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(7) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares;

(iv) A flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or

(v) Any combination of such fees.

(5) Trust or fiduciary account means an account for which the bank acts in a trustee or fiduciary capacity as defined in section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)).

(6) Year means a calendar year, or fiscal year consistently used by the bank for recordkeeping and reporting purposes.

(b) Advertising restrictions.

(1) In general. A bank complies with the advertising restriction in section 3(a)(4)(B)(ii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(II)) if advertisements by or on behalf of the bank do not advertise:

(i) 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

(ii) The securities brokerage services provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.

(2) Advertisement. For purposes of this section, the term advertisement has the same meaning as in § \_\_\_.760(g)(2).

**§ \_\_\_.722      Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.**

(a) General. A bank is exempt from meeting the “chiefly compensated” condition in section 3(a)(4)(B)(ii)(I) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(I)) to the extent that it effects transactions in securities for any account in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)) if:

(1) The bank meets the other conditions for the exception from the definition of the term “broker” under sections 3(a)(4)(B)(ii) and 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(C)); and

(2) The aggregate relationship-total compensation percentage for the bank’s trust and fiduciary business is at least 70 percent.

(b) Aggregate relationship-total compensation percentage. For purposes of this section, the aggregate relationship-total compensation percentage for a bank’s trust and fiduciary business shall be the mean of the bank’s yearly bank-wide compensation percentage for the immediately preceding year and the bank’s yearly bank-wide compensation percentage for the year immediately preceding that year.

(c) Yearly bank-wide compensation percentage. For purposes of this section, a bank’s yearly bank-wide compensation percentage for a year shall equal the relationship

compensation attributable to the bank's trust and fiduciary business as a whole during the year divided by the total compensation attributable to the bank's trust and fiduciary business as a whole during that year, with the quotient expressed as a percentage.

**§ \_\_\_\_ .723 Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.**

(a) Short-term accounts. A bank may, in determining its compliance with the chiefly compensated test in § \_\_\_\_ .721(a)(1) and § \_\_\_\_ .722(a)(2), exclude any trust or fiduciary account that had been open for a period of less than 3 months during the relevant year.

(b) Accounts acquired as part of a business combination or asset acquisition. For purposes of determining compliance with the chiefly compensated test in § \_\_\_\_ .721(a)(1) or § \_\_\_\_ .722(a)(2), any trust or fiduciary account that a bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar transaction may be excluded by the bank for 12 months after the date the bank acquired the account from the other person.

(c) Accounts transferred to a broker or dealer or other unaffiliated entity. Notwithstanding section 3(a)(4)(B)(ii)(I) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(I)) and § \_\_\_\_ .721(a)(1), a bank shall not be considered a broker for purposes of section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely because a trust or fiduciary account does not meet the chiefly compensated standard in § \_\_\_\_ .721(a)(1) if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a broker or dealer registered under section 15 of the Act (15 U.S.C. 78o) or another entity that is not an affiliate of the bank and is not required to be registered as a broker or dealer.

(d) De minimis exclusion. A bank may, in determining its compliance with the chiefly compensated test in § \_\_\_.721(a)(1), exclude a trust or fiduciary account if:

(1) The bank maintains records demonstrating that the securities transactions conducted by or on behalf of the account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account;

(2) The total number of accounts excluded by the bank under this paragraph (d) does not exceed the lesser of:

(i) 1 percent of the total number of trust or fiduciary accounts held by the bank, provided that if the number so obtained is less than 1, the amount shall be rounded up to 1; or

(ii) 500; and

(3) The bank did not rely on this paragraph (d) with respect to such account during the immediately preceding year.

**§ \_\_\_.740      Defined terms relating to the sweep accounts exception from the definition of “broker.”**

For purposes of section 3(a)(4)(B)(v) of the Act (15 U.S.C. 78c(a)(4)(B)(v)), the following terms shall have the meaning provided:

(a) Deferred sales load has the same meaning as in 17 CFR 270.6c-10.

(b) Money market fund means an open-end company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) that is regulated as a money market fund pursuant to 17 CFR 270.2a-7.



(c)(1) No-load, in the context of an investment company or the securities issued by an investment company, means, for securities of the class or series in which a bank effects transactions, that:

(i) That class or series is not subject to a sales load or a deferred sales load; and

(ii) Total charges against net assets of that class or series of the investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually.

(2) For purposes of this definition, charges for the following will not be considered charges against net assets of a class or series of an investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts:

(i) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(ii) Aggregating and processing purchase and redemption orders for investment company shares;

(iii) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(iv) Processing dividend payments for the investment company;

(v) Providing sub-accounting services to the investment company for shares held beneficially;

(vi) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

(d) Open-end company has the same meaning as in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-5(a)(1)).

(e) Sales load has the same meaning as in section 2(a)(35) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(35)).

**§ \_\_\_\_ .741 Exemption for banks effecting transactions in money market funds.**

(a) A bank is exempt from the definition of the term “broker” under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions on behalf of a customer in securities issued by a money market fund, provided that:

(1) The bank provides the customer, directly or indirectly, any other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under section 15(a) of the Act; and

(2)(i) The class or series of securities is no-load; or

(ii) If the class or series of securities is not no-load,

(A) The bank provides the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities; and

(B) The bank does not characterize or refer to the class or series of securities as no-load.

(b) Definitions. For purposes of this section:

(1) Money market fund has the same meaning as in § \_\_\_.740(b).

(2) No-load has the same meaning as in § \_\_\_.740(c).

**§ \_\_\_.760      Exemption from definition of “broker” for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.**

(a) Employee benefit plan accounts and individual retirement accounts or similar accounts. A bank is exempt from the definition of the term “broker” under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities for an employee benefit plan account or an individual retirement account or similar account for which the bank acts as a custodian if:

(1) Employee compensation restriction. The bank complies with the employee compensation restrictions in paragraph (c) of this section;

(2) Advertisements. Advertisements by or on behalf of the bank do not—

(i) Advertise that the bank accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts or similar accounts, except as part of advertising the other custodial or safekeeping services the bank provides to these accounts; or

(ii) Advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account; and

(3) Advertisements and sales literature for individual retirement or similar accounts. Advertisements and sales literature issued by or on behalf of the bank do not describe the securities order-taking services provided by the bank to individual retirement or similar accounts more prominently than the other aspects of the custody or safekeeping services provided by the bank to these accounts.

(b) Accommodation trades for other custodial accounts. A bank is exempt from the definition of the term "broker" under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities for an account for which the bank acts as custodian other than an employee benefit plan account or an individual retirement account or similar account if:

(1) Accommodation. The bank accepts orders to effect transactions in securities for the account only as an accommodation to the customer;

(2) Employee compensation restriction. The bank complies with the employee compensation restrictions in paragraph (c) of this section;

(3) Bank fees. Any fee charged or received by the bank for effecting a securities transaction for the account does not vary based on:

- (i) Whether the bank accepted the order for the transaction; or
- (ii) The quantity or price of the securities to be bought or sold;

(4) Advertisements. Advertisements by or on behalf of the bank do not state that the bank accepts orders for securities transactions for the account;

(5) Sales literature. Sales literature issued by or on behalf of the bank:

(i) Does not state that the bank accepts orders for securities transactions for the account except as part of describing the other custodial or safekeeping services the bank provides to the account; and

(ii) Does not describe the securities order-taking services provided to the account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account; and

(6) Investment advice and recommendations. The bank does not provide investment advice or research concerning securities to the account, make recommendations to the account concerning securities or otherwise solicit securities transactions from the account; provided, however, that nothing in this paragraph (b)(6) shall prevent a bank from:

(i) Publishing, using or disseminating advertisements and sales literature in accordance with paragraphs (b)(4) and (b)(5) of this section; and

(ii) Responding to customer inquiries regarding the bank's safekeeping and custody services by providing:

(A) Advertisements or sales literature consistent with the provisions of paragraphs (b)(4) and (b)(5) of this section describing the safekeeping, custody and related services that the bank offers;

(B) A prospectus prepared by a registered investment company, or sales literature prepared by a registered investment company or by the broker or dealer that is the

principal underwriter of the registered investment company pertaining to the registered investment company's products;

(C) Information based on the materials described in paragraphs (b)(6)(ii)(A) and (B) of this section; or

(iii) Responding to inquiries regarding the bank's safekeeping, custody or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.

(c) Employee compensation restriction. A bank may accept orders pursuant to this section for a securities transaction for an account described in paragraph (a) or (b) of this section only if no bank employee receives compensation, including a fee paid pursuant to a plan under 17 CFR 270.12b-1, from the bank, the executing broker or dealer, or any other person that is based on whether a securities transaction is executed for the account or that is based on the quantity, price, or identity of securities purchased or sold by such account, provided that nothing in this paragraph shall prohibit a bank employee from receiving compensation that would not be considered incentive compensation under § \_\_\_.700(b)(1) as if a referral had been made by the bank employee, or any compensation described in § \_\_\_.700(b)(2).

(d) Other conditions. A bank may accept orders for a securities transaction for an account for which the bank acts as a custodian under this section only if the bank:

(1) Does not act in a trustee or fiduciary capacity (as defined in section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)) with respect to the account;

(2) Complies with section 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(C)) in handling any order for a securities transaction for the account; and

(3) Complies with section 3(a)(4)(B)(viii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(viii)(II)) regarding carrying broker activities.

(e) Non-fiduciary administrators and recordkeepers. A bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan for which another bank acts as custodian may rely on the exemption provided in this section if:

(1) Both the custodian bank and the administrator or recordkeeper bank meet the requirements of this section; and

(2) The administrator or recordkeeper bank does not execute a cross-trade with or for the employee benefit plan or net orders for securities for the plan, other than orders for shares of open-end investment companies not traded on an exchange.

(f) Evasions. In considering whether a bank meets the terms of this section, both the form and substance of the relevant account(s), transaction(s) and activities (including advertising activities) of the bank will be considered in order to prevent evasions of the requirements of this section.

(g) Definitions. When used in this section:

(1) Account for which the bank acts as a custodian means an account that is:

(i) An employee benefit plan account for which the bank acts as a custodian;

(ii) An individual retirement account or similar account for which the bank acts as a custodian; or

(iii) An account established by a written agreement between the bank and the customer that sets forth the terms that will govern the fees payable to, and rights and obligations of, the bank regarding the safekeeping or custody of securities.

(2) Advertisement means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings).

(3) Employee benefit plan account means a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan, including, without limitation, an employer-sponsored plan qualified under section 401(a) of the Internal Revenue Code (26 U.S.C. 401(a)), a governmental or other plan described in section 457 of the Internal Revenue Code (26 U.S.C. 457), a tax-deferred plan described in section 403(b) of the Internal Revenue Code (26 U.S.C. 403(b)), a church plan, governmental, multiemployer or other plan described in section 414(d), (e) or (f) of the Internal Revenue Code (26 U.S.C. 414(d), (e) or (f)), an incentive stock option plan described in section 422 of the Internal Revenue Code (26 U.S.C. 422); a Voluntary Employee Beneficiary Association Plan described in section 501(c)(9) of the Internal Revenue Code (26 U.S.C. 501(c)(9)), a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan, and a supplemental unemployment benefit plan.



(4) Individual retirement account or similar account means an individual retirement account as defined in section 408 of the Internal Revenue Code (26 U.S.C. 408), Roth IRA as defined in section 408A of the Internal Revenue Code (26 U.S.C. 408A), health savings account as defined in section 223(d) of the Internal Revenue Code (26 U.S.C. 223(d)), Archer medical savings account as defined in section 220(d) of the Internal Revenue Code (26 U.S.C. 220(d)), Coverdell education savings account as defined in section 530 of the Internal Revenue Code (26 U.S.C. 530), or other similar account.

(5) Sales literature means any written or electronic communication, other than an advertisement, that is generally distributed or made generally available to customers of the bank or the public, including circulars, form letters, brochures, telemarketing scripts, seminar texts, published articles, and press releases concerning the bank's products or services.

(6) Principal underwriter has the same meaning as in section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(29)).

**§ \_\_.771      Exemption from the definition of “broker” for banks effecting transactions in securities issued pursuant to Regulation S.**

(a) A bank is exempt from the definition of the term “broker” under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)), to the extent that, as agent, the bank:

(1) Effects a sale in compliance with the requirements of 17 CFR 230.903 of an eligible security to a purchaser who is outside of the United States within the meaning of 17 CFR 230.903;

(2) Effects a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a person who is not a U.S. person under 17 CFR 230.902(k) to a purchaser who is outside the United States within the meaning of 17 CFR 230.903 or a registered broker or dealer, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904; or

(3) Effects a resale of an eligible security after its initial sale outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a registered broker or dealer to a purchaser who is outside the United States within the meaning of 17 CFR 230.903, provided that if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale is made in compliance with the requirements of 17 CFR 230.904.

(b) Definitions. For purposes of this section:

(1) Distributor has the same meaning as in 17 CFR 230.902(d).

(2) Eligible security means a security that:

(i) Is not being sold from the inventory of the bank or an affiliate of the bank; and

(ii) Is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank.

(3) Purchaser means a person who purchases an eligible security and who is not a U.S. person under 17 CFR 230.902(k).

**§ \_\_.772 Exemption from the definition of “broker” for banks engaging in securities lending transactions.**

(a) A bank is exempt from the definition of the term “broker” under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)), to the extent that, as an agent, it engages in or effects securities lending transactions, and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be:

(1) A qualified investor as defined in section 3(a)(54)(A) of the Act (15 U.S.C. 78c(a)(54)(A)); or

(2) Any employee benefit plan that owns and invests on a discretionary basis, not less than \$ 25,000,000 in investments.

(b) Securities lending transaction means a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties.

(c) Securities lending services means:

(1) Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower;

(2) Receiving, delivering, or directing the receipt or delivery of loaned securities;

(3) Receiving, delivering, or directing the receipt or delivery of collateral;

(4) Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction;

(5) Investing, or directing the investment of, cash collateral; or

(6) Indemnifying the lender of securities with respect to various matters.

**§ \_\_.775      Exemption from the definition of “broker” for the way banks effect excepted or exempted transactions in investment company securities.**

(a) A bank that meets the conditions for an exception or exemption from the definition of the term “broker” except for the condition in section 3(a)(4)(C)(i) of the Act (15 U.S.C. 78c(a)(4)(C)(i)), is exempt from such condition to the extent that it effects transactions in securities issued by an open-end company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system, provided that:

(1) Such transactions are effected through the National Securities Clearing Corporation’s Mutual Fund Services or directly with a transfer agent acting for the open-end company; and

(2) The securities are distributed by a registered broker or dealer, or the sales charge is no more than the amount a registered broker or dealer may charge pursuant to the rules of a securities association registered under section 15A of the Act (15 U.S.C. 78o-3) adopted pursuant to section 22(b)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-22(b)(1)).

(b) Definitions. For purposes of this section:

(1) Interdealer quotation system has the same meaning as in 17 CFR 240.15c2-11.

(2) Open-end company has the same meaning as in § \_\_.740.

**§ \_\_.780      Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.**

(a) No contract entered into before [insert date 18 months after effective date of the final rule], shall be void or considered voidable by reason of section 29(b) of the Act (15 U.S.C. 78cc(b)) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Act (15 U.S.C. 78o(a)), any other applicable provision of the Act, or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created.

(b) No contract shall be void or considered voidable by reason of section 29(b) of the Act (15 U.S.C. 78cc(b)) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Act (15 U.S.C. 78o(a)) or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created, if:

(1) At the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with section 3(a)(4)(B) of the Act and the rules and regulations thereunder; and

(2) At the time the contract was created, any violation of the registration requirements of section 15(a) of the Act by the bank did not result in any significant harm or financial loss or cost to the person seeking to void the contract.

**§ \_\_.781      Exemption from the definition of “broker” for banks for a limited period of time.**

A bank is exempt from the definition of the term “broker” under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) until the first day of its first fiscal year commencing after June 30, 2008.

**FEDERAL RESERVE SYSTEM**

**12 CFR Part 218**

**[Regulation R; Docket No. R-\_\_\_\_]**

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 240 and 247**

**[Release No. 34-; File No. S7- -06]**

**RIN 3235-AJ74**

**DEFINITIONS OF TERMS AND EXEMPTIONS RELATING TO THE  
“BROKER” EXCEPTIONS FOR BANKS**

**AGENCIES:** Board of Governors of the Federal Reserve System (“Board”) and Securities and Exchange Commission (“SEC” or “Commission”) (collectively, the Agencies).

**ACTION:** Proposed rule.

**SUMMARY:** The Board and the Commission jointly are issuing, and requesting comment on, proposed rules that would implement certain of the exceptions for banks from the definition of the term “broker” under Section 3(a)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), as amended by the Gramm-Leach-Bliley Act (“GLBA”). The proposed rules would define terms used in these statutory exceptions and include certain related exemptions. In developing this proposal, the Agencies have consulted with the Office of the Comptroller of the Currency (“OCC”), the Federal Deposit Insurance Corporation (“FDIC”) and the Office of Thrift Supervision (“OTS”). The proposal is intended, among other things, to facilitate banks’ compliance with the GLBA.

**DATES:** Comments should be received on or before [INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:**

**BOARD:** You may submit comments, identified by Docket No. R- , by any of the following methods:

- **Board's Web site:** <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.
- **E-mail:** [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- **Fax:** (202) 452-3819 or (202) 452-3102.
- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's Web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments also may be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (C and 20<sup>th</sup> Streets, NW) between 9:00 a.m. and 5:00 p.m. on weekdays.

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

Electronic Comments:

- Use the Commission's Internet comment form  
(<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7- -06 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7- -06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:**

**BOARD:** Kieran J. Fallon, Assistant General Counsel, (202) 452-5270, Andrew Miller, Counsel, (202) 452-3428, or Andrea Tokheim, Senior Attorney, (202) 452-2300, Legal Division, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW, Washington, DC 20551. Users of Telecommunication Device for Deaf (TTD) only, call (202) 263-4869.



**SEC:** Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel, Richard C. Strasser, Attorney Fellow, John Fahey, Special Counsel, Haimera Workie, Special Counsel, at (202) 551-5550, Office of the Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

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**I. Introduction and Background**

The GLBA amended several federal statutes governing the activities and supervision of banks, bank holding companies, and their affiliates.<sup>1</sup> Among other things, it lowered barriers between the banking and securities industries erected by the Banking Act of 1933 (“Glass-Steagall Act”).<sup>2</sup> It also altered the way in which the supervisory responsibilities over the banking, securities, and insurance industries are allocated among financial regulators. Among other things, the GLBA repealed most of the separation of investment and commercial banking imposed by the Glass-Steagall Act. The GLBA also revised the provisions of the Exchange Act that had completely excluded banks from broker-dealer registration requirements.

In enacting the GLBA, Congress adopted functional regulation for bank securities activities, with certain exceptions from Commission oversight for specified securities activities. With respect to the definition of “broker,” the Exchange Act, as amended by the GLBA, provides eleven specific exceptions for banks.<sup>3</sup> Each of these exceptions permits a bank to act as an agent with respect to specified securities products or in transactions that meet specific statutory conditions.

In particular, Section 3(a)(4)(B) of the Exchange Act provides conditional

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<sup>1</sup> Pub. L. No. 106-102, 113 Stat. 1338 (1999).

<sup>2</sup> Pub. L. No. 73-66, ch. 89, 48 Stat. 162 (1933) (as codified in various Sections of 12 U.S.C.).

<sup>3</sup> 15 U.S.C. 78c(a)(4).

exceptions from the definition of broker for banks that engage in certain securities activities in connection with third-party brokerage arrangements;<sup>4</sup> trust and fiduciary activities;<sup>5</sup> permissible securities transactions;<sup>6</sup> certain stock purchase plans;<sup>7</sup> sweep accounts;<sup>8</sup> affiliate transactions;<sup>9</sup> private securities offerings;<sup>10</sup> safekeeping and custody activities;<sup>11</sup> identified banking products;<sup>12</sup> municipal securities;<sup>13</sup> and a de minimis number of other securities transactions.<sup>14</sup>

On October 13, 2006, President Bush signed into law the “Financial Services

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<sup>4</sup> Exchange Act Section 3(a)(4)(B)(i). This exception permits banks to enter into third-party brokerage, or “networking” arrangements with brokers under specific conditions.

<sup>5</sup> Exchange Act Section 3(a)(4)(B)(ii). This exception permits banks to effect transactions as trustees or fiduciaries for securities customers under specific conditions.

<sup>6</sup> Exchange Act Section 3(a)(4)(B)(iii). This exception permits banks to buy and sell commercial paper, bankers’ acceptances, commercial bills, exempted securities, certain Canadian government obligations, and Brady bonds.

<sup>7</sup> Exchange Act Section 3(a)(4)(B)(iv). This exception permits banks, as part of their transfer agency activities, to effect transactions for certain issuer plans.

<sup>8</sup> Exchange Act Section 3(a)(4)(B)(v). This exception permits banks to sweep funds into no-load money market funds.

<sup>9</sup> Exchange Act Section 3(a)(4)(B)(vi). This exception permits banks to effect transactions for affiliates, other than broker-dealers.

<sup>10</sup> Exchange Act Section 3(a)(4)(B)(vii). This exception permits certain banks to effect transactions in certain privately placed securities, under certain conditions.

<sup>11</sup> Exchange Act Section 3(a)(4)(B)(viii). This exception permits banks to engage in certain enumerated safekeeping or custody activities, including stock lending as custodian.

<sup>12</sup> Exchange Act Section 3(a)(4)(B)(ix). This exception permits banks to buy and sell certain “identified banking products,” as defined in Section 206 of the GLBA.

<sup>13</sup> Exchange Act Section 3(a)(4)(B)(x). This exception permits banks to effect transactions in municipal securities.

<sup>14</sup> Exchange Act Section 3(a)(4)(B)(xi). This exception permits banks to effect up to 500 transactions in securities in any calendar year in addition to transactions referred to in the other exceptions.

Regulatory Relief Act of 2006 (“Regulatory Relief Act”).”<sup>15</sup> Among other things, the Regulatory Relief Act requires that the SEC and the Board jointly adopt a single set of rules to implement the bank broker exceptions in Section 3(a)(4) of the Exchange Act.<sup>16</sup> It also requires that not later than 180 days after the date of enactment of the Regulatory Relief Act, the SEC and the Board jointly issue a single set of proposed rules to implement these exceptions.

Section 401 of the Regulatory Relief Act also amended the definition of “bank” in Section 3(a)(6) of the Exchange Act to include any Federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, as used in this proposal, the term “bank” includes any savings association that qualifies as a “bank” under Section 3(a)(6) of the Exchange Act, as amended.

In accordance with these statutory provisions, the SEC and Board are jointly requesting comment on proposed rules to implement the broker exceptions for banks relating to third-party networking arrangements, trust and fiduciary activities, sweep activities, and safekeeping and custody activities.<sup>17</sup> The proposed rules include certain exemptions related to these activities, as well as exemptions related to foreign securities transactions, securities lending transactions conducted in an agency capacity, the execution of transactions involving mutual fund shares, the potential liability of banks under Section 29 of the Exchange Act, and the date on which the GLB Act’s “broker”

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<sup>15</sup> Pub. L. No. 109-351, 120 Stat. 1966 (2006).

<sup>16</sup> See Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act. The Regulatory Relief Act also requires that the Board and SEC consult with, and seek the concurrence of, the OCC, FDIC and OTS prior to jointly adopting final rules. As noted above, the Board and the SEC also have consulted extensively with the OCC, FDIC and OTS in developing these joint proposed rules.

<sup>17</sup> See 15 U.S.C. 78c(a)(4)(B)(i), (ii), (v) and (viii).

exceptions for banks will go into effect.<sup>18</sup> The proposed rules are designed to accommodate the business practices of banks and protect investors.

Any additions or changes to these rules that may be appropriate to implement Section 3(a)(4)(B) of the Exchange Act will be adopted jointly by the SEC and Board in accordance with the consultation provisions in Section 101(b) of the Regulatory Relief Act. Identical sets of the final rules will be published by the SEC in Title 17 of the Code of Federal Regulations and by the Board in Title 12 of the Code of Federal Regulations.

In developing this proposal, the Agencies considered, among other things, the language and legislative history of the “broker” exceptions for banks adopted in the GLBA, the rules previously issued or proposed by the Commission relating to these exceptions and the comments received in connection with those prior rulemakings. The Agencies request comment on all aspects of these proposals as well as on the specific provisions and issues identified below. In addition, the Agencies request comment on whether it would be useful or appropriate for the Agencies to adopt rules implementing the other bank “broker” exceptions in Section 3(a)(4)(B) of the Exchange Act that are not addressed in this proposal. If any rules (including exemptions) related to these other exceptions are adopted in the future, they would be adopted jointly by the SEC and Board.

As required by the GLBA, the Board, OCC, FDIC, and OTS (collectively, the Banking Agencies) will develop, and request public comment on, recordkeeping rules for banks that operate under the “broker” exceptions in Section 3(a)(4) of the Exchange

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<sup>18</sup> Employees of a bank that operates in accordance with the exceptions in Section 3(a)(4)(B) of the Exchange Act and, where applicable, the proposed rules also shall not be required to register as a “broker” to the extent that the employees’ activities are covered by the relevant exception or rule.

Act.<sup>19</sup> These rules, which will be developed in consultation with the SEC, will establish recordkeeping requirements to enable banks to demonstrate compliance with the terms of the statutory exceptions and the final rules ultimately jointly adopted and that are designed to facilitate compliance with the statutory exceptions and those rules.

## **II. Networking Arrangements**

The third-party brokerage (“networking”) exception in Exchange Act Section 3(a)(4)(B)(i) permits a bank to avoid being considered a broker if, under certain conditions, it enters into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers (“networking arrangement”).<sup>20</sup> The networking exception does not address the type or amount of compensation that a bank may receive from its broker-dealer partner under a networking arrangement. However, the networking exception generally provides that a bank may not pay its unregistered employees<sup>21</sup> incentive compensation for referring a customer to the broker-dealer or for any securities transaction conducted by the customer at the broker-dealer. Nevertheless, the statutory exception does permit a bank employee to receive a “nominal one-time cash fee of a fixed dollar amount” for referring bank customers to the broker-dealer if payment of the referral fee is not “contingent on whether the referral results in a transaction.”<sup>22</sup> Congress included the limitation on

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<sup>19</sup> See 12 U.S.C. 1828(t)(1).

<sup>20</sup> 15 U.S.C. 78c(a)(4)(B)(i).

<sup>21</sup> An unregistered bank employee is an employee that is not an associated person of a broker or dealer and is not qualified pursuant to the rules of a self-regulatory organization.

<sup>22</sup> 15 U.S.C. 78c(a)(4)(B)(i)(VI).



incentive compensation to reduce securities sales practice concerns regarding unregistered bank employees.<sup>23</sup>

A. Proposed Definitions Related to the Payment of Referral Fees

The proposed rules define certain terms used in the networking exception in the Exchange Act related to referral fees and terms used in these proposed definitions. The proposed rules also provide an exemption from certain of the requirements in the networking exception with respect to payment for referrals of certain institutional customers and high net worth customers.

1. Proposed Definition of “Nominal One-Time Cash Fee of a Fixed Dollar Amount”

Under the proposal, the term “nominal one-time cash fee of a fixed dollar amount” would be defined as a cash payment for a referral in an amount that meets any one of three alternative standards.<sup>24</sup> The Agencies believe that these alternatives provide useful and appropriate flexibility to banks of all sizes and locations to use different business models and to take into account economic differences around the country in assessing whether a cash referral fee paid in a particular instance is a “nominal” amount for purposes of the networking exception. The three alternatives are consistent with the statutory “nominal” fee requirement because the amount of compensation permitted under each of the three formulations would be small in relation to the employee’s overall compensation and therefore unlikely to create undue incentives for bank employees to pre-sell securities to bank customers.

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<sup>23</sup> See H.R. Rep. No. 106-74, pt. 3, at 163 (1999) (“[T]he conditions contained in the networking exception . . . restrict the securities activities of unregistered bank personnel to reduce sales practice concerns.”).

<sup>24</sup> Proposed Exchange Act Rule 700(c).

Under the first alternative, a referral fee would be considered nominal if it did not exceed either twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the relevant employee, or 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the relevant employee.<sup>25</sup> The proposed rules define a “job family” for these purposes as a group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank, or a separate unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation.<sup>26</sup> Depending on a bank’s internal employee classification system, examples of a job family may include tellers, loan officers, or branch managers. A bank should not deviate from its ordinary classification of jobs for purposes of determining whether a referral fee would be considered nominal under this standard.

Under the second alternative, a referral fee would be considered “nominal” if it did not exceed twice the employee’s actual base hourly wage.<sup>27</sup> Thus, unlike the first option, this alternative is based on the actual hourly base wage of the employee receiving the referral fee.

Under the third alternative, a referral fee would be considered “nominal” for purposes of the networking exception if the payment did not exceed twenty-five dollars

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<sup>25</sup> Proposed Exchange Act Rule 700(c)(1).

<sup>26</sup> Proposed Exchange Act Rule 700(d).

<sup>27</sup> Proposed Exchange Act Rule 700(c)(2).

(\$25).<sup>28</sup> This dollar amount would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value of the Employment Cost Index For Wages and Salaries, Private Industry Workers (or any successor index thereto), as published by the Bureau of Labor Statistics, from December 31, 2006.<sup>29</sup> The Agencies selected this index because it is a widely used and broad indicator of increases in the wages of private industry workers, which includes bank employees.

A bank employee may receive a referral fee under the networking exception and Proposed Exchange Act Rule 700 for each referral made to a broker-dealer, including separate referrals of the same individual or entity. Referral fees paid under the networking exception must be paid in cash and fixed. The networking exception and the proposed rules do not permit a bank to pay referral fees in non-cash forms, such as vacation packages, stock grants, annual leave, or consumer goods.<sup>30</sup> We request comments on whether these alternatives provide banks sufficient flexibility to pay nominal referral fees without creating inappropriate incentives.

2. Proposed Definition of “Contingent on Whether the Referral Results in a Transaction”

Under the statutory networking exception, a nominal fee paid to an unregistered bank employee for referring a customer to a broker or dealer may not be contingent on whether the referral results in a transaction. The objective is to reward bank employees for furthering the relationship with the broker without creating concerns about the

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<sup>28</sup> Proposed Exchange Act Rule 700(c)(3).

<sup>29</sup> Each adjustment would be rounded to the nearest multiple of \$1. Proposed Exchange Act Rule 700(f).

<sup>30</sup> See Exchange Act Section 3(a)(4)(B)(i)(VI), permitting payment of a “nominal one-time cash fee.”

securities sales practices of unregistered bank employees. Under the proposal, a fee would be considered “contingent on whether the referral results in a transaction” if payment of the fee is dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker or dealer; whether the referral results in a transaction involving a particular type of security; or whether the referral results in multiple securities transactions.<sup>31</sup> The proposed rules, however, also recognize that a referral fee may be contingent on whether a customer (1) contacts or keeps an appointment with a broker or dealer as a result of the referral; or (2) meets any objective, base-line qualification criteria established by the bank or broker or dealer for customer referrals, including such criteria as minimum assets, net worth, income, or marginal federal or state income tax rate, or any requirement for citizenship or residency that the broker or dealer, or the bank, may have established generally for referrals for securities brokerage accounts.<sup>32</sup>

### 3. Proposed Definition of “Incentive Compensation”

As noted above, the networking exception prohibits unregistered employees of a bank that refer customers to a broker or dealer under the exception from receiving “incentive compensation” for the referral or any securities transaction conducted by the customer at the broker-dealer other than a nominal, non-contingent referral fee. To provide banks and their employees additional guidance in this area, Proposed Rule 700(b) defines “incentive compensation” as compensation that is intended to encourage a bank

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<sup>31</sup> Proposed Exchange Act Rule 700(a). “Referral” would be defined to mean the action taken by a bank employee to direct a customer of the bank to a broker or dealer for the purchase or sale of securities for the customer’s account. Proposed Exchange Act Rule 700(e).

<sup>32</sup> Proposed Exchange Act Rule 700(a).

employee to refer potential customers to a broker or dealer or give a bank employee an interest in the success of a securities transaction at a broker or dealer.<sup>33</sup>

The proposed “incentive compensation” definition excludes certain types of bonus compensation. The purpose of the exclusions is to recognize that certain types of bonuses are not likely to give unregistered employees a promotional interest in the brokerage services offered by the broker-dealers with which the bank networks and to avoid affecting bonus plans of banks generally. The proposal excludes compensation paid by a bank under a bonus or similar plan that is paid on a discretionary basis and based on multiple factors or variables. These factors or variables must include significant factors or variables that are not related to securities transactions at the broker or dealer.<sup>34</sup> In addition, a referral made by the employee to a broker or dealer may not be a factor or variable in determining the employee’s compensation under the plan and the employee’s compensation under the plan may not be determined by reference to referrals made by any other person.<sup>35</sup>

In addition, the proposed rule provides that the definition of incentive compensation shall not be construed to prevent a bank from compensating an officer, director or employee on the basis of any measure of the overall profitability of (1) the

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<sup>33</sup> Proposed Exchange Act Rule 700(b).

<sup>34</sup> Proposed Exchange Act Rule 700(b)(1)(ii)(A). A non-securities factor or variable would be considered “significant” under this proposed provision if it plays a non-trivial role in determining an employee’s compensation under the bonus or similar plan. Moreover, a bank would not be in compliance with this proposed provision to the extent that it established or maintained a “sham” non-securities factor or variable in its bonus or similar plan for the purpose of evading this proposed restriction.

<sup>35</sup> Proposed Exchange Act Rule 700(b)(1)(ii)(C) and (D). The requirement that an employee’s compensation not be based on “a referral” made by the employee or another person also means that the employee’s compensation under the bonus or similar plan may not vary based on the number of securities referrals made by the employee or another person to a broker or dealer.

bank, either on a stand-alone or consolidated basis; (2) any of the bank's affiliates (other than a broker or dealer) or operating units; or (3) a broker or dealer if such profitability is only one of multiple factors or variables used to determine the compensation of the officer, director, or employee and those factors or variables include significant factors or variables that are not related to the profitability of the broker or dealer.<sup>36</sup> Under this definition, banks would be permitted to take account of the full range of business for high net worth or institutional customers that an employee has brought to the bank and its partner broker-dealers. Comment is solicited on whether existing bank bonus programs would fit, or could be easily adjusted to fit, within the proposed exclusions from the definition of incentive compensation discussed in this Section.

**B. Proposed Exemption for Payment of More than a Nominal Fee for Referring Institutional Customers and High Net Worth Customers**

The proposal also includes a conditional exemption that would permit a bank to pay an employee a contingent referral fee of more than a nominal amount for referring to a broker or dealer an institutional customer or high net worth customer with which the bank has a contractual or other written networking arrangement.<sup>37</sup> Banks that pay their employees only nominal, non-contingent fees in accordance with Proposed Rule 700 for referring customers—including institutional or high net worth customers—to a broker or dealer would not need to rely on this exemption for these purposes.

The purpose of the proposed exemption and its conditions is to recognize that sizable institutions and high net worth individuals, when provided appropriate information, are more likely to be able to understand and evaluate the relationship

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<sup>36</sup> Proposed Exchange Act Rule 700(b)(2).

<sup>37</sup> Proposed Exchange Act Rule 701.

between the bank and its employees and its broker-dealer partner and any resulting securities transaction with the broker-dealer. To take advantage of the proposed exemption, the bank must comply with the conditions in the proposed exemption as well as the terms and conditions in the statutory networking exception (other than the compensation restrictions in Section 3(a)(4)(B)(i)(VI) of the Exchange Act's networking exception). The conditions in the proposed exemption are designed, among other things, to help ensure that institutional and high net worth customers receive appropriate investor protections and have the information to understand the financial interest of the bank employee so they can make informed choices. The following summarizes the conditions included in the proposed exemption.

1. Definitions of "Institutional Customer" and "High Net Worth Customer"

The proposed exemption defines an "institutional customer" to mean any corporation, partnership, limited liability company, trust, or other non-natural person that has at least \$10 million in investments or \$40 million in assets. A non-natural person also may qualify as an "institutional customer" with respect to a referral if the customer has \$25 million in assets and the bank employee refers the customer to the broker or dealer for investment banking services.<sup>38</sup> The lower asset threshold for referrals for

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<sup>38</sup> Proposed Exchange Act Rule 701(d)(2). "Investment banking services" are defined to include, without limitation; acting as an underwriter in an offering for an issuer, acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction, providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments, serving as placement agent for an issuer, and engaging in similar activities. Id. at 701(d)(3). When used in this proposal, the term "include, without limitation" means a non-exhaustive list. This usage is not intended to suggest that the term "including" as used in the Exchange Act and the rules under that Act means an exhaustive list. The use of the term "including, but not limited to" in Exchange Act Rules 10b-10 and 15b7-1 is also not intended to create a negative implication regarding the use of "including" without the term "but not limited to" in other Exchange Act rules. See Exchange Act Release No. 49879, 69 FR 39682 (June 30, 2004), at footnote 76.

investment banking services is designed to permit banks to facilitate access to capital markets by referring smaller businesses to broker-dealers. “High net worth customer” is defined to mean any natural person who, either individually or jointly with his or her spouse, has at least \$5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse.

The dollar amount threshold for both institutional customers and high net worth customers would be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect changes in the value of the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce, from December 21, 2006. The Agencies selected this index because it is a widely used and broad indicator of inflation in the U.S. economy.

A bank would be required to determine that a non-natural person referred to a broker or dealer under the exemption is an institutional customer before the referral fee is paid to the bank employee. In the case of a customer that is a natural person, the bank, prior to or at the time of any referral, would be required either to (1) determine that the customer is a high net worth customer; or (2) obtain a signed acknowledgment from the customer that the customer meets the standards to be considered a high net worth customer. The purpose of this condition is to provide the bank with a reasonable basis to believe the person meets the requirements of the exemption.<sup>39</sup>

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<sup>39</sup> Proposed Exchange Act Rule 701(a)(2)(ii). As discussed below (*see infra* at II.B.4.), the written agreement between the bank and the broker or dealer also must require the broker or dealer to determine whether a customer meets these qualification standards before the referral fee is paid to the bank employee.



## 2. Conditions Relating to Bank Employees

For a bank employee to receive a contingent or greater-than-nominal referral fee under the proposed exemption, the bank employee must meet other conditions designed to help ensure that the referral occurs in the ordinary course of the unregistered bank employee's activities and that the employee has not previously been disqualified under the Exchange Act. In particular, the bank employee--

- May not be qualified or otherwise required to be qualified pursuant to the rules of a self-regulatory organization ("SRO");<sup>40</sup>
- Must be predominantly engaged in banking activities other than making referrals to a broker-dealer;<sup>41</sup>
- Must not be subject to a "statutory disqualification" as that term is defined in Section 3(a)(39) of the Exchange Act (other than subparagraph (E) of that Section);<sup>42</sup> and
- Must encounter the "high net worth customer" or "institutional customer" in the ordinary course of the bank employee's assigned duties for the bank.<sup>43</sup>

## 3. Other Conditions Relating to the Banks

The proposed exemption also would require that the bank provide the high net worth customer or institutional customer being referred to the bank's broker-dealer partner certain written disclosures about the employee's interest in the referral prior to or

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<sup>40</sup> Proposed Exchange Act Rule 701(a)(1)(i)(A).

<sup>41</sup> Proposed Exchange Act Rule 701(a)(1)(i)(B).

<sup>42</sup> Proposed Exchange Act Rule 701(a)(1)(i)(C).

<sup>43</sup> Proposed Exchange Act Rule 701(a)(1)(ii).

at the time of the referral.<sup>44</sup> These disclosures would have to clearly and conspicuously disclose (1) the name of the broker or dealer; and (2) that the bank employee participates in an incentive compensation program under which the employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and that payment of the fee may be contingent on whether the referral results in a transaction with the broker or dealer.<sup>45</sup>

In addition, to allow verification before the referral fee is paid to the bank employee, the bank would be required to provide the broker or dealer the name of the employee and such other identifying information that may be necessary for the broker or dealer to determine whether the bank employee is associated with a broker or dealer or is subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act, other than subparagraph (E)).<sup>46</sup>

The proposed exemption also provides that a bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of the proposed exemption would not be considered a “broker” under Section 3(a)(4) of the Exchange Act solely because the bank fails, in a particular instance, to determine that a customer is an institutional or high net worth customer, provide the customer the required disclosures, or provide the broker or dealer the required information concerning the bank employee receiving the referral fee within the time periods prescribed. If the bank is seeking to comply and takes reasonable and prompt steps to remedy the error, such as by

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<sup>44</sup> Proposed Exchange Act Rule 701(a)(2)(i).

<sup>45</sup> Proposed Exchange Act Rule 701(b).

<sup>46</sup> Proposed Exchange Act Rule 701(a)(2)(iii).

promptly making the required determination or promptly providing the broker or dealer the required information, the bank should not lose the exemption from registration in these circumstances. Similarly, to promote compliance with the terms of the exemption, the bank must make reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for a referral that does not, following any required remedial actions, meet the requirements of the exemption and that exceeds the amount the bank otherwise would be permitted to pay under the statutory networking exception and proposed Exchange Act Rule 700.<sup>47</sup>

#### 4. Provisions of Written Agreement

The proposed exemption also would require that the bank and its broker-dealer partner include certain provisions in their written agreement that obligate the bank or the broker or dealer to take certain actions. These provisions are designed to help ensure that banks and broker-dealers operate within the terms of the exemption and provide appropriate protections to customers referred under the exemption. Banks, brokers and dealers are expected to comply with the terms of their written networking agreements. If a broker or dealer or bank does not comply with the terms of the agreement, however, the bank would not become a “broker” under Section 3(a)(4) of the Exchange Act or lose its ability to operate under the proposed exemption.<sup>48</sup> A bank should not be required to register as a result of the actions of the broker or dealer.

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<sup>47</sup> Proposed Exchange Act Rule 701(a)(2)(iv).

<sup>48</sup> The Commission anticipates that it will be necessary for either NASD or the Commission to adopt a rule requiring broker-dealers to comply with the written agreements discussed in this Section.

a. Customer and Employee Qualifications

First, the proposed exemption provides that the written agreement between the bank and the broker or dealer must provide for the bank and the broker-dealer to determine, before a referral fee is paid to a bank employee under the exemption, that the employee is not subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act (other than subparagraph (E) of that Section). In addition, as noted above, the written agreement must provide for the broker-dealer to determine, before the referral fee is paid, that the customer being referred is an institutional or high net worth customer.<sup>49</sup>

b. Suitability or Sophistication Analysis by Broker-Dealer

As a method of providing additional investor protections, the proposed exemption requires that the written agreement between the bank and broker or dealer must provide for the broker or dealer to perform a suitability or sophistication analysis of a securities transaction or the customer being referred, respectively. The type and timing of the analysis needed to be conducted by the broker or dealer depends on whether the referral fee is contingent on the completion of a securities transaction at the broker or dealer.

For contingent fees, the written agreement between the bank and the broker-dealer must provide for the broker or dealer to conduct a suitability analysis of any securities transaction that triggers any portion of the contingency fee in accordance with the rules of the broker's or dealer's applicable SRO as if the broker or dealer had recommended the

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<sup>49</sup> Proposed Exchange Act Rule 701(a)(3)(i).

securities transaction.<sup>50</sup> This analysis must be performed by the broker or dealer before each securities transaction on which the referral fee is contingent is conducted.

For a non-contingent referral fee, the written agreement must provide for the broker or dealer to conduct, before the referral fee is paid, either (1) a “sophistication” analysis of the customer being referred; or (2) a suitability analysis with respect to all securities transactions requested by the customer contemporaneously with the referral. Under the “sophistication” analysis option, the broker or dealer would be required to determine that the customer has the capability to evaluate investment risk and make independent decisions, and determine that the customer is exercising independent judgment based on the customer’s own independent assessment of the opportunities and risks presented by a potential investment, market factors, and other investment considerations.<sup>51</sup> This “sophistication” analysis is based on elements of NASD IM-2310-3 (Suitability Obligations to Institutional Customers).

Alternatively, the broker or dealer could perform a suitability analysis of all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the broker’s or dealer’s applicable SRO as if the broker or dealer had recommended the securities transaction.<sup>52</sup> Thus, the proposed exemption gives a broker or dealer the flexibility to perform a suitability analysis in connection with

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<sup>50</sup> Proposed Exchange Act Rule 701(a)(3)(ii)(A). Because the proposed exemption provides for a broker or dealer to conduct its suitability analysis in accordance with the rules of its applicable SRO, the broker or dealer may follow and take advantage of any applicable SRO rules or interpretations that allow the broker or dealer to make an alternative suitability evaluation. See, e.g., NASD IM-2310-3 (discussing a member’s suitability obligations with respect to certain institutional investors).

<sup>51</sup> Proposed Exchange Act Rule 701(a)(3)(ii)(B)(1).

<sup>52</sup> Proposed Exchange Act Rule 701(a)(3)(ii)(B)(2).

all referrals made under the exemption (regardless of whether the referral fee is contingent or not) if the broker or dealer determines that such an approach is appropriate for business reasons.

c. Notice from Broker-Dealer to Bank Regarding Customer Qualification

Under the proposed exemption, the written agreement between the bank and the broker-dealer would also be required to provide that the broker-dealer must promptly inform the bank if the broker-dealer determines that (1) the customer referred to the broker-dealer is not a “high net worth customer” or an “institutional customer,” as applicable; (2) the bank employee receiving the referral fee is subject to statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, except subparagraph (E) of that Section; or (3) the customer or the securities transaction(s) to be conducted by the customer do not meet the applicable standard set forth in the suitability or sophistication determination Section above.<sup>53</sup> The notice will help banks monitor their compliance with the exemption and take remedial action when necessary.

5. Referral Fees Permitted under the Exemption

If the foregoing conditions are met, the proposed exemption would allow a bank employee to receive a referral fee for referring an institutional or high net worth customer to a broker or dealer that is greater than a “nominal” amount and that is contingent on whether the referral results in a transaction at the broker or dealer. The exemption places certain limits on how such a referral fee may be structured to reduce the potential “salesman’s stake” of the bank employee in securities transactions conducted at the broker-dealer. Specifically, the exemption provides that the referral fee may be a dollar

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<sup>53</sup> Proposed Exchange Act Rule 701(a)(3)(iii).

amount based on a fixed percentage of the revenues received by the broker or dealer for investment banking services provided to the customer.<sup>54</sup>

Alternatively, the referral fee may be a predetermined dollar amount, or a dollar amount determined in accordance with a predetermined formula, so long as the amount does not vary based on (1) the revenue generated by, or the profitability of, securities transactions conducted by the customer with the broker or dealer; (2) the quantity, price, or identity of securities purchased or sold over time by the customer with the broker or dealer; or (3) the number of customer referrals made.<sup>55</sup> For these purposes, “predetermined” means established or fixed before the referral is made.

As the exemption provides, these restrictions do not prevent a referral fee from being paid in multiple installments or from being based on a fixed percentage of the total dollar amount of assets placed in an account with the broker or dealer. Additionally, these restrictions do not prevent a referral fee from being based on the total dollar amount of assets maintained by the customer with the broker or dealer, or from being contingent on whether the customer opens an account with the broker or dealer or executes one or more transactions in the account during the initial phases of the account. A bank employee also may receive a permissible referral fee for each referral made under the exemption. We request comment on all aspects of the definition of a referral fee.

#### 6. Permissible Bonus Compensation Not Restricted

The proposed exemption for high net worth and institutional customers expressly provides that nothing in the exemption would prevent or prohibit a bank from paying, or

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<sup>54</sup> Proposed Exchange Act Rule 701(d)(4)(ii).

<sup>55</sup> Proposed Exchange Act Rule 701(d)(4)(i).

a bank employee from receiving, any type of compensation under a bonus or similar plan that would not be considered incentive compensation under paragraph (b)(1), or that is described in paragraph (b)(2), of proposed Exchange Act Rule 700 (implementing the networking exception).<sup>56</sup> As explained above, these types of bonus arrangements do not tend to create the kind of financial incentives for bank employees that the statute was designed to address.

### C. Scope of Networking Exception and Institutional/High Net Worth Exemption

Nothing in the statutory networking exception or the proposed rules limits or restricts the ability of a bank employee to refer customers to other departments or divisions of the bank itself, including, for example, the bank's trust, fiduciary or custodial department. Likewise, the networking exception and the proposed rules do not apply to referrals of retail, institutional or high net worth customers to a broker or dealer or other third party solely for transactions not involving securities, such as loans, futures contracts (other than a security future), foreign currency, or over-the-counter commodities.

## **III. Trust and Fiduciary Activities Exception**

Section 3(a)(4)(B)(ii) of the Exchange Act (the "trust and fiduciary exception") permits a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without being registered as a broker.<sup>57</sup> Under this exception from the definition of "broker," a bank must effect such transactions in its trust department, or other department that is regularly examined by bank examiners for compliance with

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<sup>56</sup> Proposed Exchange Act Rule 701(c).

<sup>57</sup> 15 U.S.C. 78c(a)(4)(B)(ii).



fiduciary principles and standards.<sup>58</sup> The bank also must be “chiefly compensated” for such transactions, consistent with fiduciary principles and standards, on the basis of: (1) an administration or annual fee; (2) a percentage of assets under management; (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions; or (4) any combination of such fees.<sup>59</sup> These fees are referred to as “relationship compensation” in the proposed rules.

Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities in conjunction with advertising their other trust activities.<sup>60</sup> In addition, a bank that effects a transaction in the United States of a publicly traded security under the exception must execute the transaction in accordance with Exchange Act Section 3(a)(4)(C).<sup>61</sup>

This Section requires that the bank direct the trade to a registered broker-dealer for execution, effect the trade through a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary that is not in contravention of fiduciary principles established under applicable federal or state law, or effect the trade in some other manner that the Commission permits.<sup>62</sup> The purpose of the

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<sup>58</sup> Id. The Agencies will rely on the appropriate Federal banking agency for a bank to determine whether the bank’s activities are conducted in the bank’s trust department or other department regularly examined by the agency’s examiners for compliance with fiduciary principles and standards.

<sup>59</sup> 15 U.S.C. 78c(a)(4)(B)(ii)(I).

<sup>60</sup> 15 U.S.C. 78c(a)(4)(B)(ii)(II).

<sup>61</sup> 15 U.S.C. 78c(a)(4)(C).

<sup>62</sup> 15 U.S.C. 78c(a)(4)(C)(i) - (iii). As discussed below (see infra at VI.C.), the Agencies are proposing to adopt a rule that would permit banks to effect trades in investment company securities through the National Securities Clearing Corporation’s Mutual Fund Services (“Fund/SERV”) or directly with the investment company’s transfer agent. Trades effected by a

rules in this area is to explain the Agencies' interpretation of certain terms and concepts used in the statute and to implement the exception. The trust and fiduciary exception recognizes the traditional securities role banks have performed for trust and fiduciary customers and includes conditions to help ensure that a bank does not operate a securities broker in the trust department.

A. "Chiefly Compensated" Test and Bank-Wide Exemption Based on Two-Year Rolling Averages

The proposed rules provide that a bank meets the "chiefly compensated" condition in the trust and fiduciary exception if the "relationship-total compensation percentage" for each trust or fiduciary account of the bank is greater than 50 percent.<sup>63</sup> The "relationship-total compensation percentage" for a trust or fiduciary account would be calculated by (1) dividing the relationship compensation attributable to the account during each of the immediately preceding two years by the total compensation attributable to the account during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.<sup>64</sup> Under the proposal, a "trust or fiduciary account" means an account for which the bank acts in a trustee or fiduciary capacity as defined in Section 3(a)(4)(D) of the Exchange Act.<sup>65</sup>

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bank in accordance with the proposed Fund/SERV rule would be conducted in accordance with Section 3(a)(4)(C) of the Exchange Act.

<sup>63</sup> Proposed Exchange Act Rule 721(a)(1).

<sup>64</sup> The rule provides for this process to be accomplished by calculating the "yearly compensation percentage" and the "relationship-total compensation percentage" for the account. Proposed Exchange Act Rule 721(a)(2) and (3).

<sup>65</sup> Proposed Exchange Act Rule 721(a)(5). The definition of "fiduciary capacity" included in Section 3(a)(4)(D) of the Exchange Act is based on the definition of that term in part 9 of the OCC's regulations, which relates to the trust and fiduciary activities of national banks, in effect at the time of enactment of the GLB Act.

The proposed rules also include an exemption that would permit a bank to follow an alternate test to the account-by-account approach to the “chiefly compensated” condition. Under this exemption, the bank may calculate the compensation it receives from all of its trust and fiduciary accounts on a bank-wide basis. The alternative is designed to simplify compliance, alleviate concerns about inadvertent noncompliance, and reduce the costs and disruptions banks likely would incur under the account-by-account approach.

To use this bank-wide methodology, the bank would have to meet two conditions. First, the bank would have to comply with the conditions in the trust and fiduciary exception (other than the compensation test in Section 3(a)(4)(B)(ii)(I)) and comply with Section 3(a)(4)(C) (relating to trade execution) of the Exchange Act.<sup>66</sup> In addition, the “aggregate relationship-total compensation percentage” for the bank’s trust and fiduciary business as a whole would have to be at least 70 percent.<sup>67</sup> We chose this percentage to ensure that a bank’s trust department is not unduly dependent on non-relationship compensation from securities transactions. We invite comments generally on the appropriateness of the proposed exemption as well as this percentage and the other specific terms of the exemption.

The “aggregate relationship-total compensation percentage” of a bank operating under the bank-wide approach would be calculated in a similar manner as the “relationship-total compensation percentage” of an account under the account-by-account, except that the calculations would be based on the aggregate relationship

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<sup>66</sup> Proposed Exchange Act Rule 722(a)(1).

<sup>67</sup> Proposed Exchange Act Rule 722(a)(2).

compensation and total compensation received by the bank from all of its trust and fiduciary accounts during each of the two immediately preceding years. That is, it would be determined by (1) dividing the relationship compensation attributable to the bank's trust and fiduciary business as a whole during each of the immediately preceding two years by the total compensation attributable to the bank's trust and fiduciary business as a whole during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.<sup>68</sup>

Under either the account-by-account or bank-wide approach, a bank would have the flexibility to elect to use a calendar year or the bank's fiscal year for purposes of complying with these compensation provisions.<sup>69</sup> In addition, whether a bank decides to use the account-by-account approach or the bank-wide approach, the bank's compliance with the relevant compensation restriction would be based on a two-year rolling average of the compensation attributable to the trust or fiduciary account or the bank's trust or fiduciary business, respectively. This is to allow for short-term fluctuations that otherwise could lead a bank to fall out of compliance with the exception or exemption from year to year.

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<sup>68</sup> As a technical matter, the rule provides for this process to be accomplished by calculating the "yearly bank-wide compensation percentage" and the "aggregate relationship-total compensation percentage" for the bank's trust and fiduciary business as a whole. Proposed Exchange Act Rule 722(b) and (c).

<sup>69</sup> Proposed Exchange Act Rule 721(a)(6).

## B. Proposed Definition of “Relationship Compensation”

Both the account-by-account and bank-wide approaches discussed above are based in part on the relationship compensation attributable to one or more of a bank’s trust or fiduciary accounts. The proposal defines the term “relationship compensation” to mean any compensation a bank receives that consists of (1) an administration fee; (2) an annual fee (payable on a monthly, quarterly or other basis); (3) a fee based on a percentage of assets under management; (4) a flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or (5) any combination of these fees.<sup>70</sup> These types of compensation are identified in the statute.

The proposed rules also provide examples of fees that would be considered an administration fee or a fee based on a percentage of assets under management for these purposes. Specifically, the rule provides that a fee based on a percentage of assets under management (an “AUM fee”) includes, without limitation—

- A fee paid by an investment company pursuant to a plan under 17 CFR 270.12b-1. Although Rule 12b-1 fees are related to mutual funds, we believe they should be viewed as relationship compensation because they are paid on an assets under management basis, rather than on a transactional basis;<sup>71</sup>

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<sup>70</sup> Proposed Exchange Act Rule 721(a)(4).

<sup>71</sup> Proposed Exchange Act Rule 721(a)(4)(iii)(A).

- A fee paid by an investment company for personal service or the maintenance of shareholder accounts;<sup>72</sup> and
- A fee paid by an investment company based on a percentage of assets under management for any of the following services: (1) providing transfer agent or sub-transfer agent services for the beneficial owners of investment company shares; (2) aggregating and processing purchase and redemption orders for investment company shares; (3) providing the beneficial owners with account statements showing their purchases, sales, and positions in the investment company; (4) processing dividend payments to the account for the investment company; (5) providing sub-accounting services to the investment company for shares held beneficially in the account; (6) forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or (7) receiving, tabulating, and transmitting proxies executed by the beneficial owners of investment company shares in the account.<sup>73</sup>

In addition, the rule provides that the term “administration fee” includes, without limitation—

- A fee paid for personal services, tax preparation, or real estate settlement services; and

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<sup>72</sup> Proposed Exchange Act Rule 721(a)(4)(iii)(B).

<sup>73</sup> Proposed Exchange Act Rule 721(a)(4)(iii)(C).

- A fee paid by an investment company for personal service, the maintenance of shareholder accounts or the types of sub-transfer agent or other services described above.<sup>74</sup>

The examples of an administration fee and an asset under management fee included in the proposed rules are provided only for illustrative purposes. Other types of fees or fees for other types of services could be an administration fee or an AUM fee. In addition, an administration fee, annual fee or AUM fee attributable to a trust or fiduciary account is considered relationship compensation regardless of what entity or person pays the fee, and regardless of whether the fee is related to only securities assets, to a combination of securities and non-securities assets, or to only non-securities assets. These fees are part of the compensation for acting as a trustee or fiduciary.—

Under the proposal, relationship compensation also would include a flat or capped per order processing fee, paid by (or on behalf of) a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts.<sup>75</sup> If a bank seeks to include within this per order processing fee any fixed or variable processing costs incurred by the bank beyond those charged by the executing broker or dealer, the bank should maintain appropriate policies and procedures governing the allocation of these costs to the orders processed for

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<sup>74</sup> Proposed Exchange Act Rule 721(a)(4)(i). To the extent these fees are paid by an investment company based on a percentage of assets under management, these fees would be a permissible AUM fee.

<sup>75</sup> Proposed Exchange Act Rule 721(a)(4)(iv).

trust or fiduciary customers.<sup>76</sup> This should help ensure that profits derived from per trade charges are not masked as costs of processing the trades.

### C. Advertising Restrictions

Section 3(a)(4)(B)(ii)(II) of the Exchange Act addresses advertisements and the proposed rules explain the Agencies' understanding of the terms used in the statute. The proposed rules provide that a bank complies with the advertising 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 provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.<sup>77</sup>

An "advertisement" for these purposes means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, blast e-mail, or telephone directories (other than routine listings).<sup>78</sup> Other types of material or information that is not distributed

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<sup>76</sup> A bank effecting transactions for trust or fiduciary customers through its trust or fiduciary departments may use other divisions or departments of the bank, or other affiliated or unaffiliated third parties, to handle aspects of these transactions. The bank must continue to act in a trustee or fiduciary capacity with respect to the account and, accordingly, should exercise appropriate diligence in selecting persons to provide services to the bank's trust or fiduciary customers and in overseeing the services provided in accordance with the bank's fiduciary obligations. No party, other than the bank (including, without limitation, a transfer agent or investment adviser), working in conjunction with the bank may rely on the bank's exception or exemption from "broker" status. To the extent that any such third party performs activities that would make that entity a broker under Section 3(a)(4) of the Exchange Act that entity would be required to register as a broker (in the absence of an applicable exemption or regulatory relief) notwithstanding any written or unwritten agreement the third party may have with the bank.

<sup>77</sup> Proposed Exchange Act Rule 721(b).

<sup>78</sup> Proposed Exchange Act Rule 721(b)(2) (referencing Proposed Exchange Act Rule 760(g)(2)).



through public media would not be considered an advertisement. In addition, in considering whether an advertisement advertises the securities brokerage services provided to trust or fiduciary customers more prominently than the bank's other trust or fiduciary services, the nature, context and prominence of the information presented—and not simply the length of text or information devoted to a particular subject—should be considered.

D. Proposed Exemptions for Special Accounts, Transferred Accounts, and a De Minimis Number of Accounts

The proposed rules also would permit a bank to exclude certain types of accounts for purposes of determining its compliance with the account-by-account or bank-wide compensation tests discussed above. These exclusions are intended to reduce administrative burdens and facilitate compliance in connection with accounts that do not present a pronounced risk that a bank is operating a securities broker within the trust department. We solicit comment on these exclusions and their specific proposed terms.

Under the proposal, a bank could, in determining its compliance with either the account-by-account or bank-wide compensation tests, exclude any trust or fiduciary account that had been open for a period of less than 3 months during the relevant year.<sup>79</sup> The proposal would also permit a bank to exclude, for purposes of determining its compliance with either of these compensation tests, any trust or fiduciary account that the bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar transaction by the bank for 12 months after the date the bank acquired the account from the other person.<sup>80</sup> Of course, in excluding such accounts, the

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<sup>79</sup> Proposed Exchange Act Rule 723(a).

<sup>80</sup> Proposed Exchange Act Rule 723(b).

bank would have to exclude all compensation it receives from such accounts from the relationship compensation to total compensation comparison. This approach would allow a bank to bring into compliance a group of acquired accounts.

Two additional exemptions would be provided for banks using the account-by-account approach. Specifically, a bank that uses the account-by-account approach would not be considered a broker for purposes of Section 3(a)(4) of the Exchange Act solely because a particular trust or fiduciary account does not meet the “chiefly compensated” test if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a registered broker-dealer or another unaffiliated entity (such as an unaffiliated bank) that is not required to be registered as a broker or dealer.<sup>81</sup>

Moreover, a bank using the account-by-account approach could exclude a small number of trust or fiduciary accounts not exceeding the lesser of (1) 1 percent of the total number of trust or fiduciary accounts held by the bank provided that if the number so obtained is less than 1, the amount would be rounded up to 1; or (2) 500.<sup>82</sup> To rely on this exemption with respect to an account, the bank must not have relied on this exemption for such account during the immediately preceding year.<sup>83</sup> In addition, the bank would be required to maintain records demonstrating that the securities transactions

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<sup>81</sup> Proposed Exchange Act Rule 723(c).

<sup>82</sup> Proposed Exchange Act Rule 723(d).

<sup>83</sup> Proposed Exchange Act Rule 723(d)(3).

conducted by or on behalf of the excluded account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.<sup>84</sup>

#### **IV. Sweep Accounts and Transactions in Money Market Funds**

Exchange Act Section 3(a)(4)(B)(v) excepts a bank from the definition of “broker” to the extent it “effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund.”<sup>85</sup>

##### **A. Proposed Sweep Account Definitions**

To provide banks with guidance on the sweep accounts exception, the proposal defines various terms under the exception. One key term is “no-load.” Under the proposal, no-load, in the context of an investment company or the securities it issues, means that the securities are part of a class or series in which a bank effects transactions that is not subject to a sales charge or a deferred sales charge. In addition, total charges against net assets of that class or series of securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts may not exceed 0.0025 of average net assets annually.<sup>86</sup>

Consistent with NASD rules,<sup>87</sup> under the proposed no-load definition, charges for the following would not be considered charges against net assets of a class or series of an

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<sup>84</sup> Proposed Exchange Act Rule 723(d)(1).

<sup>85</sup> See Exchange Act Section 3(a)(4)(B)(v).

<sup>86</sup> Proposed Exchange Act Rule 740(c).

<sup>87</sup> See NASD Rule 2830.

investment company's securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts:

- (1) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;
- (2) Aggregating and processing purchase and redemption orders for investment company shares;
- (3) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;
- (4) Processing dividend payments for the investment company;
- (5) Providing sub-accounting services to the investment company for shares held beneficially;
- (6) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or
- (7) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.<sup>88</sup>

B. Proposed Exemption Regarding Money Market Fund Transactions

The proposal also includes a new exemption that would permit banks, without registering as a broker, to effect transactions on behalf of a customer in securities issued by a money market fund under certain conditions.<sup>89</sup> This proposed exemption recognizes that banks have long offered sweeps and other services that invest customer funds in

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<sup>88</sup> Proposed Exchange Act Rule 740(c)(2).

<sup>89</sup> Proposed Exchange Act Rule 741.

money market funds that do not qualify as no-load funds under Commission and NASD rules. In particular, to qualify for the proposed exemption from broker registration, the bank would be required to provide the customer, directly or indirectly, any other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under Section 15(a) of the Exchange Act.<sup>90</sup> In addition, the class or series of money market fund securities that the bank provides the customer either would have to be no-load, or, if it is not no-load, the bank could not characterize or refer to the class or series of securities as no-load. For securities that are not no-load, the bank would be required to provide the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities.<sup>91</sup>

## **V. Safekeeping and Custody**

### **A. Overview of Statutory Exception**

Section 3(a)(4)(B)(viii) of the Exchange Act provides banks with an exception from the “broker” definition for certain bank custody and safekeeping activities (“custody and safekeeping exception”). In particular, this provision allows a bank to perform the following activities if performed as part of its customary banking activities without registering as a “broker”:

- Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;

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<sup>90</sup> Proposed Exchange Act Rule 741(a)(1).

<sup>91</sup> Proposed Exchange Act Rule 741(a)(2)(ii)(A).

- Facilitating the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities;
- Effecting securities lending or borrowing transactions with or on behalf of customers as part of the above-described custodial services or investing cash collateral pledged in connection with such transactions;
- Holding securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; and
- Serving as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.<sup>92</sup>

#### B. Proposed Exemption

The proposed rules contain an exemption that allows banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as a custodian.<sup>93</sup> In addition, the exemption allows banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of

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<sup>92</sup> 15 U.S.C. 78c(a)(4)(B)(viii).

<sup>93</sup> Proposed Exchange Act Rule 760(a).

custodial accounts.<sup>94</sup> These proposed exemptions are intended to allow a bank to perform the types of securities order-taking activities at times conducted in a custody department subject to conditions and limitations to protect investors and prevent a bank from using the exemptions to operate a securities broker in the bank.

The Agencies seek comment on all aspects of the proposed exemptions, including the conditions they contain. The proposed rules do not contain other rules to implement the custody and safekeeping exception. The Agencies request comment on whether other rules in this area are appropriate or needed.

A bank would have no need to rely on the custody exemption to the extent the bank conducts other custodial activities permitted by Section 3(a)(4)(B)(viii) (e.g., exercising warrants or other rights with respect to securities or effecting securities lending or borrowing transactions on behalf of custodial customers) or another of the proposed rules (e.g., proposed Exchange Act Rule 772, which permits banks to effect securities lending or borrowing transactions on behalf of certain non-custodial customers). In addition, a bank would not have to rely on the proposed exemption to the extent the bank holds securities in custody for a customer and provides clearance and settlement services to the account in connection with such securities, but the bank does not accept orders for securities transactions for the account or engage in other activities with respect to the account that would require the bank to be registered as a broker. The following discusses the scope and terms of the proposed custody exemption.

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<sup>94</sup> Proposed Exchange Act Rule 760(b).

1. Employee Benefit Plan Accounts and Individual Retirement or Similar Accounts

Under the proposed exemption, a bank would not be considered a broker for purposes of Section 3(a)(4) of the Exchange Act to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities in an “employee benefit plan account”<sup>95</sup> or an “individual retirement account or similar account”<sup>96</sup> for which the bank acts as a custodian if the bank complies with the following.

a. Employee Compensation Restriction

The proposed custody exemption provides that, if a bank accepts securities orders for an employee benefit plan or individual retirement or similar account under the exemption, then no bank employee may receive compensation (including a fee paid pursuant to a 12b-1 plan) from the bank, the executing broker or dealer, or any other person that is based on (1) whether a securities transaction is executed for the account; or

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<sup>95</sup> “Employee benefit plan account” would mean a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan, including, without limitation, an employer-sponsored plan qualified under Section 401(a) of the Internal Revenue Code (26 U.S.C. 401(a)), a governmental or other plan described in Section 457 of the Internal Revenue Code (26 U.S.C. 457), a tax-deferred plan described in Section 403(b) of the Internal Revenue Code (26 U.S.C. 403(b)), a church plan, governmental, multiemployer or other plan described in Section 414(d), (e) or (f) of the Internal Revenue Code (26 U.S.C. 414(d), (e) or (f)), an incentive stock option plan described in Section 422 of the Internal Revenue Code (26 U.S.C. 422); a Voluntary Employee Beneficiary Association Plan described in Section 501(c)(9) of the Internal Revenue Code (26 U.S.C. 501(c)(9)), a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan, and a supplemental unemployment benefit plan.

<sup>96</sup> “Individual retirement account or similar account” would mean an individual retirement account as defined in Section 408 of the Internal Revenue Code (26 U.S.C. 408), Roth IRA as defined in Section 408A of the Internal Revenue Code (26 U.S.C. 408A), health savings account as defined in Section 223(d) of the Internal Revenue Code (26 U.S.C. 223(d)), Archer medical savings accounts as defined in Section 220(d) of the Internal Revenue Code (26 U.S.C. 220(d)), Coverdell education savings account as defined in Section 530 of the Internal Revenue Code (26 U.S.C. 530), or other similar account.



(2) the quantity, price, or identity of the securities purchased or sold by the account.<sup>97</sup>

These proposed restrictions, which we believe are consistent with banking practices, are intended to reduce the financial incentives a bank employee might have to encourage a customer to submit securities orders to the bank and use a custody account as the functional equivalent of a securities brokerage account. They do not prohibit a bank employee from receiving compensation that is based on whether a customer establishes a custodial account with the bank, or that is based on the total amount of assets in a custodial account at account opening or at any other time.

The proposed custody exemption also expressly provides that these employee compensation restrictions do not prevent a bank employee from receiving payments under a bonus or similar plan that would be permissible under proposed Exchange Act Rule 700(b)(1) of the networking rules as if a referral had been made, or any profitability-based compensation described in proposed Exchange Act Rule 700(b)(2) of the networking rules. In addition, because these restrictions relate to securities transactions conducted in the relevant custody account, they would not prevent a bank employee from receiving a referral fee for referring the customer to a broker or dealer to engage in securities transactions at the broker-dealer that are unrelated to the custody account in accordance with the networking exception or the institutional customer and high net worth customer exemption (proposed Exchange Act Rule 701) for networking arrangements.

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<sup>97</sup> Proposed Exchange Act Rule 760(c).

b. Advertisements and Sales Literature

The proposed custody exemption provides that a bank relying on the exemption may not advertise that it accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts or similar accounts for which the bank acts as custodian, except as part of advertising the other custodial or safekeeping services the bank provides to these accounts. In addition, the bank may not advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account.<sup>98</sup> With respect only to individual retirement or similar accounts, advertisements and sales literature issued by or on behalf of the bank may not describe the securities order-taking services provided by the bank to these accounts more prominently than the other aspects of the custody or safekeeping services the bank provides.<sup>99</sup> The purpose of these restrictions is similar to the purpose of the advertising rules in the trust and fiduciary exception.

c. Other Conditions

The proposed custody exemption provides that a bank may accept orders for a securities transaction for an employee benefit plan account or an individual retirement account or similar account only if (1) the bank does not act in a trustee or fiduciary

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<sup>98</sup> Proposed Exchange Act Rule 760(a)(2)(i) and (ii). As discussed above, the proposed rules define the term "advertisement" to mean material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings). Proposed Exchange Act Rule 760(g)(2).

<sup>99</sup> Proposed Exchange Act Rule 760(a)(3). "Sales literature" would mean any written or electronic communication, other than an advertisement, that is generally distributed or made generally available to customers of the bank or the public, including circulars, form letters, brochures, telemarketing scripts, seminar texts, published articles, and press releases concerning the bank's products or services. Proposed Exchange Act Rule 760(g)(5).

capacity (as defined in Section 3(a)(4)(D) of the Exchange Act) with respect to that account; (2) the bank complies with Section 3(a)(4)(C) of the Exchange Act in handling any order for a securities transaction for the account;<sup>100</sup> and (3) the bank complies with Section 3(a)(4)(B)(viii)(II) of the Exchange Act relating to carrying broker activities.<sup>101</sup>

d. Non-Fiduciary and Non-Custodial Administrators or Recordkeepers

The proposed exemption also would allow a bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan to accept securities orders for the plan if the bank and the custodian bank comply with all the conditions discussed in Sections V.B.1.a, b and c above and, in addition, the administrator/recordkeeper bank does not execute a cross-trade with or for the employee benefit plan or net orders for securities for the plan, other than orders for shares of open-end investment companies not traded on an exchange.<sup>102</sup> Executing cross-trades involves setting prices for securities transactions. The Agencies request comment on whether these conditions are consistent with the existing practices of banks acting as non-fiduciary and non-custodial administrators or recordkeepers.

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<sup>100</sup> 15 U.S.C. 78c(a)(4)(C). This provision provides that, to meet one of the exceptions from the “broker” definition under the Exchange Act one of three conditions with respect to transactions effected under the applicable Section must be satisfied. In particular, the bank must direct such trade to a registered broker-dealer for execution. In the alternative, the trade must be a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary and is not in contravention of fiduciary principles established under applicable Federal or State law. Alternatively, the trade must be conducted in some other manner permitted under rules, regulations, or orders as the Commission may prescribe or issue.

<sup>101</sup> 15 U.S.C. 78c(a)(4)(B)(viii)(II). This provision prohibits a custodian bank from acting as a carrying broker (as such term, and different formulations thereof, are used in Exchange Act Section 15(c)(3) and the rules and regulations under that Section) for any broker or dealer, unless such carrying broker activities are engaged in with respect to government securities.

<sup>102</sup> Proposed Exchange Act Rule 760(e).

## 2. Accommodation Transactions

Besides accepting securities orders for employee benefit plan and individual retirement and similar custodial accounts, banks also accept securities orders for other custodial accounts as an accommodation to the customer. The proposed custody exemption allows banks to continue to provide these order-taking services to other custodial accounts, subject to certain conditions designed to help ensure that these services continue to be provided only as an accommodation to customers and that a bank does not operate a securities broker out of its custody department. These conditions are discussed below.

### a. Accommodation Basis

The proposed custody exemption expressly provides that a bank may accept securities orders for other custodial accounts only as an accommodation to the customer.<sup>103</sup> The Banking Agencies will develop guidance to assist Banking Agency examiners in reviewing, as part of the agencies' ongoing supervisory and examination process, the order-taking services provided to other custodial accounts. This guidance will describe the types of policies, procedures and systems that a bank should have in place to help ensure that the bank accepts securities orders for other custodial accounts only as an accommodation to the customer and in a manner consistent with both the terms and purposes of the custody exemption and the GLB Act.

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<sup>103</sup> Proposed Exchange Rule Act 760(b)(1).

b. Employee Compensation Restriction

In order for a bank to rely on the custody exemption to accept orders for custodial accounts on an accommodation basis, the bank must comply with the employee compensation restrictions described above in Section B.1.a that apply with respect to employee benefit plans and individual retirement and similar accounts.<sup>104</sup>

c. Bank Fees

The proposed exemption also expressly limits the types of fees a bank that accepts accommodation orders for an account may charge for effecting securities transactions for the account. Specifically, any fee charged or received by the bank for effecting a securities transaction for the account may not vary based on (1) whether the bank accepted the order for the transaction; or (2) the quantity or price of the securities to be bought or sold.<sup>105</sup> These restrictions do not prevent a bank from charging or receiving a fee that is based on the type of security purchased or sold by the account (e.g., a foreign security), provided the fee complies with the conditions set forth in the proposed exemption.

d. Advertising and Sales Literature Restrictions

Under the proposed exemption, the bank's advertisements may not state that the bank accepts orders for securities transactions for a custodial account (other than an employee benefit plan or individual retirement account or similar account). In addition, the bank's sales literature (1) may state that the bank accepts securities orders for such an account only as part of describing the other custodial or safekeeping services the bank

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<sup>104</sup> Proposed Exchange Act Rule 760(b)(2) and (c).

<sup>105</sup> Proposed Exchange Act Rule 760(b)(3).

provides to the account; and (2) may not describe the securities order-taking services provided to such an account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account.<sup>106</sup>

e. Investment Advice or Recommendations

Under the proposed exemption, a bank that accepts securities orders for a custodial account on an accommodation basis would not be permitted to provide investment advice or research concerning securities to the account, make recommendations concerning securities to the account, or otherwise solicit securities transactions from the account. These restrictions would not, however, prohibit the bank from advertising its custodial services and disseminating sales literature that comply with the restrictions in the proposed exemption. These restrictions also would not prevent a bank employee from responding to customer inquiries regarding the bank's safekeeping and custody services by providing advertisements or sales literature describing the safekeeping, custody and related services the bank offers (provided those advertisement and sales literature comply with the restrictions in the proposed exemption), a prospectus prepared by a registered investment company, sales literature prepared by a registered investment company or by the broker or dealer that is the principal underwriter of the registered investment company pertaining to the registered investment company's products, or information based on any of those materials. Moreover, the proposed exemption allows a bank's employees to respond to customer inquiries concerning the bank's safekeeping, custodial or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does

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<sup>106</sup> Proposed Exchange Act Rule 760(b)(4) and (5).

not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.

The limitations and restrictions discussed in this part V.B.2, including those relating to investment advice and recommendations, relate only to those custodial accounts for which the bank accepts securities orders on an accommodation basis. Thus, for example, these limitations would not apply to (1) an employee benefit plan account or an individual retirement account or similar account; or (2) a trust or fiduciary account maintained by a customer with a bank even if that customer also maintains a custodial account with the bank. Similarly, the custody exemption does not prohibit a bank from cross-marketing the other products or services of the bank, including trust or fiduciary services, to its custodial customers.

f. Other Conditions

In addition to these conditions, a bank that accepts securities orders as an accommodation to a custodial account must comply with the conditions described in Section V.B.1.c. Thus, the bank may not rely on this proposed exemption to accept accommodation orders for a custodial account if the bank is acting in a trustee or fiduciary capacity (as defined in Section 3(a)(4)(D) of the Exchange Act) with respect to that account. In addition, the bank must comply with Section 3(a)(4)(C) of the Exchange Act in handling any order for a securities transaction for the account and with Section 3(a)(4)(B)(viii)(II) concerning carrying broker activities.<sup>107</sup> The reason for these additional conditions is to reinstate the statutory requirements for executing transactions and for the bank to refrain from acting as a carrying broker. In addition, a condition is

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<sup>107</sup> Proposed Exchange Act Rule 760(d).

added that makes it clear that a bank may not use this exemption to avoid the conditions applicable to a trust or fiduciary account when it is acting in a trustee or fiduciary capacity with respect to that account.

### 3. Evasion

As the proposed rules provide, to prevent evasions of the custody exemption, the Agencies will consider both the form and substance of the relevant account(s), transaction(s) and activities (including advertising activities) in considering whether a bank meets the terms of the exemption.<sup>108</sup> As part of the regular examination process, the Banking Agencies will monitor the securities transactions in custodial accounts. If the appropriate Banking Agency were to find that a bank is evading the terms of the custody exemption to run a brokerage business out of its custody department, the agency would take appropriate action to address the problem.

## **VI. Other Proposed Exemptions**

The proposal also includes certain other exemptions relating to the securities “broker” activities of banks. These are discussed below.

### A. Proposed Exemption for Regulation S Transactions with Non-U.S. Persons

Persons that conduct a broker or dealer business while located in the United States must register as broker-dealers (absent an exception or exemption), even if they direct all of their selling efforts offshore.<sup>109</sup> A bank industry group requested an exemption from broker-dealer registration requirements to permit banks to sell to non-U.S. persons securities that are covered by Regulation S, the safe harbor from U.S. securities

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<sup>108</sup> Proposed Exchange Act Rule 760(e).



registration requirements.<sup>110</sup> The group also requested that the exemption extend to the resale of Regulation S securities held by non-U.S. persons to other non-U.S. persons in transactions pursuant to Regulation S.

Non-U.S. persons typically will not rely on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks.<sup>111</sup> Non-U.S. persons usually can purchase the same securities from banks located outside of the United States and would not have the protections of U.S. law when purchasing these securities offshore. The proposal therefore would exempt a bank from the definition of “broker” under Section 3(a)(4) of the Exchange Act, to the extent that, as agent, the bank effects one of three types of transactions. In particular, the proposed exemption would apply if the bank effects a sale in compliance with the requirements of 17 CFR 230.903 of an “eligible security” to a “purchaser” who is outside of the United States within the meaning of 17 CFR 230.903.

The proposed exemption would also be available if the bank effects a resale of an “eligible security” after its initial sale with a reasonable belief that the “eligible security”

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<sup>109</sup> Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013.

<sup>110</sup> Letter dated May 27, 2004, from Lawrence R. Uhlick, Executive Director & General Counsel, Institute of International Bankers to Catherine McGuire, Chief Counsel, Division of Market Regulation, Commission. Regulation S specifies the requirements for an offer or sale of securities to be deemed to occur outside the United States and therefore not subject to the registration requirements of Section 5 of the Securities Act. Regulation S permits the sale of newly issued off-shore securities and re-sales of off-shore securities from a non-U.S. person to a non-U.S. person. 17 CFR 230.901, et seq. The letter also requests a separate exemption from Section 3(b)(5) of the Exchange Act for riskless principal transactions, which are treated as a “dealer” (and not a “broker”) activity under the Exchange Act. The Commission will solicit comments on that proposed rule in a separate contemporaneous release.

<sup>111</sup> Although no rules have been adopted, the exemption provided by Exchange Act Section 30(b), pertaining to foreign securities, has been held unavailable if the United States is used as a base for securities fraud perpetuated on foreigners. See Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976); see also Exchange Act Release No. 27017 supra note 110.

was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a person who is not a U.S. person under 17 CFR 230.902(k) to a “purchaser” who is outside the United States within the meaning of 17 CFR 230.903 or a registered broker-dealer. Under this provision of the proposal, if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale would have to be made in compliance with the requirements of 17 CFR 230.904.

Moreover, the proposed Regulation S exemption would apply if the bank effects a resale of an “eligible security” after its initial sale outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903, by or on behalf of a registered broker-dealer to a “purchaser” who is outside the United States within the meaning of 17 CFR 230.903. Under this proposed provision, if the sale is made prior to the expiration of the distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the sale would have to be made in compliance with the requirements of 17 CFR 230.904.<sup>112</sup> We invite comment on whether U.S. broker-dealer registration should be required for these transactions.

#### B. Proposed Securities Lending Exemption

Another exemption in the proposal addresses certain securities lending activities conducted as agent. Under the proposal, a bank would be exempt from the definition of

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<sup>112</sup> Under the proposal, “eligible security” would mean a security that: (1) is not being sold from the inventory of the bank or an affiliate of the bank; and (2) is not being underwritten by the bank or an affiliate of the bank on a firm-commitment basis, unless the bank acquired the security from an unaffiliated “distributor” that did not purchase the security from the bank or an affiliate of the bank. “Distributor” under the proposal would have the same meaning as in 17 CFR 230.902(d). “Purchaser” under the proposal would mean a person who purchases an “eligible security” and who is not a U.S. person under 17 CFR 230.902(k).

“broker” under Section 3(a)(4) of the Exchange Act, to the extent that, as an agent, it engages in or effects “securities lending transactions” and any “securities lending services” in connection with such transactions, with or on behalf of a person the bank reasonably believes to be (1) a qualified investor as defined in Section 3(a)(54)(A) of the Exchange Act;<sup>113</sup> or (2) any employee benefit plan that owns and invests on a discretionary basis, not less than \$25,000,000 in investments.<sup>114</sup> We understand that the primary role of banks in securities lending transactions, whether operating with or without custody of the securities, is to act in an agency capacity. A non-custodial securities lending arrangement permits a customer to divide custody and securities lending management between two expert entities.

The proposed exemption would reinstate, without modification, an exemption from the definition of “broker” under Section 3(a)(4) of the Exchange Act that the Commission adopted in the release implementing the GLBA bank exceptions from the definition of “dealer.” This exemption, would become void under the Regulatory Relief Act once the Agencies adopt a single set of final “broker” rules.<sup>115</sup> This exemption

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<sup>113</sup> 15 U.S.C. 78c(a)(54)(A).

<sup>114</sup> Proposed Exchange Act Rule 772. Under the proposal, “securities lending transaction” would mean a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties. Under the proposal, “securities lending services” would mean: (1) selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower; (2) receiving, delivering, or directing the receipt or delivery of loaned securities; (3) receiving, delivering, or directing the receipt or delivery of collateral; (4) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (5) investing, or directing the investment of, cash collateral; or (6) indemnifying the lender of securities with respect to various matters.

<sup>115</sup> See 17 CFR 240.15a-11. See also Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004). A bank that acts as custodian with respect to securities may effect

allows banks to engage in securities lending transactions as agent when they either do not have custody of the securities or have custody for less than the entire period of the stock loan. The exemption would permit banks to continue these activities without disruption. As discussed in an accompanying release, the Commission proposes to re-adopt, without modification, the “dealer” portions of Exchange Act Rule 15a-11 that relate to, among other things, conduit lending transactions.<sup>116</sup>

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

The proposal also includes an exemption for the way in which banks may effect transactions in investment company securities. Under the proposal, a bank that meets the conditions for an exception or exemption from the definition of “broker” except for the condition in Section 3(a)(4)(C)(i) of the Exchange Act,<sup>117</sup> which requires banks, under certain circumstances, to direct securities transactions to a registered broker-dealer for execution, is exempt from such condition to the extent that the bank effects transactions in securities issued by an open-end company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system if certain conditions are met. In particular, the proposed exemption would allow a bank to effect such transactions through the National Securities Clearing Corporation’s Mutual Fund Services (Fund/SERV) or directly with a transfer agent acting

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securities lending transactions (and provide related securities lending services) with respect to such securities as agent under the statutory custody and safekeeping exception.

<sup>116</sup> The Commission does not propose to modify or re-adopt the other portions of the “dealer” rules adopted for banks under the GLBA, including the exemption that permits banks to engage in riskless principal transactions subject to certain conditions. See 17 CFR 240.3a5-1.

<sup>117</sup> 15 U.S.C. 78c(a)(4)(C)(i).

for the open-end company. Under the proposed exemption, the securities would have to be distributed by a registered broker-dealer, or, in the alternative, the sales charge for the transaction would have to be no more than the amount a registered broker-dealer could charge pursuant to the rules of a registered securities association adopted pursuant to Section 22(b)(1) of the Investment Company Act.<sup>118</sup>

D. Proposed Temporary and Permanent Exemption for Contracts Entered Into by Banks from Being Considered Void or Voidable

Other proposed exemptions would address inadvertent failures by banks that could trigger rescission of contracts between a bank and a customer under Section 29(b) of the Exchange Act for a transition period.<sup>119</sup> Under the first proposed exemption, no contract entered into before 18 months after the effective date of the proposed exemption would be void or considered voidable by reason of Section 29 of the Exchange Act because any bank that is a party to the contract violated the registration requirements of Section 15(a) of the Exchange Act, any other applicable provision of that Act, or the rules and regulations adopted under the Exchange Act based solely on the bank's status as a broker when the contract was created.<sup>120</sup>

Under the second proposed exemption, no contract entered into would be void or considered voidable by reason of Section 29(b) of the Exchange Act without a time limit. This exemption would provide relief to a bank that violated the registration requirements

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<sup>118</sup> 15 U.S.C. 80a-22(b)(1). Under the proposal “interdealer quotation system” would have the same meaning as in 17 CFR 240.15c2-11. “Open-end company” would have the same meaning as in 17 CFR 247.740.

<sup>119</sup> 15 U.S.C. 78cc(b). Exchange Act Section 29(b) provides, in pertinent part, that every contract made in violation of the Exchange Act or of any rule or regulation adopted under the Exchange Act (with certain exceptions) shall be void.

<sup>120</sup> Proposed Exchange Act Rule 780.

of Section 15(a) of the Exchange Act or the rules and regulations adopted thereunder based solely on the bank's status as a broker when a contract was created if two conditions are met (1) at the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with Section 3(a)(4)(B) of the Exchange Act, and the rules and regulations, thereunder; and (2) any violation of the registration requirements by the bank did not result in any significant harm, financial loss or cost to the person seeking to void the contract. This exemption is provided because a bank that is acting in good faith and has reasonable policies and procedures in effect at the time a securities contract is created should not be subject to rescission claims as a result of an inadvertent failure to comply with the requirements under Section 3(c)(4) of the Exchange Act if customers are not significantly harmed.

E. Extension of Time and Transition Period

The proposal also would extend the time that banks would have to come into compliance with the Exchange Act provisions relating to the definition of "broker." Under the proposed exemption, a bank would be exempt from the definition of "broker" under Section 3(a)(4) of Exchange Act until the first day of its first fiscal year commencing after June 30, 2008.

**VII. Withdrawal of Proposed Regulation B and Removal of Exchange Act Rules 3a4-2 – 3a4-6, and 3b-17**

Under the Regulatory Relief Act, a final single set of rules or regulations jointly adopted by the Board and Commission in accordance with that Act shall supersede any other proposed or final rule issued by the Commission on or after the date of enactment of Section 201 of the GLBA with regard to the definition of "broker" under Exchange

Act Section 3(a)(4).<sup>121</sup> Moreover, the new law states that “[n]o such other rule, whether or not issued in final form, shall have any force or effect on or after that date of enactment.”

In 2001, the Commission adopted Interim Rules discussing the way in which the Commission would interpret the GLBA.<sup>122</sup> The rules that address the definition of “broker” under Section 3(a)(4) of the Exchange Act (and applicable exemptions) are Exchange Act Rules 3a4-2 through 3a4-6 and Rule 3b-17.<sup>123</sup> In 2004, the Commission proposed to revise and restructure the “broker” provisions of the Interim Rules and codify them in a new regulation, proposed Regulation B, which consists of proposed new Exchange Act Rules 710 through 781.<sup>124</sup> By operation of the Regulatory Relief Act, the joint adoption of new final rules will supersede Exchange Act Rules 3a4-2 through 3a4-6, 3b-17, and proposed Rules 710 through 781. Any discussion or interpretation of these prior rules in their accompanying releases would not apply to the single set of rules adopted by the Agencies.

## **VIII. Administrative Law Matters**

### **A. Paperwork Reduction Act Analysis**

Certain provisions of proposed Exchange Act Rules 701, 723, and 741, contain “collection of information” requirements within the meaning of the Paperwork Reduction

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<sup>121</sup> President Clinton signed the GLBA into law on November 12, 1999.

<sup>122</sup> Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001).

<sup>123</sup> 17 CFR 240.3a4-2 through 3a4-6 and 17 CFR 240.3b-17.

<sup>124</sup> 17 CFR 242.710 through 781. See Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004).

Act of 1995.<sup>125</sup> The Commission has submitted these information collections to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Board has reviewed the proposed rules under authority delegated by OMB.<sup>126</sup>

The collections of information under proposed Exchange Act Rules 701, 723, and 741 are new. The title for the new collection of information under proposed Exchange Act Rule 701 is “Rule 701: Exemption from the definition of ‘broker’ for certain institutional referrals.” The title for the new collection of information under proposed Exchange Act Rule 723 is “Rule 723: Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.” The title for the new collection of information under proposed Exchange Act Rule 741 is “Rule 741: Exemption for banks effecting transactions in money market funds.” OMB has not yet assigned a control number to the new collections of information contained in proposed Exchange Act Rules 701, 723, and 741. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.<sup>127</sup>

1. Proposed Exchange Act Rule 701

Proposed Exchange Act Rule 701 would provide a conditional exemption from the requirements under the networking exception under the Exchange Act. This proposed exemption would permit bank employees to receive payment of more than a nominal fee

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<sup>125</sup> 44 U.S.C. 3501, et seq.

<sup>126</sup> 5 CFR 1320.16; Appendix A.1.

<sup>127</sup> 44 U.S.C. 3512.



for referring institutional customers and high net worth customers to a broker or dealer and would permit such payments to be contingent on whether the customer effects a securities transaction with the broker or dealer.

a. Collection of Information

Proposed Exchange Act Rules 701(a)(2)(i) and (b) would require banks that wish to utilize the exemption provided in this proposed rule to make certain disclosures to high net worth or institutional customers. Specifically, these banks would need to clearly and conspicuously disclose (1) the name of the broker or dealer; and (2) that the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and payment of this fee may be contingent on whether the referral results in a transaction with the broker or dealer.<sup>128</sup>

In addition, one of the conditions of the exemption is that the broker or dealer and the bank need to have a contractual or other written arrangement containing certain elements, including notification and information requirements.<sup>129</sup> Proposed Exchange Act Rule 701(a)(3)(iii) requires a broker or dealer to notify its bank partner if the broker or dealer determines that (1) the customer referred under the exemption is not a high net worth or institutional customer, as applicable; (2) the bank employee making the referral is subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act);<sup>130</sup> or (3) the customer or the securities transaction(s) to be conducted by the

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<sup>128</sup> See proposed Exchange Act Rules 701(a)(2)(i) and (b).

<sup>129</sup> See proposed Exchange Act Rule 701(a) and (a)(3).

<sup>130</sup> This proposed requirement would not apply to subparagraph (E) of Section 3(a)(39) of the Exchange Act ((15 U.S.C. 78c(a)(39)).

customer do not meet the applicable suitability or sophistication determination standards set forth in the rule.<sup>131</sup> Similarly, the bank would be required to provide its broker or dealer partner with the name of the bank employee receiving the referral fee and certain other identifying information.<sup>132</sup>

b. Proposed Use of Information

The purpose of the collection of information in proposed Exchange Act Rule 701(a)(2)(i) and (b) is to provide a customer of a bank relying on the exemption with information to assist the customer in identifying and assessing any conflict of interest on the part of the bank employee making a referral to a broker or dealer. The collection of information in proposed Exchange Act Rule 701(a)(2)(iii) and (a)(3)(iii) is designed to help a bank determine whether it is acting in compliance with the proposed exemption.

c. Respondents

The proposed collection of information in proposed Exchange Act Rule 701 would apply to banks that wish to utilize the exemption provided in this proposed rule and broker-dealers with which those banks enter into networking arrangements.

d. Reporting and Recordkeeping Burden

The Agencies estimate that approximately 1,000 banks annually would use the exemption in proposed Exchange Act Rule 701 and each bank would on average make the required referral fee disclosures to 200 customers annually and provide one notice annually to its broker or dealer partner regarding the name of a bank employee and other identifying information. The Agencies also estimate that broker-dealers would, on

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<sup>131</sup> See proposed Exchange Act Rule 701(a)(3)(iii).

<sup>132</sup> See proposed Exchange Act Rule 701(a)(2)(iii).

average, notify each of the 1,000 banks approximately two times annually about a determination regarding a customer's high net worth or institutional status or suitability or sophistication standing as well as a bank employee's statutory disqualification status.

Based on these estimates, the Agencies anticipate that proposed Exchange Act Rule 701 would result in approximately 200,000 disclosures to customers, 1,000 notices to brokers or dealers, and 2,000 notices to banks per year. The Agencies further estimate (based on the level of difficulty and complexity of the applicable activities) that a bank would spend approximately 5 minutes per customer to comply with the disclosure requirement and 15 minutes per notice to a broker or dealer. The Agencies also estimate that a broker or dealer would spend approximately 15 minutes per notice to a bank. Thus, the estimated total annual reporting and recordkeeping burden for these requirements in proposed Exchange Act Rule 701 are 16,917 hours for banks and 500 hours for brokers or dealers. We solicit comment on this point as well as on the validity of all of our estimates and statements in this Section.

e. Collection of Information Is Mandatory

This collection of information would be mandatory for banks relying on proposed Exchange Act Rule 701 and their broker-dealer partners.

f. Confidentiality

A bank relying on the exemption provided in proposed Exchange Act Rule 701 would be required to provide certain referral fee disclosures to its customers as required by this proposed rule. Banks relying on the exemption provided in proposed Exchange Act Rule 701 would be also be required to enter into agreements with a broker or dealer obligating the broker or dealer to notify the bank upon becoming aware of certain

information with respect to the customer, the bank employee, or the nature of the securities transaction. Similarly, a bank would be required to notify a broker or dealer about the name of the bank employee receiving a referral fee and certain other identifying information.

g. Record Retention Period

Proposed Exchange Act Rule 701 would not include a specific record retention requirement. Banks, however, would be required to retain the records in compliance with any existing or future recordkeeping requirements established by the Banking Agencies.

2. Proposed Exchange Act Rule 723

a. Collection of Information

Proposed Exchange Act Rule 723(d)(1) would require a bank that desires to exclude a trust or fiduciary account in determining its compliance with the chiefly compensated test, pursuant to a de minimis exclusion,<sup>133</sup> to maintain records demonstrating that the securities transactions conducted by or on behalf of the account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.<sup>134</sup>

b. Proposed Use of Information

The collection of information in proposed Exchange Act Rule 723 is designed to help ensure that a bank relying on the de minimis exclusion would be able to demonstrate

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<sup>133</sup> See proposed Exchange Act Rule 723(d)(2), which would require that the total number of accounts excluded by the bank, under the exclusion from the chiefly compensated test in proposed Rule 721(a)(1), do not exceed the lesser of 1 percent of the total number of trust or fiduciary accounts held by the bank (if the number so obtained is less than 1, the amount would be rounded up to 1) or 500.

<sup>134</sup> See proposed Exchange Act Rule 723(d)(1).

that it was acting in a trust or fiduciary capacity with respect to an account excluded from the chiefly compensated test in proposed Rule 721(a)(1).

c. Respondents

The proposed collection of information in Exchange Act Rule 723 would apply to banks relying on the de minimis exclusion from the chiefly compensated test.

d. Reporting and Recordkeeping Burden

Because the Agencies expect a small number of banks would use the account-by-account approach in monitoring their compensation, the Agencies estimate that approximately 50 banks annually would use the de minimis exclusion in proposed Exchange Act Rule 723 and each such bank would, on average, need to maintain records with respect to 10 trust or fiduciary accounts annually conducted in the exercise of the banks' trust or fiduciary responsibilities. Therefore, the Agencies estimate that proposed Exchange Act Rule 723 would result in approximately 500 accounts annually for which records are required to be maintained. The Agencies anticipate that these records would consist of records that are generally created as part of the securities transaction and the account relationship and minimal additional time would be required in maintaining these records. Based on this analysis, the Agencies estimate that a bank would spend approximately 15 minutes per account to comply with the record maintenance requirement of proposed Exchange Act Rule 723. Thus, the estimated total annual reporting and recordkeeping burden for proposed Exchange Act Rule 723 is 125 hours. We solicit comment on this point as well as on the validity of all of our estimates and statements in this Section.

e. Collection of Information Is Mandatory

This collection of information would be mandatory for banks desiring to rely on de minimis exclusion contained in proposed Exchange Act Rule 723.

f. Confidentiality

Proposed Exchange Act Rule 723 does not address or restrict the confidentiality of the documentation prepared by banks under the rule. Accordingly, banks would have to make the information available to regulatory authorities or other persons to the extent otherwise provided by law.

g. Record Retention Period

Proposed Exchange Act Rule 723 would include a requirement to maintain records related to certain securities transactions. Banks would be required to retain these records in compliance with any existing or future recordkeeping requirements established by the Banking Agencies.

3. Proposed Exchange Act Rule 741

a. Collection of Information

Proposed Exchange Act Rule 741(a)(2)(ii)(A) would require a bank relying on this proposed exemption (i.e., the exemption from the definition of the term “broker” under Section 3(a)(4) of the Exchange Act for effecting transactions on behalf of a customer in securities issued by a money market fund) to provide customers with a prospectus of the money market fund securities, not later than the time the customer authorizes the bank to effect the transaction in such securities, if they are not no-load.

b. Proposed Use of Information

The purpose of the collection of information in proposed Exchange Act Rule 741 is to help ensure that a customer of a bank relying on the exemption would have sufficient information upon which to make an informed investment decision, in particular, regarding the fees the customer would pay with respect to the securities.

c. Respondents

The proposed collection of information in Exchange Act Rule 741 would apply to banks relying on the exemption provided in the proposed rule.

d. Reporting and Recordkeeping Burden

The Agencies believe that banks generally sweep or invest their customer funds into no-load money market funds. Accordingly, the Agencies estimate that approximately 500 banks annually would use the exemption in proposed Exchange Act Rule 741 and each bank, on average, would deliver the prospectus required by the proposed rule to approximately 1,000 customers annually. Therefore, the Agencies estimate that proposed Exchange Act Rule 741 would result in approximately 500,000 disclosures per year. The Agencies estimate further that a bank would spend approximately 5 minutes per response to comply with the delivery requirement of proposed Exchange Act Rule 741. Thus, the estimated total annual reporting and recordkeeping burden for proposed Exchange Act Rule 741 is 41,667 hours. We solicit comment on this point as well as on the validity of all of our estimates and statements in this Section.

e. Collection of Information Is Mandatory

This collection of information would be mandatory for banks relying on the proposed exemption.

f. Confidentiality

The collection of information delivered pursuant to proposed Exchange Act Rule 741 would be provided by banks relying on the exemption in this rule to customers that are engaging in transactions in securities issued by a money market fund that is not a no-load fund.

g. Record Retention Period

Proposed Exchange Act Rule 741 would not include a record retention requirement.

4. Request For Comment

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

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

(2) Evaluate the accuracy of the Agencies' estimates of the burden of the proposed collections of information and provide the Agencies with data on proposed Exchange Act Rules 701, 723, and 741;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collections of information on those required to respond, including through the use of automated collection techniques or other forms of information technology.



In addition to the general solicitation of comments above regarding the collections of information contained in the proposed rules, the Agencies also solicit comments regarding how many banks would rely on the exemptions provided in proposed Exchange Act Rules 701, 723, and 741, and whether banks relying on such exemptions would be able to use existing systems, programs, and procedures to comply with the collections of information requirements contained in the proposed rules.

Persons desiring to submit comments on the collection of information requirements should direct them in the manner discussed below. The Agencies propose that the information collections and burden estimates discussed above will be associated with the Board for banks and with the Commission for brokers or dealers.

Commission. Comments should be directed to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy of their comments to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, and refer to File [No. S7-\_\_\_\_-06]. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release in the Federal Register. Therefore, comments to OMB are best assured of having full effect if OMB receives them within 30 days of this publication. Requests for materials submitted to OMB by the Agencies with regard to this collection of information should be in writing, refer to File No. [S7-\_\_\_\_-06], and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549.

Board. You may submit comments, identified by the Docket number, by any of the following methods:

- Agency Web site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments on the <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- FAX: 202-452-3819 or 202-452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW, Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP-500 of the Board's Martin Building (20th and C Streets, NW) between 9 a.m. and 5 p.m. on weekdays.

B. Consideration of Benefits and Costs

1. Introduction

Prior to enactment of the GLBA, banks were exempted from the definition of “broker” in Section 3(a)(4) of the Exchange Act. Therefore, notwithstanding the fact that

banks may have conducted activities that would have brought them within the scope of the broker definition, they were not required by the Exchange Act to register as such. The GLBA replaced banks' historic exemption from the definition of "broker" with eleven exceptions.<sup>135</sup>

While banks' efforts to comply with the GLBA and the exemptions we propose would result in certain costs, the Agencies have sought to minimize these burdens to the extent possible consistent with the language and purposes of the GLBA. For example, the Agencies are proposing exemptions and interpretations which should provide banks with increased options and flexibility and help to reduce overall costs.

## 2. Discussion of Proposed Interpretations and Exemptions

The potential benefits and costs of the principal exemptions and interpretations in the proposal are discussed below.

### a. Networking Exception

Exchange Act Section 3(a)(4)(B)(i) excepts banks from the definition of "broker" if they enter into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers. This networking exception is subject to several conditions. The Section also prohibits banks from paying unregistered bank employees--such as tellers, loan officers, and private bankers--"incentive compensation" for any brokerage transaction, except that bank

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<sup>135</sup> See Exchange Act Section 3(a)(4)(B)(i) – (xi).

employees may receive a “nominal” referral fee for referring bank customers to their broker-dealer networking partners.<sup>136</sup>

Under the proposal, a “nominal” referral fee would be defined as a fee that does not exceed any of the following standards (1) twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee or 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee; (2) twice the employee’s actual base hourly wage; or (3) twenty-five dollars (\$25), as adjusted for inflation pursuant to proposed Exchange Act Rule 700(f).

The Agencies believe these alternatives should provide banks appropriate flexibility while being consistent with the statute. For example, some banks, and particularly small banks, may find it most useful to establish a flat fee or inflation-adjusted fee for securities referrals as this method is easy to understand and requires no complicated calculations. In addition, permitting banks to pay referral fees based on either an employee's base hourly rate of pay or the average rate of pay for a job family would give banks objective and easily calculable approaches to paying their employees referrals while remaining consistent with the requirements of the GLBA that such fees be “nominal” in relation to the overall compensation of the referring employees. While some start-up costs may be incurred by banks in the process of developing a fee structure in line with the requirements of the GLBA, the ability to choose among alternative

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<sup>136</sup> Exchange Act Section 3(a)(4)(B)(i)(VI) limits such referral fees to a “nominal one-time cash fee of a fixed dollar amount” and requires that the payment of the fees not be contingent on whether the referral results in a transaction.

methods (as reflected in proposed rules) should enable banks to minimize their overall costs based on their individual referral programs and cost structures.

In light of the statutory provision allowing banks to pay a “nominal one-time cash fee,” the proposal requires that all referral fees paid under the exception be paid in cash. The Agencies request comment on whether existing bank securities referral programs would be able to operate, or could easily be adjusted to operate, in accordance with the terms of proposed Exchange Act Rule 700.

The proposed rules also include a conditional exemption that would permit a bank to pay an employee a contingent referral fee of more than a nominal amount for referring an institutional customer or high net worth customer to a broker or dealer with which the bank has a contractual or other written networking arrangement.

This exemption would provide a benefit to banks by expanding the types of referrals fees that banks could utilize with respect to institutional customers and high net worth customers. However, there likely would be costs associated with complying with the conditions in the proposed exemption (such as the requirement for banks to make certain disclosures to high net worth or institutional customers and the requirement for broker-dealers to make certain determinations and provide certain notifications to banks)<sup>137</sup> as well as the other terms and conditions in the statutory networking exception. However, these costs would be either a result of the statutory requirements or costs voluntarily incurred by banks because they want to take advantage of the proposed exemption.

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<sup>137</sup> Proposed Exchange Act Rules 701(a)(2)(i), 701(a)(3)(iii), and 701(b).

Proposed Exchange Act Rule 700 also contains a definition of “incentive compensation” and excludes from this definition compensation paid by a bank under a bonus or similar plan that meets certain criteria. The bonus or similar program must be paid on a discretionary basis and based on multiple factors or variables. These factors or variables must include significant factors or variables that would not be related to securities transactions at the broker or dealer. Moreover, a referral made by the employee could not be a factor or variable in determining the employee’s compensation under the plan and the employee’s compensation under the plan could not be determined by reference to referrals made by any other person.

We request comments generally on the costs and benefits associated with the proposed provisions regarding the networking exception and the related exemption. We also invite banks to provide information, including data, to assist us in further evaluating the costs and benefits associated with the proposed provisions. We invite banks to include estimates of their start-up costs for updating their systems, and their annual ongoing costs for complying with the proposed changes discussed above. We invite commenters to provide us with data to assist in further evaluating these proposed rules. For example, we request comment on whether the proposed provisions relating to bonus and similar plans would be consistent with current compensation and bonus arrangements and any costs or burdens that would be incurred to bring existing plans into compliance with the provisions. We also request comment on any other costs banks would likely need to incur as a result of the proposal, and ask that commenters provide us with data to support their views.

b. Trust and Fiduciary Activities Exception

Exchange Act Section 3(a)(4)(B)(ii) permits a bank, under certain conditions, to effect transactions in a trustee or fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for fiduciary principles and standards without registering as a broker. To qualify for the trust and fiduciary activities exception, Exchange Act Section 3(a)(4)(B)(ii) requires that the bank be “chiefly compensated” for such transactions on the basis of the types of fees specified in the GLBA and comply with certain advertising restrictions set forth in the statute.

The Agencies believe that the proposed rules dealing with the trust and fiduciary activities exception should provide a number of benefits to banks and their customers without imposing significant costs on either group.<sup>138</sup> The proposed provisions regarding the “chiefly compensated” condition and related exemptions, while imposing some costs related to systems necessary to perform the calculations and track compensation, should reduce banks’ compliance costs and make the trust and fiduciary activities exception more useful. For example, the proposed rules would permit a bank to follow an alternate test to the account-by-account approach to the “chiefly compensated” condition. Under this proposed exemption, a bank could calculate the compensation it receives from all of its trust and fiduciary accounts on a bank-wide basis, subject to certain conditions.<sup>139</sup> This proposed alternative should provide banks with a potentially less costly approach for determining compliance with the trust and fiduciary activities exception. Similarly, the Agencies’ proposal to provide exemptions from the “chiefly compensated” condition for

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<sup>138</sup> The trust and fiduciary exception is addressed in proposed Exchange Act Rules 721-723.

<sup>139</sup> See proposed Exchange Act Rule 722.

certain short-term accounts, accounts acquired as part of a business combination or asset acquisition, accounts transferred to a broker or dealer or other unaffiliated entity, and a de minimis number of accounts should also reduce banks' compliance costs by facilitating banks' ability to comply with the "chiefly compensated" condition.<sup>140</sup> While compliance with the conditions in these proposed exemptions would likely result in some costs, such as the recordkeeping requirement associated with the de minimis exclusion, these costs would likely be more than justified by the benefits associated with the exemptions given that banks could individually determine whether they wish to utilize the exemptions.

As previously noted, banks are likely to incur some costs to comply with the GLBA. The proposed rules, however, include a number of exemptions which should help to reduce overall costs. As a result, the Agencies do not believe that banks would incur significant additional costs to comply with the liberalized exemptions proposed in Exchange Act Rules 722 through 723 or the definitional guidance proposed in Exchange Act Rule 721.

We solicit comment on the costs and benefits, if any, banks expect to incur in complying with the "chiefly compensated" condition in the statute and the proposed rules. In particular, we would like information on the start-up and annual ongoing costs to update systems to track compensation under the account-by-account approach and under the proposed bank-wide approach. We also solicit comments on the costs and burdens associated with the advertising provisions of proposed Exchange Act Rule 721(b), which would apply to banks operating under both the account-by-account and bank-wide tests.

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<sup>140</sup> See proposed Exchange Act Rule 723.



c. Sweep Accounts and Transactions in Money Market Funds

Section 3(a)(4)(B)(v) of the Exchange Act provides banks with an exception from the definition of “broker” to the extent it effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund. The proposed rules provide guidance, consistent with NASD rules,<sup>141</sup> regarding the definition of “no-load” as used in the exception. This guidance should benefit banks by clarifying the types of charges that are permissible and by providing greater legal certainty.

The proposed rules also contain an exemption that would permit banks to effect transactions on behalf of a customer in securities issued by a money market fund, subject to certain conditions.<sup>142</sup> While compliance with the conditions associated with this proposed exemption, such as the prospectus delivery requirement in certain circumstances, could require banks to incur some costs, these costs are likely to be more than justified by the investor protection benefits enjoyed by the banks’ customers and the enhanced flexibility granted banks by the exemption. Furthermore, because banks would be able to freely determine whether to incur these costs, the exemption should provide a net benefit for banks that wish to utilize the exemption. We solicit comment on the costs and benefits, if any, banks expect to incur in complying with the conditions in this proposed rule.

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<sup>141</sup> See NASD Rule 2830.

<sup>142</sup> See proposed Exchange Act Rule 741.

d. Safekeeping and Custody Exception

Section 3(a)(4)(B)(viii) of the Exchange Act provides banks with an exception from the definition of “broker” for certain bank custody and safekeeping activities. The proposed rules contain an exemption that would permit banks, subject to certain conditions, to accept orders to effect transactions in securities for accounts for which the bank acts as a custodian. Specifically, this proposed custody exemption (proposed Exchange Act Rule 760) would allow banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as a custodian. In addition, the exemption allows banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of custodial accounts. This proposal would allow banks to accept orders from custody accounts while imposing conditions designed to prevent a bank from operating a securities broker out of its custody department.

The exemption should benefit banks by permitting certain order-taking activities for securities transactions. While banks may incur some costs in complying with the conditions contained in the exemption, such as developing systems for making determinations regarding compliance with advertising and compensation restrictions, the Agencies believe the conditions contained in the rules are consistent with the practices of banks and any costs would only be imposed on banks that choose to utilize the exemption.

We solicit comment on any costs and benefits banks expect to incur in complying with the conditions in the proposed exemption.

e. Other Proposed Changes

We are proposing certain special purpose exemptions. Specifically, we are proposing an exemption that would permit banks to effect transactions pursuant to Regulation S with non-U.S. persons.<sup>143</sup> Another proposed exemption also would, under certain conditions, allow a bank to effect transactions in investment company securities through Fund/SERV or directly with a transfer agent acting for an open-end company.<sup>144</sup> In addition, we are proposing an exemption that would permit banks, as an agent, to effect securities lending transactions (and engage in related securities lending services) for securities that they do not hold in custody with or on behalf of a person the bank reasonably believes is a qualified investor (as defined in Section 3(a)(54)(A) of the Exchange Act) or any employee benefit plan that owns and invests on a discretionary basis at least \$25 million in investments.<sup>145</sup> Furthermore, we are proposing to extend the exemption from rescission liability under Exchange Act Section 29 to contracts entered into by banks acting in a broker capacity until a date that would be 18 months after the effective date of the final rule.<sup>146</sup> This proposed exemption also would, under certain circumstances, provide protections from rescission liability under Exchange Act Section 29 resulting solely from a bank's status as a broker, if the bank has acted in good faith, adopted reasonable policies and procedures, and any violation of broker registration requirements did not result in significant harm or financial loss to the person seeking to

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<sup>143</sup> See proposed Exchange Act Rule 771.

<sup>144</sup> See proposed Exchange Act Rule 775.

<sup>145</sup> See proposed Exchange Act Rule 772.

<sup>146</sup> See proposed Exchange Act Rule 780.

void the contract.<sup>147</sup> Finally, we are proposing a temporary general exemption from the definition of “broker” under Section 3(a)(4) of the Exchange Act until the first day of a bank’s first fiscal year commencing after June 30, 2008.<sup>148</sup>

The Agencies believe these proposed changes could offer a number of benefits to banks and their customers. In particular, the proposed Regulation S exemption could help to ensure that U.S. banks that effect transactions in Regulation S securities with non-U.S. customers would be more competitive with foreign banks or other entities that offer those services. The proposed exemption from rescission liability under Exchange Act Section 29 should also provide banks some legal certainty, both temporarily and on a permanent basis, as they conduct their securities activities. The proposed exemption related to securities lending services should enable banks to engage in the types of services which they currently engage thereby minimizing compliance costs, while providing the banks’ customers with continuity of service. The temporary general exemption from the definition of “broker” should also be of benefit to banks by providing them with an adequate period of time to transition to the requirements under the proposed rules.

We estimate that the costs of these proposed exemptions would be minimal and would be justified by the benefits the proposed exemptions would offer. For example, the Regulation S exemption could impose certain costs on banks that are designed to ensure that they remain in compliance with the conditions under the exemption. In particular, the proposed exemption would require banks to incur certain administrative

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<sup>147</sup> Id.

<sup>148</sup> See proposed Exchange Act Rule 781.

costs so that the proposed exemption is used only for “eligible securities” and for a purchaser who is outside of the United States within the meaning of Section 903 of Regulation S. Nevertheless, the proposed exemption is an accommodation to banks that wish to effect transactions in Regulation S securities and, as a result, the compliance costs would only be imposed on those banks that believe that it is in their best business interests to take advantage of the proposed exemption. We request comment on whether banks would incur any costs related to this proposed exemption.

Given that Exchange Act Section 29 is rarely used as a remedy, we do not anticipate that this proposed exemption would impose significant costs on the industry or on investors. We request comment on whether any bank would incur any costs or would benefit as a result of this proposed exemption. We also request comment on whether banks would incur any costs or benefits in association with the proposed exemptions concerning securities lending services and effecting transactions in investment company securities. Please provide any supporting data with respect to any costs or benefits. We would also welcome comments on the usefulness of the temporary general exemption from the definition of “broker” under Section 3(a)(4) of the Exchange Act.

C. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation

Exchange Act Section 3(f) requires the Commission, whenever it engages in rulemaking and is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.<sup>149</sup> Exchange Act Section 23(a)(2) requires the Commission, in adopting rules under that Act, to consider the impact that any such rule

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<sup>149</sup> 15 U.S.C. 78c(f).

would have on competition. This Section also prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>150</sup>

The Agencies have designed the proposed interpretations, definitions, and exemptions to minimize any burden on competition. Indeed, the Agencies believe that by providing legal certainty to banks that conduct securities activities, by clarifying the GLBA requirements, and by exempting a number of activities from those requirements, the proposed rules should allow banks to continue to conduct securities activities they already conduct consistent with the GLBA. As a result, the Agencies believe that the proposed rules would permit banks to continue to compete with broker-dealers in providing a wide range of financial services, which should preserve competition and help to keep transaction costs low for investors and for companies.

The proposed rules define terms in the statutory exceptions to the definition of broker added to the Exchange Act by Congress in the GLBA, and provide guidance to banks as to the appropriate scope of those exceptions. In addition, the proposed rules contain a number of exemptions that should provide banks flexibility in conducting their securities activities, which should further promote competition and reduce costs.

The Commission is, however, interested in receiving comments regarding the effect of the proposed rules on efficiency, competition, and capital formation.

f. General Costs

Based on the burden hours discussed in the Paperwork Reduction Act Analysis Section the Agencies expect the ongoing requirements of the proposed rules to result in a

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<sup>150</sup> 15 U.S.C. 78w(a)(2).

total of 58,709 annual burden hours for banks and 500 annual burden hours for broker-dealers, for a grand total of 59,209 annual burden hours.<sup>151</sup> The Agencies estimate that the hourly costs for these burden hours will be approximately \$68 per hour.<sup>152</sup> Therefore, the annual total costs would be approximately \$4,026,212.

In addition to the costs associated with burden hours discussed in the Paperwork Reduction Act Analysis Section, the Agencies expect that many banks also could incur start-up costs for legal and other professional services.<sup>153</sup> Many banks would utilize their in-house counsel, accountants, compliance officers, and programmers in an effort to achieve compliance with the proposed rules. Industry sources indicate the following hourly labor costs: attorneys - \$324 per hour, intermediate accountants - \$162 per hour, compliance manager - \$205 per hour, and senior programmer - \$268.<sup>154</sup> Taking an average of these professional costs, the Agencies estimate a general hourly in-house labor cost of \$240 per hour for professional services.

Based on our expectation that most start-up costs would involve bringing systems into compliance and that many banks would be able to do so either using existing systems or by slightly modifying existing systems, the Agencies estimate that the proposed rules

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<sup>151</sup> See infra at VIII.A.1.d., VIII.A.2.d., and VIII.A.3.d.

<sup>152</sup> \$68/hour figure for a clerk (e.g. compliance clerk) is from the SIA Report on Office Salaries in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

<sup>153</sup> For example, banks may incur start-up costs in the process of reviewing or developing their networking arrangements in line with the requirements of the proposed rules. See infra at VIII.B.2.a. In addition, there would likely be costs for developing systems for making determinations regarding compliance with advertising and compensation restrictions pursuant to the proposed rules regarding safekeeping and custody. See infra at VIII.B.2.d.

<sup>154</sup> The hourly figures for an attorney, intermediate account, and compliance manager is from the SIA Report on Management & Professional Earnings in the Securities Industry 2005, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

would require banks to utilize an average of 30 hours of professional services. The Agencies expect that most banks affected by the proposed rules would either use in-house counsel or employees resulting in an average total cost of \$7,200 per affected bank.<sup>155</sup> The Agencies estimate that the proposed rules would apply to approximately 9,475 banks and approximately 25 percent of these banks would incur more than a de minimis cost. Using these values, the Agencies estimate total start-up costs of \$17,055,000 ( $9,475 \times .25 \times \$7,200$ ). As previously discussed the Agencies have sought to minimize these costs to the extent possible consistent with the language and purposes of the GLBA.

Based on these estimates, the total costs for the first year would be approximately \$21,081,212 ( $\$17,055,000 + \$4,026,212$ ). The Agencies request comment on these cost estimates or any other applicable costs.

g. General Benefits

The Agencies believe that the proposed rules would provide greater legal certainty for banks in connection with their determination of whether they meet the terms and conditions for an exception to the definition of broker under the Exchange Act as well as provide additional relief through the proposed exemptions. Without the proposed rules, banks could have difficulty planning their businesses and determining whether their operations are in compliance with the GLBA. This, in turn, could hamper their business. The Agencies anticipate these benefits would prove to be useful to banks and provide saving in legal fees. Specifically, difficulties in interpreting the GBLA, absent any regulatory guidance, could result in the need for greater input from outside counsel.

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<sup>155</sup> Some banks may choose to utilize outside counsel, either exclusively or as a supplement to in-house resources. The Agencies estimate these costs as being similar to the in-house costs (Industry sources indicate the following hourly costs for hiring external workers: Attorneys - \$400, accountant - \$250, auditor - \$250, and programmer - \$160.).



Based on the number of interactive issues raised by the GBLA, the Agencies estimate that absent any regulatory guidance, banks on average would use the services of outside counsel for approximately 25 more hours for the initial year and 5 more hours per year thereafter, than with the existence of the proposed rules. Industry sources indicate that the hourly costs for hiring outside counsel is approximately \$400 per hour. The proposed rules would therefore result in an average total cost savings of approximately \$10,000 per affected bank per year during the initial year and \$2,000 per affected bank per year thereafter. The Agencies estimate that the proposed rules would apply to approximately 9,475 banks and approximately 25 percent of these banks would enjoy more than a de minimis cost savings benefit. Using these values, the Agencies estimate a total cost savings of \$23,687,500 ( $9,475 \times .25 \times \$10,000$ ) for the initial year and \$4,737,500 ( $9,475 \times 0.25 \times \$2,000$ ) per year thereafter. The Agencies request comment on these benefits or any other applicable benefit.

e. Request for Comments

The Agencies request comment on the costs and benefits of the proposed rules, and ask commenters to provide supporting empirical data for any positions advanced. Commenters should address in particular whether any of the new rules would generate the anticipated benefits or impose any costs on investors, banks, customers of banks, registered broker-dealers or other market participants. As always, commenters are specifically invited to share quantifiable costs and benefits.

#### D. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or “SBREFA,”<sup>156</sup> the Agencies must advise the Office of Management and Budget as to whether the proposed rules constitute a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- A significant adverse effect on competition, investment, or innovation.

If a rule is “major,” its effectiveness will generally be delayed for 60 days pending Congressional review. The Agencies do not believe that the proposed rules, in their current form, would constitute a major rule. We request comment on the potential impact of the proposed rules on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

#### E. Initial Regulatory Flexibility Analysis

The Agencies have prepared an Initial Regulatory Flexibility Analysis (“IRFA”), in accordance with the provisions of the Regulatory Flexibility Act (“RFA”),<sup>157</sup> regarding the proposed rules.

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<sup>156</sup> Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996) (codified in various Sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

<sup>157</sup> 5 U.S.C. 603.

## 1. Reasons for the Proposed Action

Section 201 of the GLBA amended the definition of “broker” in Section 3(a)(4) of the Exchange Act to replace a blanket exemption from that term for “banks,” as defined in Section 3(a)(6) of the Exchange Act. Congress replaced this blanket exemption with eleven specific exceptions for securities activities conducted by banks.<sup>158</sup> On October 13, 2006, President Bush signed into law the Regulatory Relief Act.<sup>159</sup> Section 101 of that Act, among other things, requires the Agencies jointly to issue a single set of proposed rules implementing the bank broker exceptions in Section 3(a)(4) of the Exchange Act within 180 days of the date of enactment of the Regulatory Relief Act.<sup>160</sup> These rules are being proposed by the Agencies to fulfill this requirement. The proposed rules are designed generally to provide guidance on GLBA exceptions from the definition of broker in Exchange Act Section 3(a)(4) and to provide conditional exemptions from the broker definition consistent with the purposes of the Exchange Act and the GLBA.

## 2. Objectives

The proposed rules would provide guidance to the industry with respect to the GLBA requirements. The proposal also provides certain conditional exemptions from the broker definition to allow banks to perform certain securities activities. The Supplementary Information Section above contains more detailed information on the objectives of the proposed rules.

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<sup>158</sup> 15 U.S.C. 78c(a)(4).

<sup>159</sup> Pub. L. No. 109-351, 120 Stat. 1966 (2006).

<sup>160</sup> See Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act. The Regulatory Relief Act also requires that the Board and SEC consult with, and seek the concurrence of, the OCC, FDIC and OTS prior to jointly adopting final rules. As noted above, the Board and the SEC also have consulted extensively with the OCC, FDIC and OTS in developing these joint proposed rules.

### 3. Legal Basis

Pursuant to Section 101 of the Regulatory Relief Act, the Agencies are issuing the proposed rules for comment. In addition, pursuant to the Exchange Act and, particularly, the Sections 3(b), 15, 23(a), and 36 thereof, the Commission is issuing the proposed rules for comment.<sup>161</sup>

### 4. Small Entities Subject to the Rule

The proposed rule would apply to “banks,” which is defined in Section 3(a)(6) of the Exchange Act to include banking institutions organized in the United States, including members of the Federal Reserve System, Federal savings associations, as defined in Section 2(5) of the Home Owners’ Loan Act, and other commercial banks, savings associations, and nondepository trust companies that are organized under the laws of a state or the United States and subject to supervision and examination by state or federal authorities having supervision over banks and savings associations.<sup>162</sup> Congress did not exempt small entity banks from the application of the GLBA. Moreover, because the proposed rules are intended to provide guidance to and exemptions for all banks that are subject to the GLBA, the Agencies determined that it would not be appropriate or necessary to exempt small entity banks from the operation of the proposed rules. Therefore, the proposed rules generally apply to all banks, including banks that would be considered small entities (i.e., banks with total assets of \$165 million or less) for purposes of the RFA.<sup>163</sup>

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<sup>161</sup> 15 U.S.C. 78c(b), 78o, 78w(a), and 78mm.

<sup>162</sup> See 15 U.S.C. 78c(a)(6); Pub. L. No. 109-351, 120 Stat. 1966 (2006).

<sup>163</sup> Small Business Administration regulations define “small entities” to include banks and savings associations with total assets of \$165 million or less. 13 CFR 121.201.

The Agencies estimate that the proposed rules would apply to approximately 9,475 banks, approximately 5,816 of which could be considered small banks with assets of \$165 million or less. We do not anticipate any significant costs to small entity banks as a result of the proposed rules.

#### 5. Reporting, Recordkeeping and Other Compliance Requirements

The proposed rules would not impose any significant reporting, recordkeeping, or other compliance requirements on banks that are small entities.<sup>164</sup>

Nevertheless, the Agencies request comment on the costs of compliance with any recordkeeping, reporting, or other requirements under the proposed rules. The Agencies also request comment on any anticipated ongoing costs associated with complying with the proposed rules.<sup>165</sup> Commenters should provide detailed estimates of these costs.

#### 6. Duplicative, Overlapping, or Conflicting Federal Rules

The Agencies believe that there are no rules that duplicate, overlap, or conflict with the proposed rules.

#### 7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,<sup>166</sup> the Agencies must consider the following types of alternatives (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for small entities; (3) the use of performance rather

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<sup>164</sup> The Agencies' estimates related to recordkeeping and disclosure are detailed in the "Paperwork Reduction Act Analysis" Section of this Release.

<sup>165</sup> The Agencies' estimates of the costs and benefits of the proposed rule amendments are detailed in the "Consideration of Costs and Benefits" Section of this release.

<sup>166</sup> 5 U.S.C. 603(c).

than design standards; and (4) an exemption from coverage of the proposed rules, or any part thereof, for small entities.

As discussed above, the GLBA does not exempt small entity banks from the Exchange Act broker registration requirements and because the proposed rules are intended to provide guidance to, and exemptions for, all banks that are subject to the GLBA, the Agencies determined that it would not be appropriate or necessary to exempt small entity banks from the operation of the proposed rules. Moreover, providing one or more special exemptions for small banks could place broker-dealers, including small broker-dealers, or larger banks at a competitive disadvantage versus small banks.

The proposed rules are intended to clarify and simplify compliance with the GLBA by providing guidance with respect to exceptions and by providing additional exemptions. As such, the proposed rules should facilitate compliance by banks of all sizes, including small entity banks.

The Agencies do not believe that it is necessary to consider whether small entity banks should be permitted to use performance rather than design standards to comply with the proposed rules because the proposed rules already use performance standards. Moreover, the proposed rules do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the proposed rules.

#### 8. Request for Comments

The Agencies encourage written comments on matters discussed in the IRFA. In particular, the Agencies request comments on (1) the number of small entities that would be affected by the proposed rules; (2) the nature of any impact the proposed rules would

have on small entities and empirical data supporting the extent of the impact; and (3) how to quantify the number of small entities that would be affected by and/or how to quantify the impact of the proposed rules. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rules are adopted, and will be placed in the same public file as comments on the proposal itself. Persons wishing to submit written comments should refer to the instructions for submitting comments in the front of this release.

#### F. Plain Language

Section 722 of the GLBA (12 U.S.C. 4809) requires the Board to use plain language in all proposed and final rules published by the Board after January 1, 2000. The Board has sought to present the proposed rules, to the maximum extent possible, in a simple and straightforward manner. The Board invites comments on whether there are additional steps that could be taken to make the proposed rules easier to understand.

### IX. Statutory Authority

Pursuant to authority set forth in the Exchange Act and particularly Sections 3(a)(4), 3(b), 15, 17, 23(a), and 36 thereof (15 U.S.C. 78c(a)(4), 78c(b), 78o, 78q, 78w(a), and 78mm, respectively) the Commission proposes to repeal by operation of statute current Rules 3a4-2, 3a4-3, 3a4-4, 3a4-5, 3a4-6, and 3b-17 (§§ 240.3a4-2, 240.3a4-3, 240.3a4-4, 240.3a4-5, 240.3a4-6, and 240.3b-17, respectively). The Commission is proposing to repeal Exchange Act Rules 15a-7 and 15a-8 (§ 240.15a-7 and §240.15a-8, respectively). The Commission, jointly with the Board of Governors of the Federal Reserve System, is also proposing new Rules 700, 701, 721, 722, 723, 740, 741, 760, 771, 772, 775, 780, and

781 under the Exchange Act (§§ 247.700, 247.701, 247.721, 247.722, 247.723, 247.740, 247.741, 247.760, 247.771, 247.772, 247.775, 247.780, and 247.881, respectively).

## **X. Text of Proposed Rules and Rule Amendments**

### **List of Subjects**

#### **12 CFR Part 218**

Banks, Brokers, Securities.

#### **17 CFR Part 240**

Broker-dealers, Reporting and recordkeeping requirements, Securities.

#### **17 CFR Part 247**

Banks, Brokers, Securities.

### **Federal Reserve System**

#### **Authority and Issuance**

For the reasons set forth in the preamble, the Board proposes to amend Title 12, Chapter II of the Code of Federal Regulations by adding a new Part 218 as set forth under Common Rules at the end of this document:

### **PART 218— EXCEPTIONS FOR BANKS FROM THE DEFINITION OF BROKER IN THE SECURITIES EXCHANGE ACT OF 1934 (REGULATION R)**

#### **Sec.**

218.100	Definition.
218.700	Defined terms relating to the networking exception from the definition of “broker.”
218.701	Exemption from the definition of “broker” for certain institutional referrals.
218.721	Defined terms relating to the trust and fiduciary activities exception from the definition of “broker.”



- 218.722 Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.
- 218.723 Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.
- 218.740 Defined terms relating to the sweep accounts exception from the definition of “broker.”
- 218.741 Exemption for banks effecting transactions in money market funds.
- 218.760 Exemption from definition of “broker” for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.
- 218.771 Exemption from the definition of “broker” for banks effecting transactions in securities issued pursuant to Regulation S.
- 218.772 Exemption from the definition of “broker” for banks engaging in securities lending transactions.
- 218.775 Exemption from the definition of “broker” for the way banks effect excepted or exempted transactions in investment company securities.
- 218.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.
- 218.781 Exemption from the definition of “broker” for banks for a limited period of time.

**Authority:** 15 U.S.C. 78c(a)(4)(F).

## **Securities and Exchange Commission**

### **Authority and Issuance**

For the reasons set forth in the preamble, the Commission proposes to amend Title 17, Chapter II of the Code of Federal Regulations as follows:

### **PART 240 — GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

1. The authority citation for Part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p,

78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

2. Sections 240.3a4-2 through 240.3a4-6, 240.3b-17, 240.15a-7, and 240.15a-8 are removed and reserved.

3. Part 247 is added as set forth under Common Rules at the end of this document:

**PART 247— REGULATION R – EXEMPTIONS AND DEFINITIONS RELATED TO THE EXCEPTIONS FOR BANKS FROM THE DEFINITION OF BROKER**

**Sec.**

247.100	Definition.
247.700	Defined terms relating to the networking exception from the definition of “broker.”
247.701	Exemption from the definition of “broker” for certain institutional referrals.
247.721	Defined terms relating to the trust and fiduciary activities exception from the definition of “broker.”
247.722	Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.
247.723	Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.
247.740	Defined terms relating to the sweep accounts exception from the definition of “broker.”
247.741	Exemption for banks effecting transactions in money market funds.
247.760	Exemption from definition of “broker” for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.
247.771	Exemption from the definition of “broker” for banks effecting transactions in securities issued pursuant to Regulation S.
247.772	Exemption from the definition of “broker” for banks engaging in securities lending transactions.

- 247.775 Exemption from the definition of “broker” for the way banks effect excepted or exempted transactions in investment company securities.
- 247.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.
- 247.781 Exemption from the definition of “broker” for banks for a limited period of time.

**Authority:** 15 U.S.C. 78c, 78o, 78q, 78w, and 78mm.

### **Common Rules**

[Text of the proposed common rules appears in Appendix B.]