SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 240

[Release No. 34–44291; File No. S7–12–01]

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Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934

AGENCY: Securities and Exchange Commission.

ACTION: Interim final rules with request for comments.

SUMMARY: The Securities and Exchange Commission is adopting, as interim final rules, new Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, 3b–17, 3b–18, 15a–7, 15a–8, and 15a–9 under the Securities Exchange Act of 1934 (''Exchange Act''), and amending Rule 30–3 of our Rules of Organization and Program Management. These new rules address the functional exceptions for banks from the definitions of ''broker'' and ''dealer'' that were added to the Exchange Act by the Gramm-Leach-Bliley Act and will become effective May 12, 2001.

We are promulgating these rules on an interim final basis, effective May 11, 2001, to clarify the terms of the functional exceptions from the definitions of broker and dealer as well as to provide additional exemptions, which will aid banks in complying with the provisions of the Gramm-Leach-Bliley Act when they become effective. We are soliciting comments on all aspects of the interim final rules and will amend these rules as appropriate in response to comments received.

DATES: *Effective Date:* May 11, 2001.

Comment Date: Comments on the interim final rules should be submitted by July 17, 2001.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, N.W., Washington, D.C. 20549–0609. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–12–01; this file number should be included on the subject line if E-mail is used. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, N.W., Washington, D.C. 20549–0102. Electronically submitted comment letters will be posted on the Commission's Internet site (http://www.sec.gov).[1]

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Chief Counsel; Lourdes Gonzalez, Assistant Chief Counsel; Linda Stamp Sundberg, Banking Fellow; Patricia Albrecht, Special Counsel; or Joseph P. Corcoran, Attorney, (202) 942–0073, Office of the Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') is adopting Rules 3a4–2 [17 CFR 240.3a4–2], 3a4–3 [17 CFR 240.3a4–3], 3a4–4 [17 CFR 240.3a4–4], 3a4–5 [17 CFR 240.3a4–5], 3a4–6 [17 CFR 240.3a4–6], 3a5–1 [17 CFR 240.3a5–1], 3b–17 [17 CFR 240.3b–17], 3b–18 [17 CFR 240.3b–18], 15a–7 [17 CFR 240.15a–7], 15a–8 [17 CFR 240.15a–8], and 15a–9 [17 CFR 240.15a–9] under the Exchange Act as interim final rules clarifying certain terms in Sections 3(a)(4) and 3(a)(5) of the Exchange Act [15 U.S.C. 78c(a)(4) and 78c(a)(5)] and providing exemptions for banks from broker-dealer registration. The Commission is delegating authority to the Division of Market Regulation through an amendment to Rule 30–3 of its Rules of Organization and Program Management [17 CFR 200.30–3] to issue to banks, savings associations, and savings banks additional exemptions from registration and regulation.

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[1] We do not edit personal, identifying information, such as names or e-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

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I. Introduction

A. Background

On November 12, 1999, the President signed the Gramm-Leach-Bliley Act (''GLBA'') into law.[2] The GLBA represents the culmination of more than 30 years of Congressional efforts aimed at reforming the regulation of financial services.[3] The GLBA changed federal statutes governing the scope of permissible activities and the supervision of banks, bank holding companies, and their affiliates. The GLBA lowers (although does not altogether eliminate) barriers between the banking and securities industries erected by the Banking Act of 1933 (popularly known as the ''Glass-Steagall Act'')[4] and between the banking and the insurance industries erected by the 1982 amendments to the Bank Holding Company Act of 1956 (the ''Bank Holding Company Act'').[5] Some have described the GLBA as the most important piece of federal banking legislation since the Depression.[6]

When Congress enacted the Exchange Act in l934, it completely exempted banks from the regulatory scheme provided for brokers and dealers. Over the past 60 years, however, evolution of the financial markets driven by competition and technology eroded the separation that previously existed between banks, insurance companies, and securities firms. Regulators responded to these changes with interpretations that increasingly sought to accommodate the market changes. The Board of Governors of the Federal Reserve System (''Federal Reserve''), the Office of the Comptroller of the Currency (''OCC''), and the Federal Deposit Insurance Corporation (''FDIC'') have long permitted banks and bank holding companies to engage in retail and institutional securities brokerage and private placement activities.

Beginning in the 1980s, these developments, coupled with arguments for competitive equality both domestically and internationally, spurred Congressional action. Congress considered major restructuring of legal restrictions preventing financial services firms from offering a full array of products, while at the same time maintaining the successful system of functional regulation of securities, insurance, and banking that existed under that framework.[7]

The Commission long supported modernizing the legal framework governing financial services, so long as it was consistent with a system of functional regulation to ensure that investors purchasing securities through banks received the same protections as those when they purchased securities from registered broker-dealers.[8] The GLBA is the product of many years of Congressional deliberation and reflects a careful balance between providing investors with the same protections wherever they purchase securities, while not unnecessarily disturbing certain bank securities activities.

Sections 201 and 202 of the GLBA substantially amended the Exchange Act's definitions of ''broker'' and ''dealer,'' respectively.[9] The amended definitions become effective on May 12,

[2] Pub. L. No. 106–102, 113 Stat. 1338 (1999).

[3] Jaworski, Robert M., ''Financial Modernization: The Federal Government Plays Catch-up,'' 54 Consumer Fin. L.Q. Rep. 2 (Winter, 2000).

[4] Pub. L. No. 73–66, ch. 89, 48 Stat. 162 (1933) (as codified in various sections of 12 U.S.C.).

[5] The Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97–320, 96 Stat. 1469 (1982) (as codified in various sections of 12 U.S.C.), amending section 4(c)(8) of the Bank Holding Company Act, 12 U.S.C. 1841–1850 (1994).

[6] *See* Jaworski, Robert M., *supra* note 3.

[7] During recent years, the Senate, the House, and Congressional committees acted on several versions of Glass-Steagall reform bills. In 1988, the Senate passed S. 1886, the ''Financial Modernization Act of 1988,'' which would have repealed the provisions of the Glass-Steagall Act that prohibit affiliations between commercial banks and investment banks. That same year the House Banking Committee reported H.R. 5094, the ''Depository Institutions Act of 1988.'' This legislation never reached the House floor. In 1991, in response to the Administration's call for financial services reform, the Senate passed S. 543, the ''Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991.'' The House Banking Committee voted to report favorably H.R. 6, the ''Financial Institutions Safety and Consumer Choice Act of 1991,'' which would have allowed banks to affiliate with securities firms, insurance companies, and commercial entities under a diversified holding company structure. The Glass-Steagall provisions of those bills were dropped, however. In 1995, the House Banking Committee approved H.R. 1062, the ''Financial Services Competitiveness Act of 1995,'' which would have allowed banks to affiliate with securities firms and engage in activities that were financial in nature. Later that same year, the House Banking Committee ordered reported another version as part of H.R. 1858, the ''Financial Institutions Regulatory Relief Act of 1995.'' Significantly, in 1997, the Administration supported, through the Treasury Department, a different version of financial services modernization legislation. The House Banking Committee also approved financial services modernization legislation in the form of H.R. 10, the ''Financial Services Competitiveness Act of 1997.'' Administration support for some version of financial services legislation, together with strong lobbying and negotiating efforts involving the affected industries, led to the passage by the House of H.R. 10 on May 13, 1998, by a one-vote margin of 214 to 213. On September 11, 1998, the Senate Banking Committee also approved its version of H.R. 10. That legislation did not reach the Senate floor.

Five comprehensive financial services reform bills were introduced in the first session of the 106th Congress in 1999. Two bills, H.R. 10 and S. 900, were reported out of committee, passed by the House and Senate, and resulted in a compromise version of S. 900 that was enacted. There was no activity on the other three bills, S. 753, H.R. 665, and H.R. 823; however, some policies in those bills, for example, in the areas of financial privacy and treatment of bank subsidiaries, were reflected to some extent in the legislation that eventually passed.

[8] *See* Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Senator Phil Gram, Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate (Oct. 14, 1999) (stating that ''the Securities and Exchange Commission has long supported financial modernization legislation that provides the protections of the securities laws to all investors.''); *see, also* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 10, the ''Financial Services Act of 1999,'' Before the Subcomm. On Finance and Hazardous Materials of the House Comm. On Commerce (May 5, 1999); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization Legislation Before the Senate Comm. On Banking, Housing, and Urban Affairs (Feb. 24, 1999); Testimony of Harvey J. Goldschmid, General Counsel, U.S. Securities and Exchange Commission, Concerning H.R. 10, the ''Financial Services Act of 1999,'' Before the House Comm. On Banking and Financial Services, U.S. House of Representatives (Feb. 12, 1999); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 10, The ''Financial Services Act of 1998,'' Before the Senate Comm. On Banking, Housing, and Urban Affairs (June 25, 1998); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the ''Financial Services Competition Act of 1997,'' Before the Subcomm. On Finance and Hazardous Materials of the House Comm. On Commerce (July 17, 1997); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization, Before House Comm. On Banking and Financial Services (May 22, 1997); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Regarding H.R. 1062, the ''Financial Services Competitiveness Act of 1995,'' Before the Subcomm. On Telecommunications and Finance and the Subcomm. On Commerce, Trade and Hazardous Materials of the House Comm. On Commerce (June 6, 1995); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning the ''Financial Services Competitiveness Act of 1995'' and Related Issues, Before the House Comm. On Banking and Financial Services (Mar. 15, 1995); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 3447 and Related Functional Regulation Issues, Before the Subcomm. On Telecommunications and Finance of the House Comm. On Energy and Commerce (Apr. 14, 1994); Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization, Before the Subcomm. On Telecommunications and Finance of the House Comm. On Energy and Commerce (July 11, 1990); Memorandum of the Securities and Exchange Commission (under Chairman David Ruder) to the Subcomm. On Telecommunications and Finance of the House Comm. On Energy and Commerce, Concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act (Apr. 11, 1988); Testimony of David S. Ruder, Chairman, U.S. Securities and Exchange Commission, Concerning the Structure and Regulation of the Financial Services Industry, Before the Subcomm. On Telecommunications and Finance of the House Comm. On Energy and Commerce (Oct. 5, 1987).

[9] Exchange Act Sections 3(a)(4) and 3(a)(5) [15 U.S.C. 78c(a)(4) and 78c(a)(5)].

2001. Before the amendment, Sections 3(a)(4) and 3(a)(5) of the Exchange Act provided that the terms ''broker'' and ''dealer'' did not include a ''bank.''[10] Accordingly, banks [11] that engaged in securities activities were excepted from the requirement to register as broker-dealers under the Exchange Act.[12] The amended definitions replace this general exception for banks with specific functional exceptions from broker-dealer registration for certain bank securities activities.

In particular, the amended definitions create 11 ''broker'' and 4 ''dealer'' exceptions for banks. Three of these exceptions are similar for both ''broker'' and ''dealer.'' The exceptions are outlined briefly below:[13]

1. Exceptions From Both ''Broker'' And ''Dealer'' Definitions

• *Trust and fiduciary activities:* permits banks to act as brokers and dealers in securities so long as they act as ''trustees'' or ''fiduciaries'' and meet other conditions.

• *Permissible securities transactions:* permits banks to act as brokers and dealers with respect to exempted securities, Canadian government obligations, and Brady bonds.

• *Identified banking products:* permits banks to act as brokers and dealers for certain ''identified banking products,'' as defined in Section 206 of the GLBA.

2. Other Exceptions From ''Broker'' Definition

• *Third party brokerage arrangements:* permits banks to enter into contractual arrangements with registered broker-dealers to sell securities to bank customers under specified conditions.

• *Certain stock purchase plans:* permits banks, as a part of their transfer agent activities, to effect certain securities transactions in employee benefit plans, dividend reinvestment plans, and issuer plans under specified conditions.

• *Sweep accounts:* permits banks to sweep customer funds into no-load money market funds.

• *Affiliate transactions:* permits banks to effect transactions for affiliates, other than affiliates that are registered broker-dealers or affiliates engaged in merchant banking.

• *Private securities offerings:* permits banks that are not affiliated with broker-dealers to privately place securities under specified conditions.

• *Safekeeping and custody activities:* permits banks to hold securities, pledge securities, lend securities held in custody, and reinvest collateral.

• *Municipal securities:* permits banks to act as brokers in municipal securities.

• *De minimis exception:* permits banks to engage in 500 securities transactions annually without registering as brokers.

3. Other Exception From ''Dealer'' Definition

• *Asset-backed products:* permits banks to underwrite and sell asset-backed securities representing obligations predominantly originated by a bank, an affiliate of the bank other than a broker-dealer, or a syndicate in which the bank is a member, for some types of products.

In recent weeks, we have received an increasing number of inquiries regarding how we will interpret some of the terms in the new specific functional exceptions.[14] Because the exceptions from the definitions of broker and dealer are exceptions to the Exchange Act, we are statutorily charged with interpreting these exceptions. In response to interpretive questions that have arisen, we are adopting, as interim final rules,[15] new Exchange Act Rules 3b–17 and 3b–18.[16]

New Rule 3b–17 defines terms applicable to three exceptions from the definition of broker: (1) Networking arrangements; (2) trust and fiduciary activities; and (3) sweep accounts. Rule 3b–17 also provides legal certainty to banks regarding the availability of the fiduciary activities exception when they act as indenture trustees or as trustees for tax-deferred accounts. New Rule 3b–18 defines terms for the exception from the definition of dealer for banks that sell asset-backed securities.

To alleviate concerns that have been expressed to us in recent months, we also grant five exemptions under which banks may effect transactions in

[10] Current Exchange Act Section 3(a)(4) defines the term ''broker'' as ''any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.'' Current Exchange Act Section 3(a)(5) defines the term ''dealer'' as ''any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank * * * .''

[11] Exchange Act Section 3(a)(6) [15 U.S.C. 78c(a)(6)] defines the term ''bank'' as:

(A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency * * * and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

[12] Exchange Act Section 15(a) [15 U.S.C. 78o(a)] generally provides that:

[i]t shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with [the provisions] of this section.

[13] This outline is a summary. It does not describe the exceptions in full.

[14] Letter from Melanie L. Fein to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 30, 2001); Letter from Scott M. Albinson, Managing Director, OTS, to Annette L. Nazareth, Director, Division of Market Regulation, Commission, and Paul F. Roye, Director, Division of Investment Management, Commission (Mar. 20, 2001); Letter from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers, to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 15, 2001); Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura Unger, Acting Chairman, Commission (Mar. 13, 2001); Letter from Melanie L. Fein to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 13, 2001); Letter from Melanie L. Fein to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 7, 2001); Letter from Sarah A. Miller, Director, Center for Securities, Trust and Investments, American Bankers Association, to Laura Unger, Acting Chairman, Commission (Feb. 28, 2001).

[15] Several of the banking agencies promulgated interim final rules implementing various provisions of the GLBA and solicited comments to implement the bank activity sections of the GLBA. *See* Interim Final Rule with Request for Comments, Repurchases of Stock by Recently Converted Savings Associations, Mutual Holding Company Dividend Waivers, 65 Fed Reg. 43088 (July 12, 2000), comment period extended, 65 FR 60095 (Oct. 10, 2000) (Office of Thrift Supervision (''OTS'')); Joint Interim Final Rule with Request for Comments, Bank Holding Companies and Changes in Bank Control, 65 FR 16460 (Mar. 28, 2000) (Board of Governors of the Federal Reserve System (''Federal Reserve'') and Department of Treasury (''Treasury'')); Interim Final Rules with Request for Comment, Activities and Investments of Insured State Banks, 65 FR 15526 (Mar. 23, 2000), Final Rule, 66 FR 1018 (Jan. 5, 2001) (Federal Deposit Insurance Corporation (''FDIC'')); Interim Final Rule with Request for Comments, Financial Subsidiaries, 65 FR 14819 (Mar. 20, 2000) (Federal Reserve); Joint Interim Final Rule with Request for Comments, Financial Subsidiaries, 65 FR 15050 (Mar. 20, 2000) (Treasury and Federal Reserve); Interim Final Rule with Request for Comments, Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions with Affiliates and Intraday Extensions of Credit to Affiliates, 66 FR 24229 (May 11, 2001) (Federal Reserve).

[16] Exchange Act Section 3(b) [15 U.S.C. 78c(b)] authorizes us to define terms in the Exchange Act.

securities without being registered as broker-dealers. New Rule 3a4–2 responds to concerns banks have expressed about calculating the compensation condition in the trust and fiduciary activities exception. This rule permits banks to compute their compensation, for purposes of the compensation condition, based on their total amount of trust and fiduciary activities, subject to a 10% limit and internal maintenance procedures. New Rule 3a4–3 allows banks to effect transactions as indenture trustees in no-load money market funds without meeting the ''chiefly compensated'' condition in the trust and fiduciary activities exception.

New Rule 3a4–4 provides a conditional exemption to allow small banks to effect transactions in investment company securities held in tax-deferred custody accounts and to be compensated for this brokerage activity. We define small banks as banks that had less than $100 million in assets as of December 31 in both of the prior two calendar years, and have not been, since December 31 of the third prior calendar year, an affiliate of a bank holding company or financial holding company that, as of December 31 of both of the prior two calendar years, had total assets of $1 billion or more. Small banks may not rely this exemption if they are affiliated with, or have networking arrangements with, registered broker-dealers. New Rule 3a4–5 conditionally exempts all banks that effect transactions in securities for custody accounts without, directly or indirectly, receiving compensation for providing this service. A bank relying on this exemption may pass on to the customer the broker-dealer's charge for executing the transactions. Like Rule 3a4–4, this exemption imposes conditions on banks' solicitation of transactions.

New Rule 3a4–6 provides a conditional exemption that allows banks to continue to execute transactions in investment company securities through the National Securities Clearing Corporation's (''NSCC'') Mutual Fund Services, including Fund/SERV, instead of through a registered broker-dealer as required by Exchange Act Section 3(a)(4)(C). This exemption is available only to banks that otherwise meet the conditions of another exception or exemption.

New Rule 3a5–1 conditionally exempts from the definition of ''dealer'' banks engaged in riskless principal transactions if they do not exceed the *de minimis* transactions exception limit in Exchange Act Section 3(a)(4)(B)(xi).

We understand that banks will need time to determine whether any securities activities must be conducted through registered broker-dealers after May 11, 2001. In addition, some banks may not have completed the process of ensuring that securities transactions are conducted through registered broker-dealers, where required. Accordingly, new Rule 15a–7 exempts banks that are engaging in securities activities from the definitions of broker and dealer until October 1, 2001.[17] In addition, Rule 15a–7 exempts banks whose compensation arrangements do not meet the compensation conditions of a particular exception or exemption from the definition of broker until January 1, 2002, if they meet the other conditions for an exception or exemption.

New Rule 15a–8 exempts banks from the potential voiding under Exchange Act Section 29(b) of contracts entered into before January 1, 2003, because the bank violated the broker-dealer registration requirements or any applicable provision of the Exchange Act and rules thereunder based solely on the bank's status as a broker or dealer at the time the bank entered into the contract. Finally, new Rule 15a–9 exempts savings associations and savings banks[18] from the definitions of ''broker'' and ''dealer'' under Exchange Act Sections 3(a)(4) and 3(a)(5) on the same terms and conditions that apply to banks.

We recognize that banks have developed their particular securities activities under the general exception from broker-dealer registration that existed prior to the passage of the GLBA. Because particular banks may have individual considerations that may be appropriate for additional relief, we are authorizing the Director of the Division of Market Regulation to consider, on a case-by-case basis, individual requests for exemptive relief from banks. We also are directing the staff to consider requests from savings associations and savings banks for additional exemptive relief.[19] To facilitate the processing of these requests, we have delegated exemptive authority to the staff of the Division of Market Regulation through an amendment to Rule 30–3 of our Rules of Organization and Program Management. We expect the staff to submit novel and complex requests for exemption to us.

As a general matter, under the federal securities laws, parties relying on an exception or exemption have the burden of demonstrating that they qualify for such exception or exemption. We would therefore expect banks, as a matter of good business practice, to be able to demonstrate that they meet the terms of a particular exemption. We solicit comment regarding whether the requirements that the bank regulators are required to adopt under Section 18(t) of the FDIA[20] will be sufficient for this purpose or whether the Commission itself should adopt record keeping rules relating to these exemptions. We solicit comment on what records banks have or can develop to demonstrate to the Commission that they meet the terms of a particular exemption. We also solicit comment on whether it is necessary for savings association and savings bank regulators to adopt record keeping requirements for savings associations and savings banks analogous to those adopted for banks.

We request comment on all aspects of the interim final rules as well as comment on the specific provisions and issues highlighted below.

B. The Gramm-Leach-Bliley Act

As highlighted above, the GLBA repealed certain provisions of the Glass-Steagall Act[21] and other restrictions applicable to banks and bank holding companies. As a result, banks are able to affiliate with securities firms and insurance companies within the same financial holding company.

The GLBA codified the concept of functional regulation—that is, regulation of the same functions, or activities, by the same expert regulator, regardless of the type of entity engaging in those activities. Congress believed that, given the expansion of the activities and affiliations in the financial marketplace, functional regulation was important to building a coherent financial regulatory scheme.[22] Accordingly, Title II of the GLBA amended the federal securities laws to provide for functional regulation of securities activities by eliminating the complete exception for banks from the definitions of ''broker'' and ''dealer.'' As the legislative history noted, prior to the passage of the GLBA, the exception for banks from broker-dealer registration

[17] Exchange Act Section 36 [15 U.S.C. 78mm] authorizes us to exempt any person, security, or transaction from the provisions of the Exchange Act, to the extent that such exemption is necessary or appropriate in the public interest, and consistent with the protection of investors.

[18] This exemption is limited to savings associations and savings banks that have deposits insured by the FDIC under the Federal Deposit Insurance Act (''FDIA''). 12 U.S.C. 1811 *et seq.*

[19] *See id.* The same limitation applies to this delegation.

[20] 12 U.S.C. 1828(t).

[21] *Supra* note 4.

[22] H.R. Rep. No. 106–74, pt. 3, at 106th Cong., 1st Sess. at 113 (1999).

created a competitive disparity by permitting banks to engage in securities activities without being subject to the same regulatory requirements as broker-dealers. In the legislative history, Congress specifically expressed concern that the complete exception had permitted banks to engage in securities activities without being subject to the provisions of the federal securities laws that were designed to protect investors.[23]

The federal securities laws provide a comprehensive and coordinated system of regulation of securities activities. They are specifically and uniquely designed to assure the protection of investors through full disclosure concerning securities and the prevention of unfair and inequitable practices in the securities markets. The securities laws also have as a goal fair competition among all participants in the securities markets. Broker-dealer registration is an important element of this regulatory system. Absent broker-dealer registration, bank securities activities generally are regulated only under banking law, which has as its primary purposes the protection of depositors and the preservation of the financial soundness of banks.[24] Thus, bank securities activities take place outside of the coordinated system of securities regulation that is designed to protect investors, leading to regulatory disparities.

For example, to become licensed to sell securities, all persons associated with a broker-dealer are required to pass a qualifications test covering substantive aspects of the securities business.[25] Commission and self-regulatory organization (''SRO'') rules also assure that those persons associated with broker-dealers who have committed abuses that would make them subject to a statutory disqualification are prohibited from working in the securities industry or are subject to conditions such as enhanced supervision.[26] The SROs also require that persons involved in the management of the broker-dealer pass additional examinations relating to supervisory procedures and requirements.[27] These qualification requirements are supplemented by continuing education requirements, the broker-dealer's duty to supervise its employees to prevent violations of the federal securities laws, and the specific supervisory procedures imposed by the SROs.[28] In addition, our rules and those of the SROs specifically address sales practice abuses.[29] By contrast, bank personnel generally are not subject to licensing or other regulations designed to test their knowledge of the securities business.

Another area in which banking and securities regulation differ is communications with the public, including advertising. Broker-dealers must comply with specific guidelines concerning the content and review of communications with the public, including advertisements.[30] With certain limited exceptions, there are no equivalent rules governing the advertisement of bank securities activities.[31]

Broker-dealers are subject to inspections and examinations not only by our staff but also by the SROs with our supervision. SRO examinations are designed to assure compliance with the federal securities laws, in particular sales practices and financial responsibility regulations. Banks, on the other hand, are not members of SROs. While bank examiners may review for violations of the banking agencies' securities guidelines, the primary focus is on ensuring the safety and soundness of the bank rather than the protection of investors.

Congress considered the different purposes of bank and securities regulation when it eliminated the blanket exception from broker-dealer registration for banks' securities activities.[32] The GLBA replaced the general exception with eleven specific functional exceptions to the definition of broker and four specific functional exceptions to the definition of dealer. In replacing the general exception with more narrowly tailored exceptions, the GLBA sought to apply broker-dealer regulation to bank securities activities where appropriate to strengthen investor protection, taking into account the nature of the securities activities being conducted. This approach resulted in the specific exceptions enumerated in the amended definitions of broker and dealer in the Exchange Act that will continue to allow banks to engage directly in many securities activities without conducting those activities through a registered broker or dealer. The new exceptions go into effect on May 12, 2001.

II. Rule 3b–17—Definitions Related to Exception From ''Broker''

Exchange Act Section 3(a)(4) generally defines a ''broker'' to be ''any person engaged in the business of effecting transactions in securities for the account of others.''[33] Prior to the passage of the GLBA, this definition was modified by the words ''but does not include a bank'' (emphasis added).[34] The GLBA repealed this exception and replaced it with eleven specific exceptions for certain securities activities that a bank may engage in without being considered a broker.[35]

We are adopting Rule 3b–17[36] to clarify some of the exceptions enumerated in amended Exchange Act Section 3(a)(4).[37] Rule 3b–17 defines certain terms that are used in the exceptions regarding third-party brokerage arrangements, trust and fiduciary activities, and sweep accounts. In addition, both in this Part and in Part III of this Release below, we discuss exceptions in Exchange Act Section 3(a)(4) related to safekeeping and custody activities, affiliate transactions, and a *de minimis* number of securities transactions.

A. Networking Exception

Section 3(a)(4)(B)(i) of the Exchange Act provides an exception from the

[23] *Id.* at 113–14.

[24] *See Board of Governors of Federal Reserve System* v. *Investment Co. Institute,* 450 U.S. 46, 61, 101 S. Ct. 973, 984, 67 L. Ed. 2d 36 (1981); 75 Cong. Rec. 9913–9914 (1932) (remarks of Sen. Bulkley). Employees that perform purely cerical and ministerial duties are not required to pass a qualifications test.

[25] *See, e.g.,* NASD Rules 1031 and 1032, relating to the registration of representatives of member firms; and New York Stock Exchange (''NYSE'') Rule 345, relating to employee registration, approval, and records.

[26] *See, e.g.,* Exchange Act Section 19(h)(3) [15 U.S.C. 78s(h)(3)].

[27] *See, e.g.,* NASD Rules 1021 and 1022, relating to the registration of principals of member firms.

[28] *See, e.g.,* Exchange Act Section 15(b)(7) [15 U.S.C. 78o(b)(7)]; NASD Rules 1120 (''Continuing Education Requirements'') and 3010 (''Supervision''); NYSE Rules 345A (''Continuing Education for Registered Persons'') and 405(b) (''Supervision of Accounts'').

[29] *See, e.g.,* Exchange Act Rule 15g–9 [17 CFR 240.15g–9] (''Sales Practice Requirements for Certain Low-Priced Securities''); NASD Rule 2310 (''Recommendations to Customers (Suitability)''); NASD Rule 2440 (''Fair Prices and Commissions'').

[30] *See* NASD Rule 2210 (''Communications with the Public''); NYSE Rule 472 (''Communications with the Public''). These rules include standards for communications with the public, approval, record keeping, and filing requirements. The NASD and the NYSE also require supervisory review of communication with the public. NASD Conduct Rule 3010 (''Supervision''); NYSE Rule 342 (''Offices-Approval, Supervision, and Control'').

[31] *See, e.g.,* The Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994), 7 Fed. Banking L. Rep. (CCH) ¶ 70–101 (joint statement by the Federal Reserve, OTS, FDIC, and the OCC).

[32] H.R. Rep. No. 106–74, pt. 3, at 113–14, 161–62 (1999).

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

[34] Former Exchange Act Section 3(a)(4).

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

[36] 17 CFR 240.3b–17.

[37] Exchange Act Section 3(b) [15 U.S.C. 78c(b)] authorizes us to define terms used in the Exchange Act, consistent with the provisions and purposes of the Exchange Act.

definition of broker for banks that enter into third-party brokerage (''networking'') arrangements.[38] Under this exception, and subject to certain conditions, a bank will not be considered a broker if it ''enters into a contractual or other written arrangement'' with a registered broker-dealer through which the broker-dealer ''offers brokerage services on or off the premises of the bank.'' [39] Statutorily imposed conditions to the exception address separation of brokerage and banking services, compliance with advertising conditions, functions and compensation of bank employees, conditions to fully disclose the customers' accounts to broker-dealers, and conditions on banks acting as carrying brokers.

One particular condition prohibits unregistered bank employees from receiving:

incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction.[40]

Legislative history indicates that this condition, like the other conditions in the networking exception, was designed to promote investor protection.[41] Specifically, Congress included the limitation on incentive compensation to unregistered bank employees to ensure that those people who have a ''salesman's stake'' in securities transactions are subject to the sales practice standards and other requirements of the federal securities laws.[42]

We have kept Congress' limit in mind in interpreting two terms in the provision. First, Rule 3b–17(h) defines the term ''referral'' to mean a bank employee arranging a first securities-related contact between a registered broker-dealer and a bank customer. The term ''referral'' does not include any activity (including any part of the account opening process) related to effecting transactions in securities beyond arranging that first securities-related contact.[43]

Second, Rule 3b–17(g) provides two alternative definitions of the term ''nominal one-time cash fee of a fixed dollar amount.'' First, the rule provides that a nominal one-time cash fee of a fixed dollar amount may be a payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making the referral. Second, the rule also provides that a nominal one-time cash fee of a fixed dollar amount may be a payment in the form of points in a system or program that covers a range of bank products and non-securities related services, where the points count toward a bonus that is cash or non-cash, if the points awarded for referrals involving securities are not greater than the points awarded for products or services not involving securities. Banks may use either alternative in setting nominal payments if they meet the requirements discussed below, including the requirement that any payment not be designed as an incentive to a bank employee to solicit particular investors to open accounts or to engage in securities transactions.

We provided two alternative ways to measure cash compensation to give banks the flexibility of compensating their employees for securities referrals based either on their current wages or on what the banks pay for referrals of other products and services. By creating two alternative standards, we allow banks to develop a market-based approach to employee compensation that is consistent with the compensation limitation in the networking exception. In either case, as discussed below, we require that any payment not be designed as an incentive to a bank employee to solicit particular investors to open accounts or to solicit investors to engage in securities transactions.

We considered choosing a set dollar amount as the measure for a nominal cash payment. We decided against this approach after considering that we would likely have to adjust periodically any set dollar amount to reflect changes in the economy that would affect its real value. We also determined that, given the economic differences across the country, an across-the-board dollar amount may not have a nominal value everywhere or in every part of the bank. For example, what is considered a nominal dollar amount in San Francisco, California may be considered generous in Wichita, Kansas. Similarly, one system may be used for teller referrals and another system for private banker referrals. Using one hour of the cash wages of the unregistered bank employee making a referral should alleviate these concerns. Hourly wages are generally adjusted, not just to reflect the current state of the economy, but also to reflect the economic climate of a particular location and the duties of a particular employee. Also, using one hour of cash wages as the measure for a nominal cash payment, we ensured that the referral fee is proportionate to an employee's overall wages.

We understand that bank employees making referrals typically are paid a yearly salary rather than an hourly wage. In these cases, translating the yearly salaries into hourly wages should still be a simple task. We request comment on whether an hour's wages, subject to the limits described below, is a proper measure of a ''nominal'' fee.

Use of a point system under the second alternative reflects our understanding that banks do not always reward employees with a set cash referral fee. Payment of bonuses as part of a point system or program offered to bank employees is not necessarily inconsistent with the networking exception. A point system may do nothing more than translate a nominal one-time cash referral fee into nominal one-time referral points. If the point system is part of an overall system that includes products other than securities and lines of business other than brokerage, and the securities-related referral points have a value that is no greater than the points received under the system for any other product or service, it should have only a nominal value in the system. Accordingly, we have provided this alternative definition in an effort to accommodate existing bank practices. Of course, the program may not be structured in any way that allows unregistered bank employees to be compensated either directly or indirectly for meeting sales targets

[38] This exception follows a long line of letters issued by the Commission staff regarding these types of arrangements. H.R. Rep. No. 106–74, pt. 3, at 163 (1999); *see, e.g.,* Letter re: *Chubb Securities Corp.* (Nov. 24, 1993) (''Chubb Letter''). The Chubb Letter superseded prior staff positions regarding these arrangements. *See also* NASD Rule 2350 (Broker-Dealer conduct on the Premises of Financial Institutions). The Chubb Letter will remain in effect for required service corporations of savings associations and savings banks; however, the Chubb Letter is available only to service corporations so long as a savings association or savings bank is required to use one. A savings association or savings bank that complies with the terms of the networking exception will automatically comply with the terms of the Chubb Letter.

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

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

[41] *See* H.R. Rep. No. 106–74, pt. 3, at 163 (1999) (''The [third-party brokerage arrangements] exception is * * * limited by a variety of conditions designed to promote investor protection.'').

[42] *See id.* (''[T]he conditions contained in the networking exception * * * restrict the securities activities of unregistered bank personnel to reduce sales practice concerns.'').

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

related to securities products or services.

We understand that banks may choose to provide prizes, rather than cash bonuses, to bank employees that meet a certain point goal.[44] As long as the point system meets the conditions described above, including the requirement that any payment not be designed as an incentive to a bank employee to solicit particular investors to open accounts or to solicit investors to engage in securities transactions, we would view the system as consistent with the statutory exception.[45]

Regardless of the form of payment banks decide to use, Rule 3b–17(g) also provides that any payment may not be designed to provide, either directly or indirectly,[46] an incentive to a bank employee to solicit investors to open accounts or to solicit investors to engage in securities transactions. Therefore, Rule 3b–17(g) also specifies that payments may not be based on: (1) The size, value, or completion of any securities transaction; (2) the amount of securities-related assets gathered; (3) the size or value of any customer's bank or securities account; or (4) the customer's financial status.

This interpretation is consistent with the Commission staff's historical position on networking activities.[47] Also, while nominal referral payments that are not based on the success of any securities transactions may provide a limited salesman's stake, we believe these parameters will help ensure that the effect of the stake will be small.[48]

We are concerned that referral payments, while ''nominal'' when considered independently, may not be ''nominal'' when considered in the aggregate. For example, one referral payment to a teller for one referral in one day of work may be ''nominal,'' but twenty referral payments to a teller for twenty referrals in one day may not be ''nominal'' when considered in the aggregate. ''Nominal'' payments are to be paid to employees for whom referrals to the broker-dealer constitute an insubstantial part of an employee's duties. If a referral fee system were structured in such a manner that referral fees constituted a substantial portion of an employee's total compensation, it would raise serious questions about whether the payments were designed to encourage the bank employee to solicit securities activities. We solicit comment on whether we need to establish gross compensation standards so that referral payments that are ''nominal'' do not become incentive compensation when aggregated, and if so, what those limits should be.

Banks also have questioned whether bonuses paid in addition to a point system, either in the form of cash or non-cash compensation, are acceptable under the exception. We do not believe that bonuses based on brokerage referrals fall within the compensation limits of the exception.[49] While bonuses sometimes fall within the category of a one-time payment, by their very nature they are incentive compensation. The networking exception prohibits unregistered bank employees from receiving incentive compensation for any brokerage-related activity except for nominal one-time cash payments of a fixed dollar amount for a referral.

Banks, however, may give bonuses, either in the form of cash or non-cash compensation, to unregistered bank employees based on the overall profitability of the bank regardless of the contribution of employee or employees receiving the bonus. To rely on the third-party brokerage exception, however, banks cannot indirectly pay their unregistered bank employees incentive compensation for securities transactions through a branch, department, or line of business or through a bonus program related to the securities transactions of a branch, department, or line of business.

In addition, the language and legislative history of the networking exception indicate that brokerage referral fees can only be paid to natural persons who are bank employees.[50] The compensation limit, however, does not interfere with any incentive-based compensation arrangements between the broker-dealer and the bank as a whole. Therefore, a broker-dealer in a third-party brokerage arrangement with a bank may make transaction-related payments to the bank for brokerage transactions conducted by the broker-dealer with the bank's customers.[51]

We find that the definitions in Rule 3b–17 related to the networking exception are consistent with the provisions and purposes of the Exchange Act.[52] We request comment on the interpretation of the limits on incentive compensation in the networking exception. Commenters are specifically requested to identify other issues related to the payment of various types of incentive compensation.

B. Trust And Fiduciary Activities Exception

Exchange Act Section 3(a)(4)(B)(ii)[53] excepts banks that act as trustees or fiduciaries from the definition of ''broker,'' subject to certain conditions. Under the terms of this exception, a bank will not be considered a ''broker'' if it meets the following conditions in conducting brokerage activities: (1)

[44] Non-cash compensation can include, but is not necessarily limited to, merchandise, gifts, prizes, travel expenses, meals, and lodging. *See* NASD Rule 2830(b)(1)(D) (providing essentially the same definition of non-cash compensation for NASD rule limiting cash and non-cash compensation to members in connection with investment company securities activities).

[45] This condition does not necessarily dictate equal weighting for referrals to different business lines. Rather, it means that, to the extent there are differential referral payouts, points for referrals to broker-dealers should not have greater weight than points for any other type of referral.

[46] We look behind the terms of a compensation arrangement to determine its economic substance, that is, to determine whether it is transaction-related. Thus, a fee arrangement designed to compensate a person for what that person would have received if the person directly received transaction-related compensation (for example, a flat fee that is recalculated periodically to reflect an increase or decrease in the number of transactions) would be the equivalent of transaction-related compensation. In this regard, a flat fee representing a percentage of expected future commissions could be considered transaction-related.

[47] *See* Chubb Letter, *supra* note 38.

[48] This is important, in our view, because referral compensation may create an improper salesman's incentive. For example, in 1998 NationsSecurities and NationsBank, N.A., without admitting or denying the matters set forth in the settlement order, settled administrative proceedings brought by us for alleged misleading sales practices relating to two high-risk sales of closed-end bond funds. In the Matters of NationsSecurities and NationsBank, N.A., Securities Act Rel. No. 7532; Exchange Act Rel. No. 39947; File No. 3–9596 (May 4, 1998). The bank also adopted a referral fee system that created heightened incentives for bank employees to make customer referrals to the broker-dealer. Under this program, the broker-dealer paid the bank 5% of the broker-dealer's gross commission for making referrals to the broker-dealer and the bank then paid the referring bank employee. The payment was conditioned on closing a sale of securities and was proportional to the size of the sale. In some instances, bank employees substantially increased their monthly compensation during this period by making referrals to the broker-dealer. The statutory limitations on the networking exception are designed to prevent precisely these types of incentives to unregistered bank personnel.

[49] The statute also does not contemplate deferred compensation on a sliding scale, a grid, or breakpoints for referrals. *See* H.R. Rep., No. 106–74, pt. 3, at 163 (''[B]ank employees who are not registered representatives may not receive incentive compensation in connection with securities transactions.''). In the securities industry, variable commission payments are designed to be incentive compensation. *See generally* Report of the Committee on Compensation Practices (April 10, 1995) (''Tully Report'').

[50] *See generally* Exchange Act Section 3(a)(4)(B)(i) [15 U.S.C. 78c(a)(4)(B)(i)]; H.R. Rep. No. 106–74, at 163 (1999) (both the language of the statute and the legislative history of the exception refer only to bank employees in the context of individual natural persons, especially when comparing their status to registered representatives; registered representatives are always individual natural persons).

[51] Banks cannot structure arrangements with networking broker-dealers or affiliated broker-dealers in which the bank becomes the carrying broker for the affiliates or networking broker-dealers. *See* Exchange Act Section 3(a)(4)(B)(viii)(II) [15 U.S.C. 78c(a)(4)(B)(viii)(II)].

[52] Exchange Act Section 3(b) [15 U.S.C. 78c(b)].

[53] 15 U.S.C. 78c(a)(4)(B)(ii).

Effects transactions in a trustee or fiduciary capacity; (2) effects such transactions in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards; (3) is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing such securities transactions or any combination of such fees; and (4) does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.[54] A bank also must execute such transactions through a registered broker-dealer or in a cross trade.[55]

This exception recognizes the traditional role banks have played in effecting securities transactions for trust customers. These activities generally were inherent in a bank's trust operation itself, or arose as an accommodation to bank customers or through a traditional trust arrangement, rather than through promotion and public solicitation of bank brokerage services.[56] Congress expressed the expectation that we would not disturb traditional bank trust activities under this exception.[57] Congress, however, did not intend the trust exception to be used to conduct a securities brokerage operation in the bank trust department without the appropriate investor protections provided under the federal securities laws.[58] We believe that this legislative history indicates that the trust and fiduciary activities exception was designed not only to preserve these traditional securities-related bank trust activities but also to apply broker-dealer protections to securities activities outside those traditional lines. We have kept that intent in mind in interpreting this exception.

1. Trustee Capacity

The trust and fiduciary activities exception excepts banks that act in a ''trustee capacity'' or in a ''fiduciary capacity'' from the definition of broker.[59] Trustees typically are subject to the strongest of fiduciary duties to trust beneficiaries.

We have been asked, however, whether a bank that acts as a ''trustee'' in three specific situations involving securities accounts directed by others qualify for trust and fiduciary activities exception. This question arises because banks in these situations may not be subject to significant fiduciary responsibilities. These three situations are indenture trustees, Employee Retirement Security Act (''ERISA'') and other pension plan trustees, and Individual Retirement Account (''IRA'') trustees. In each of these situations, the person who assumes certain ministerial duties for tax, employee benefit, or trust indenture purposes is labeled a trustee, often under a federal statute, but does not actually assume a comprehensive set of fiduciary duties under either state or federal law.

a. Indenture Trustees. Under certain forms of trust indenture,[60] a bank acting as an indenture trustee may invest idle cash in shares of money market mutual funds or other securities.[61] Sometimes, the issuer of the bonds actually directs the investments. In this case, an indenture trustee might act as an order-taker at the direction of the bond issuer, within the investment parameters set forth in the indenture. However, an indenture trustee acts in a constrained order-taking capacity, because the indenture trustee is responsible for making sure that any investments it undertakes fall within the investment parameters of the trust indenture.

Indenture trustees are subject to the Trust Indenture Act of 1939 (''TIA'') when the corporate securities that underlie the indenture are sold to the public by use of the mails or in interstate commerce.[62] State law also may provide additional duties in circumstances where the TIA and federal common law are not controlling.[63] However, the courts, in expounding and construing the law regarding indenture trustees, have not always agreed on the type and nature of the duties of indenture trustees.[64]

b. ERISA And Other Similar Trustees. ERISA [65] Section 403(a) generally requires that ''all assets of an employee benefit plan shall be held in trust by one or more trustees,'' who are to be named in the trust instrument or appointed by a named fiduciary of the plan. [66] The term ''fiduciary,'' as defined under ERISA Section 3(21)(A),[67] provides that:

Except as otherwise provided in subparagraph (B),[68] a person is a fiduciary

[54] Exchange Act Sections 3(a)(4)(B)(ii)(I) and (II); [15 U.S.C. 78c(a)(4)(B)(ii)(I) and (II)].

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

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

[57] H.R. Conf. Rep. No. 106–434, pt. 3, 164 (1999).

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

[59] Exchange Act Section 3(a)(4)(B)(ii) [15 U.S.C. 3(a)(4)(B)(ii) excepts any bank * * * ''that effects transactions in a trustee capacity, or effects transactions in a fiduciary capacity. * * *'' Exchange Act Section 3(a)(4)(D)(i) [15 U.S.C. 78c(a)(4)(D)(i)] defines the term ''fiduciary capacity'' to mean ''* * * in the capacity as trustee.''

[60] The difficulties of issuing secured corporate debt to numerous bondholders gave rise to the need for indenture trustees. Since it would be wholly impractical to have the security run to the group of bondholders directly or to have a separate security instrument for each bondholder, a trustee exercises its powers and duties on behalf of the bondholders. *See* G. Bogert, TRUSTS AND TRUSTEES 250, pp. 254–55 (West 1977); *E.F. Hutton v. Union Planters National Bank,* 953 F.2d 963, 968 (5th Cir. 1992).

The need for an indenture trustee for issues of modern day unsecured corporate debentures also continues because the debt represented by the debenture is typically not secured by specific assets of the issuer and is frequently subordinated to senior indebtedness of the issuer. Thus, the corporate trustee is needed to protect the rights of the many holders of the debentures and to perform certain ministerial tasks connected with the normal operation of the debentures. Although the debts created by debentures run directly from the issuer to the holders, the contractual rights conferred by the indenture run from the issuer to the trustee for the benefit of the holders of the debentures. *E.F. Hutton,* 953 F.2d at 968.

[61] *See, e.g.,* Investment Company Act Rel. No. 15900, *Community Program Loan Trust No. 1987 A; Application,* 52 FR 28628 (Applicant represented that trust indenture agreement permitted indenture trustee to invest funds of indenture trust in certain eligible investments as described in the agreement).

[62] 15 U.S.C. 77aaa *et seq.* (1988).

[63] Martin D. Sklar, *The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?,* 106 Banking L.J. 42, 49 (1989).

[64] *See Meckel* v. *Continental Resources Co.,* 758 F.2d 811, 816 (2d Cir. 1985) and *Elliott Associates* v. *J. Henry Schroder Bank and Trust Co.,* 838 F. 2d 66, 71 (2d Cir. 1988), both of which held that indenture trustees have no duties above the specific obligations imposed in the indenture. *But see Dabney* v. *Chase National Bank,* 196 F.2d 668 (2d Cir. 1952), *appeal dismissed,* 346 U.S. 863, 74 S. Ct. 102, 103, 98 L. Ed. 374 (1953), where Judge Learned Hand, writing for the Second Circuit, reached a somewhat different conclusion when the indenture trustee was a creditor of the obligor, and the court found the indenture trustee liable for prematurely collecting a debt from the obligor. The bondholders sued the indenture trustee, alleging that it had forced the obligor into bankruptcy. Judge Hand stated that the duty of a trustee not to profit at the possible expense of his beneficiary is the most fundamental of the duties, which he accepts when he becomes a trustee. It is a part of his obligation to give his beneficiary his undivided loyalty, free from any conflicting personal interest; an obligation that has been nowhere more jealously and rigidly enforced than in New York where these indentures were executed. Judge Hand indicated that indenture trustees are not fiduciaries by saying: ''We can find no warrant for so supposing; and, indeed, a trust for the benefit of a numerous and changing body of bondholders appears to us to be preeminently an occasion for a scruple even greater than ordinary; for such beneficiaries often have too small a stake to follow the fate of their investment and protect their rights.'' *Id.* at 671.

[65] 29 U.S.C. 1001 *et seq.*

[66] 29 U.S.C. 1103(a).

[67] 29 U.S.C. 1105(c)(1)(A).

[68] Subparagraph (B) states that an investment company registered under the Investment Company Act of 1940, and the company's investment adviser or principal underwriter, are not deemed to be

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with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B).[69]

Under ERISA, a person performing any of the duties described in the definition of ''fiduciary'' would be considered a fiduciary.[70] A person is a fiduciary, however, only to the extent that he performs ''fiduciary'' functions.[71] For example, a person may be a fiduciary with respect to some plan assets but not others.[72]

While a trustee can be considered a plan fiduciary if the trustee has discretionary authority over the plan and its assets, depending on the structure of the particular retirement plan, the trustee may be subject to investment direction from the ''named fiduciary'' of the plan, investment managers, or plan participants.[73] Thus, the issue becomes whether an ERISA plan trustee who is subject to another person's investment direction is a fiduciary. Similar issues may arise regarding state and local government plans permitted under Section 457 of the Internal Revenue Code (''IRC'').[74] Although courts have disagreed regarding whether a trustee subject to investment direction is a fiduciary under ERISA,[75] the Department of Labor takes the position that a trustee of an ERISA plan is a fiduciary by the very nature of its position.[76]

c. IRA Trustees. An IRA[77] account can be created through a trust or custody agreement with a bank under the IRC.[78] Whichever type of agreement is used, an IRA account must be maintained at all times as a domestic trust in the United States.[79] The trustee's duties with respect to an account are generally ministerial in nature.[80] IRA trustees do not have discretion regarding the management of the IRA assets.[81]

Courts that have considered IRA trustees in other contexts generally, but not uniformly, have reached the conclusion that an IRA trust does not establish a fiduciary relationship and that an IRA should not be treated as a trust is treated under other law.[82] An IRA trustee does not actually assume a comprehensive set of fiduciary duties towards investors under either state or federal law.

d. Definitional Exemption Alleviates Uncertainty. The law is unclear as to whether banks acting in these three capacities should be covered by the trust and fiduciary activities exception because they are acting, at most, in a limited fiduciary capacity with regard to investors who direct their investments, despite their ''trustee'' label. To alleviate this legal uncertainty, we are providing an exemption for these trustees if they conduct their securities activities in accordance with all of the other terms of the exception for trustee activities, including being within a ''trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.''[83]

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fiduciaries or parties in interest to plans investing in the company's securities (except for in-house plans of such persons). ERISA Section 3(21)(B) [29 U.S.C. 1002(21)(B)].

[69] ERISA Section 405(c)(1)(B) [29 U.S.C. 1105(c)(1)(B)] describes the designation by named fiduciaries of other persons to carry out fiduciary responsibilities.

[70] *See, e.g., Olson* v. *E.F. Hutton and Co.,* 957 F.2d 622 (8th Cir. 1992) (ERISA applied to a broker-dealer).

[71] *See, e.g., Chicago Board Options Exchange* v. *Connecticut General Life,* 713 F.2d 254 (7th Cir. 1983).

[72] *See* Class Exemption for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers, 49 F.R. 9494, 9496 (1984).

[73] *See* Sections 403(a) and 404(c) of ERISA, 29 U.S.C. 1103(a) and 1104(c).

[74] 26 U.S.C. 457(b). Assets and deferred amounts of Section 457(b) plans can be held in trust, custodial accounts, or annuity contracts. 26 U.S.C. 457(g). However, custodial accounts and annuity contracts are treated as trusts, and regardless of how the assets and deferred amounts are held, they must be held for the exclusive benefit of participants and their beneficiaries for the plan. 26 U.S.C. 457(g)(1) and (3).

[75] *See, e.g, Bedall* v. *State Street Bank and Trust Co.,* 137 F.3d 12 (1st Cir. 1998) (bank, which held plan assets ''in trust'' but did not manage, administer, or conduct valuations of the assets, was not a fiduciary); *Maniace* v. *Commerce Bank of Kansas City, N.A.,* 40 F.3d 264 (8th Cir. 1994), *cert. denied,* 514 U.S. 1111 (1995) (bank trustee of an employee stock ownership plan was not a fiduciary under ERISA because it did not have real discretion over the plan's assets, and because the trust document explicitly limited the bank's discretion with respect to employer stock); *Donovan* v. *Cunningham,* 541 F. Supp. 276, 290 (S.D. Tex 1982), modified on other grounds, 716 F.2d 1455 (5th Cir. 1983), *cert. denied,* 476 U.S. 1251 (1984) (trustee, who was a ''directed trustee'' under ERISA Section 403(a)(1), was not liable for breach of fiduciary duties where its activities were confined to the ''limited role of directed trustee''); *Robbins* v. *First American Bank,* 514 F. Supp. 1183 (1981 N.D. Ill.) (bank was not a fiduciary when acting as directed trustee following instructions of a plan fiduciary, or is custodian of plan assets); *Bradshaw* v. *Jenkins,* 1984 WL 2405, Fed. Sec. L. Rep. P 99,719 (W.D.Wash. Mar. 9, 1984) (bank, which was a ''directed trustee,'' was a ''mere custodian of plan assets who follows the instructions of another fiduciary'').

[76] *See* 29 CFR 2509.75–8, D–3 (trustee is a fiduciary by the very nature of its position). If a bank trustee does not make any recommendations concerning the selection of particular investment company securities, but another plan fiduciary independently selects, from mutual fund families made available to the bank, particular funds to be made available for investment by plan participants, these duties will not arise if the bank gives notice to the plan sponsor before modifying the list of funds available for investment by plan participants. *See* Department of Labor (''DOL'') Advisory Opinion 97–16A (May 22, 1997) regarding Frost National Bank (''The Department points out that the act of limiting designative investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function, which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any particular direction of such plan.''); DOL Information Letter to Mark H. Sokolsky, WSB File No. DL0523 (Sept. 5, 1996) (a trustee subject to direction from a named fiduciary has ''residual'' fiduciary authority for determining whether the direction is proper and consistent with ERISA); *see also* 29 CFR 2550.404c–1(f)(8).

[77] *See* Section 408 of the Internal Revenue Code of 1986 [26 U.S.C. 408] and the regulations promulgated thereunder. 26 CFR 1.408–2.

[78] The IRC permits an IRA to be denominated as a ''trust'' or a ''custodial account.'' *See* 26 CFR 1.408–2(b) and (d). Other entities also may become the holder of custodial or trustee accounts for IRAs if they meet the requirements established by the Internal Revenue Service under the Department of the Treasury. 26 U.S.C. 408(h) and 26 CFR 408–2(e). For our purposes, this alternative qualification procedure is not relevant because banks, which are the focus of our analysis, are automatically qualified to undertake this role under the statute.

[79] *See* 26 CFR 1.408–2(b).

[80] The bank must file form ''5498 IRA Contribution Information'' on an annual basis. The bank also must file appropriate form ''1099–R Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.'' to reflect distributions from any IRA account.

[81] ERISA Section 403(a) establishes the general requirement that a plan trustee ''shall have exclusive authority and discretion to manage and control the assets of a plan.'' An exception to the general rule is when a trustee receives directions from a named plan fiduciary, that is, when it acts as a ''directed trustee.'' *See* ERISA Section 403(a)(1) for basis of ''directed trustee'' exception.

[82] For example, Texas courts have likened IRAs to safe deposit boxes where the bank administers the IRA, keeping records and compiling reports, and the IRA depositor decides what assets the IRA will contain. *See Colvin* v. *Alta Mesa Resources, Inc.,* 920 S.W. 2d 688 (Tex.App.''Houston 1996); *Lee* v. *Gutierrez,* 876 S.W. 2d 382 (Tex.App.''Austin 1994, writ denied). Other courts have reached similar conclusions. *See In re Houck, Eisenberg* v. *Houck,* 181 B.R. 187 (Bankr. E.D. Pa. April 19, 1995) (court found that an IRA was not a trust as that term was commonly used); *Estate of Davis* v. *Davis,* 171 Cal.App.3d 854, 217 Cal. Rptr. 734 (1985) (court found that an IRA was not an express trust because there was no intent to establish a trust; an IRA was a trust for the purpose of tax deferment only). *But see In re Gillett, Tavormina* v. *Merchants Bank of Miami,* 55 B.R. 675, 13 Bankr.Ct.Dec. 1101 (Bankr. S.D. Fla., Dec. 19, 1985).

[83] Because banks may act as trustees or custodians for IRAs, it is important to note that this exemption is available only when the bank acts as a trustee and meets all of the other conditions of the trustee exception. The trust and fiduciary activities exception does not apply to IRA custodians. However, as described below, we are using our exemptive authority to grant two conditional exemptions under the safekeeping and custody exception to permit banks to effect securities

Specifically, Rule 3b–17(k) defines the term ''trustee capacity'' in the trust and fiduciary activities exception to include trust indenture trustees and trustees for certain tax-deferred accounts.[84] By clarifying that ''trustee capacity,''[85] as set forth in the trustee and fiduciary activities exception, includes these types of trustees, banks will be able to continue to effect securities transactions for investors free from doubt regarding their broker-dealer status under the trust and fiduciary activities exception.[86]

We invite comment on the scope of the fiduciary responsibilities of indenture trustees, ERISA trustees, IRA trustees, and trustees for other pension plans. We also invite comment on the scope of the fiduciary responsibilities of indenture trustees that are not subject to the TIA. In addition, we invite comment on the circumstances under which, if any, indenture trustees, ERISA trustees, IRA trustees and trustees for other pension plans may disclaim fiduciary responsibilities, which fiduciary responsibilities they may or may not disclaim, and whether, in such circumstances, this definitional exemption is appropriate.

2. Fiduciary Capacity

The trust and fiduciary activities exception applies to banks acting in a trustee or fiduciary capacity to investors. The term fiduciary capacity is defined in Exchange Act Section 3(a)(4)(D), which identifies several alternative forms of fiduciary capacity. Banks may qualify as acting in a fiduciary capacity if they act as a ''trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minor act * * *''[87] Banks also may qualify as acting in a fiduciary capacity if they act as an investment adviser if the bank ''receives a fee for its investment advice'' or ''possess[es] investment discretion on behalf of another.''[88] Finally, banks may act in a fiduciary capacity if they act ''in any other similar capacity.''[89]

In general, we analyze the activities that a person is engaged in, as well as the label used, to determine whether a person is acting in a particular capacity. We take the same approach in considering whether a bank is acting as a fiduciary under the trust and fiduciary activities exception. As Justice Frankfurter stated in another context, ''to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?''[90] We understand that the exact nature of the fiduciary obligations differ depending on the type and nature of the fiduciary relationship between the customer and the bank.[91]

Congress intended that banks act in a ''strict trustee or fiduciary capacity''[92] that provides investors the protection of strong fiduciary principles if conducting securities activities without broker-dealer regulation under the trust and fiduciary activities exception. We address specific situations with respect to the term ''fiduciary capacity.''

a. *Transfer Agent.* One category included in the statutory definition of fiduciary capacity that requires special explanation is ''transfer agent.''[93] In considering the fiduciary capacity role of transfer agents for purposes of the trust and fiduciary activities exception, we must take into account the Exchange Act definition of transfer agent.[94] Under the Exchange Act, a transfer agent is generally any person who engages in certain activities ''on behalf of an issuer of securities or on behalf of itself as an issuer of securities. * * *'' This definition makes clear that the fiduciary relationship of acting as a transfer agent runs primarily to the issuer, and any

transactions as IRA custodians. Furthermore, the small bank custody exemption is available to trustees and fiduciaries that are acting as custodians. For example, the small bank custody exemption is available to small bank trustees that have custody of assets and are effecting transactions in investment company securities consistent with the terms of that exemption.

[84] We are providing this definitional exemption under our exemptive authority under Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1)]. Exchange Act Section 36(a)(1) allows us to grant exemptions from any provision of the Exchange Act or the Exchange Act's Rules, if an exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. *See also* Exchange Act Section 15(a)(2) [15 U.S.C. 78o(a)(2)], Exchange Act Section 15(a)(2) [15 U.S.C. 78o(a)(2)] allows us to grant exemptions from Exchange Act 15(a)(1) [15 U.S.C. 78o(a)(1)], which generally requires brokers and dealers to be registered if effecting transactions in securities, if the exemption is consistent with the public interest and the protection of investors.

[85] It is important to note that our definitional exemption regarding the term ''trustee capacity'' in Section 3(a)(4)(B)(ii) of the Act does not alter our view that Section 3(c)(3) of the Investment Company Act of 1940 [15 U.S.C. 80a–3(c)(3)] is unavailable to common trust funds holding IRA assets.

As amended by the GLBA, Section 3(c)(3) excludes from the definition of investment company:

''any common trust fund or similar trust fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian, if—

''(A) such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose;

''(B) except in connection with the ordinary advertising of the bank's fiduciary services, interests in such fund are not—

''(i) advertised; or

''(ii) offered for sale to the general public; and

''(C) fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable Federal or State law.''

The GLBA added paragraphs (A) through (C). These changes, among other things, codify our longstanding interpretation that the common trust fund exception is unavailable to common trust funds holding IRA assets because such assets are not held ''for a fiduciary purpose.'' *See* In re Commercial Bank and Marvin C. Abeene, Securities Act Rel. No. 7116, Investment Company Act Rel. No. 20757, Admin. Proc. File No. 3–8567, 58 SEC Dkt. 0487, 0491 (Dec. 6, 1994) (Order Instituting Public Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, Imposing Remedial Sanctions and Ordering Respondents to Cease and Desist). See also Santa Barbara Bank and Trust, SEC No-Action Letter (Nov. 1, 1991) (citing Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Before the Subcommittee On Telecommunications and Finance of the House Committee on Energy and Commerce (Oct. 4, 1990)); United Missouri Bank of Kansas City, N.A., SEC No-Action Letter (Dec. 31, 1981).

[86] This exception should not, however, be considered by banks in analyzing whether they are acting in a ''similar capacity'' as that term is used in the definition of ''fiduciary capacity.'' Exchange Act Section 3(a)(4)(D). *See also* discussion of ''similar capacity,'' *infra* at Part 3 of this section.

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

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

[89] Exchange Act Section 3(a)(4)(D)(iii) [15 U.S.C. 78c(a)(4)(D)(iii)].

[90] *SEC* v. *Chenery Corp.,* 318 U.S. 80, 85–86, 87 L. Ed. 626, 63 S. Ct. 454 (1943).

[91] *See* 1 Austin Wakeman Scott and William Franklin Fratcher, The Law of Trusts 8.1 (4th ed. 1987) (''When a bank * * * receives the position of securities or other property from a customer, its duties depend on what it undertakes to do.'').

[92] *See* H.R. Rep. No. 106–74, pt. 3, at 165 (1999) note 9 above, at 165 (''Because these activities will be conducted by banks acting in a strict trustee or fiduciary capacity, subject to Federal and State trust law, and rigorously and regularly examined by bank examiners, bank trust customers will be afforded some basic protections. This mitigates concerns that would otherwise exist because of the lack of Federal securities law protections for these customers. *Absent this protection, the exemption may be inappropriate.*'') (emphasis added).

[93] Exchange Act Section 3(a)(4)(B)(iv) [15 U.S.C. 78c(a)(4)(B)(iv)] also provides a separate exception for banks that effect transactions, as part of their transfer agent activities, in certain stock purchase plans.

[94] Exchange Act Section 3(a)(25) [15 U.S.C. 78c(a)(25)] provides that a transfer agent is:

''any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates. The term ''transfer agency'' does not include any insurance company or separate account which performs such functions solely with respect to variable annuity contracts or variable life policies which it issues or any registered clearing agency which performs such functions solely with respect to options contracts which it issues.''

fiduciary duties that a transfer agent may have to shareholders when carrying out transfer agent activities are the same as the issuer's duty to the shareholder.[95]

Taken together, the definitions of ''fiduciary capacity'' and ''transfer agent'' in the Exchange Act indicate that the trust and fiduciary activities exception in Exchange Act Section 3(a)(4)(B)(ii) does not extend to securities activities that a bank transfer agent conducts with the shareholders of an issuer that resemble those of a broker-dealer. If a bank that is registered as a transfer agent engages in transfer agent activities for shareholders on behalf of the issuer of the type that are specified in the Exchange Act's definition of transfer agent and other similar activities, the bank may rely on the trust and fiduciary activities exception for those particular activities. Other securities activities would not be covered by the fiduciary responsibilities owed to the shareholder that are contemplated under the exception.[96] Accordingly, unless another exemption was available,[97] broker-dealer registration would be required for bank transfer agents that also effected securities transactions for investors.

We request comment on any fiduciary role of transfer agents. We also request comment on any fiduciary responsibilities owed directly to the shareholders.

b. Investment Adviser If The Bank Receives A Fee For Its Investment Advice. As further described below, if a bank provides its customer with investment advice for a fee for an account, even though the customer is free to accept or reject the bank's advice, the bank may rely on the trust and fiduciary activities exception. In this situation, the bank would be acting as ''an investment adviser if the bank receives a fee for its investment advice,'' as described in the definition of fiduciary capacity.[98] For the reasons stated below, Rule 3b–17(d) defines the term ''investment adviser if the bank receives a fee for its investment advice'' to mean a relationship between the bank and a customer in which the bank: (1) provides, in return for a fee, continuous and regular investment advice to a customer's account that is based upon the individual needs of the customer; and (2) under state law, federal law, contract, or customer agreement owes a duty of loyalty, including an affirmative duty to make full and fair disclosure to the customer of all material facts relating to conflicts.

i. Continuous And Regular Investment Advice. Banks act in an advisory capacity to varying degrees in non-discretionary accounts. It may be difficult to determine whether a bank that provides some investment advice to a non-discretionary account falls within the fiduciary capacity category of an investment adviser that receives a fee for its advice. Accordingly, we are providing guidance to aid banks in determining which advisory relationships to non-discretionary accounts are covered by the fiduciary category of ''investment adviser if the bank receives a fee for its investment advice.''

Congress did not intend the trust and fiduciary activities exception to allow a bank to administer an account offering primarily brokerage without the investor protections of the federal securities laws.[99] At its narrowest, a brokerage relationship comes into existence when ''the order has been placed and the broker has consented to execute it'' and ''ends when the transaction is complete.''[100] Accordingly, where the responsibilities of a bank to its customer arise only when the customer places an order for his account, and terminate once the transaction is complete,[101] that account has the indicia of a brokerage account that the federal securities laws are designed to regulate. The bank's activities, therefore, would not fall within the trust and fiduciary activities exception. We reach the same conclusion even if the bank provides incidental, ancillary investment advice to the account. Because full-service broker-dealers frequently also give incidental, ancillary investment advice,[102] such an account would still have the indicia of a brokerage account, and thus, the fees paid would be primarily for brokerage services, not for advice.

Accordingly, Rule 3b–17(c) provides that a bank providing only non-discretionary investment advice must provide the customer's account with ''continuous and regular investment advice * * * that is based on the individual needs of the customer'' in order for the bank to fall within the definition of an ''investment adviser if the bank receives a fee for its investment advice.'' Rule 3b–17(e) neither purports nor attempts to provide a comprehensive definition of ''investment advice'' or of the types of investment advice banks may offer their customers. The rule identifies the circumstances where the bank's non-discretionary advisory services to a customer's account for a fee are sufficiently substantial that any brokerage services provided for that fee are merely ancillary to the advice. To state it another way, the rule identifies the circumstances where the fees paid by the account may be viewed properly as for investment advice, rather than for brokerage, when the bank provides both investment advice and brokerage to the account. The rule thus gives effect to Congress' intent, as discussed earlier,

[95] *See generally* Uniform Commercial Code Section 8–407 (transfer agent performing transfer agent functions has the same obligation, with regard to those functions, as the issuer has with those functions). *See also Caleb and Co.* v. *E.I. DuPont de Nemours and Co.,* 599 F. Supp. 1468, 1475 (S.D.N.Y. 1984) (transfer agent acting within scope of agency, if found to have acted detrimentally to alter the rights of shareholders, would be held to fiduciary standards with respect to shareholders).

[96] Legal authorities have generally found that transfer agents who have acted outside the scope of usual transfer agent activities are more than transfer agents and therefore, owe shareholders more extensive fiduciary duties under the federal securities laws. *See Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151–52 (1972) (if bank employees claiming to be acting as transfer agents had performed purely transfer agent functions, instead of acting as market makers for stock, they would not have expanded their liability under the federal securities laws); *see also Goldman* v. *McMahan, Brafman, Morgan and Co.,* 1987 WL 12820, *22 (S.D.N.Y. June 18, 1987) (citing *Affiliated Ute Citizens* to support holding that defendant acted as more than a transfer agent by actively engaging in activity to create fraudulent trading losses, thereby expanding its fiduciary duties beyond the scope of the transfer agency to plaintiff).

[97] Banks have a separate exception for transactions effected ''as part of [their] transfer agency activities'' in the securities of an issuer as part of certain stock purchase plans of the issuer. Exchange Act Section 3(a)(4)(B)(iv) [15 U.S.C. 78c(a)(4)(B)(iv)].

[98] Exchange Act Section 3(a)(4)(D)(i).

[99] *See* H.R. Rep. No. 106–74, pt. 3, at 164 (1999).

[100] *Robinson* v. *Merrill Lynch, Pierce, Fenner and Smith, Inc.,* 337 F. Supp. 107, 111 (N.D. Ala. 11971), aff'd, 453 F.2d 417 (5th Cir.1972); *see also E.F. Hutton and Company, Inc.,* 49 S.E.C. 829, 832 n.9 (1988) (citing *Robinson* v. *Merrill Lynch, Pierce, Fenner and Smith, Inc.* as support for conclusion that broker-dealer became customer's agent for the purpose of executing a limit order). The decision in *E.F. Hutton and Company, Inc.,* also known as the Manning Decision after the name of the customer, became the genesis for the NASD's Limit Order Protection Rule, IM–2110–2, which prohibits any member from trading at the same price as, or at a better price than, a customer limit order that it holds.

[101] *See Certain Broker-Dealers Deemed Not To Be Investment Advisers,* Exchange Act Rel. No. 42099, Investment Advisers Act Rel. No. 1845 (Nov. 4, 1999) (notice of proposed rulemaking); *see also Merrill Lynch, Pierce, Fenner and Smith, Inc.* v. *Cheng,* 697 F. Supp. 1224, 1226–27 (D.D.C. 1988) (finding that fiduciary relationship between stockbroker and customer holding a non-discretionary account limited to time between placement of order and subsequent purchase).

[102] *See Certain Broker-Dealers Deemed Not To Be Investment Advisers,* Exchange Act Rel. No. 42099, Investment Advisers Act Rel. No. 1845 (Nov. 4, 1999) (proposing to codify the position that the Advisers Act applies only to those customers to whom the broker-dealer provides advice that is not incidental to brokerage services); *see also De Kwiatkowski* v. *Bear Stearns and Co., Inc.,* 126 F. Supp. 2d 672 (S.D.N.Y. 2000) (finding that broker-dealer acted as investment adviser when broker-dealer gave continuous investment advice that went beyond ancillary matters).

that a bank not be permitted to offer what is essentially a brokerage account absent the investor protections of the federal securities laws.[103]

A bank will provide ''continuous and regular'' investment advice under Rule 3b–17(e) if the bank has ongoing (as opposed to episodic or periodic) responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the customer may purchase or sell. We adopted this same standard under Section 203A(a)(2) of the Investment Advisers Act (''Advisers Act''), which uses ''continuous and regular'' to determine which advisers have $25 million or more of ''assets under management'' and thus are eligible for Commission registration.[104] Congress added this provision to the Advisers Act in 1996, as part of the National Securities Markets Improvement Act (''NSMIA'').[105]

In developing the Commission's rules to implement NSMIA, we faced the question of when are non-discretionary advisory services significant and ongoing enough to constitute ''assets under management.'' Albeit with different import, we face a similar question here '' namely, when are the bank's non-discretionary advisory services significant enough that the fee paid ''for advice'' is for an ongoing advisory relationship with the customer account rather than a brokerage relationship. In both cases, we look to the actual nature of the underlying advisory services that the adviser, or bank, provides and to the duties and responsibilities that the adviser, or bank, accepts.[106]

If a bank provides continuous and regular guidance for a fee to a non-discretionary account based on the individual needs of that account, the bank would fit the definition of ''investment adviser if the bank receives a fee for its investment advice,'' even if a customer makes self-directed trades in the account independent of the bank's advice. Accordingly, we would consider the bank to be acting in a fiduciary capacity for purposes of the trust and fiduciary activities exception.[107]

If, however, the bank provides brokerage and ancillary, incidental advice in return for a fee to a self-directed non-discretionary account, such advice would not meet the continuous and regular standard, and the fee would be viewed as payment for brokerage, rather than payment for the advice. For instance, if the bank provides only impersonal advice, such as market newsletters, or provides advice only on an intermittent or periodic basis upon the request of the client or in response to some market event, the bank would not be giving continuous and regular investment advice.[108] Also, if a bank offers a certain number of trades for a set fee for an ''advisory'' account without providing continuous and regular advisory services, we would not consider the account to fall within the trust and fiduciary activities exception. Such an account is more similar to a brokerage account described above than the type of fiduciary account covered under the trust and fiduciary activities exception.

Customer agreements outlining an account holder's relationship with a bank will be instructive in distinguishing those non-discretionary accounts for which banks provide continuous and regular investment advice from those for which they provide little investment advice. The nature of the bank's advice and the nature of the trading in the account also will be relevant to the analysis.

ii. Full And Fair Disclosure. Investment advisers historically have been considered to be fiduciaries with corresponding duties.[109] If a bank acts in the capacity of an investment adviser and receives a fee for its advice, the bank will perforce be subject to an investment adviser's duties. The Supreme Court has stated that the most important duty an investment adviser has is a duty of loyalty.[110] This includes an affirmative duty to make full and fair disclosure of material facts, thereby eliminating, or at least exposing, conflicts of interest.[111] Therefore, the investment adviser must act with ''utmost good faith'' and ''solely'' in the best interests of the client.[112] By disclosing all of its potential conflicts of interest to a client, the investment adviser enables the client to make an informed decision of whether to enter into or continue in an advisory relationship with the adviser or whether to take some action to protect himself against the specific conflict of interest involved.[113] The definition of ''investment adviser if the bank receives a fee for its investment advice'' in Rule 3b–17(c) acknowledges the importance of this duty by providing that banks giving investment advice for a fee must owe a duty of loyalty that includes making full and fair disclosure to their clients. We find that this definition is

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

[104] Investment Advisers Act Release No. 1633, Rules Implementing Amendments to the Investment Advisers Act of 1940 (May 15, 1997) [62 FR 33008 (May 22, 1997)] (adopting release).

[105] The amendment was part of the Investment Advisers Supervision Coordination Act, which was Title III of NSMIA. Pub. L. 104–290, 110 Stat. 3416 (1996). The Coordination Act effected several amendments to the Advisers Act, and the most significant of these was to divide responsibility for regulating investment advisers between the Commission and the securities administrators of the several states. Following NSMIA, the Commission regulates advisers that have at least $25 million in ''assets under management'' and the states regulate advisers with assets under management under $25 million. Congress defined ''assets under management'' to mean the ''securities portfolios with respect to which an investment adviser provides continuous and regular supervisory or management services.'' [15 U.S.C. 80b–3a].

[106] See Investment Advisers Act Rel. No. 1601, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (December 20, 1996) (proposing release) (''Whether an adviser that does not have discretionary authority will be considered to provide continuous and regular management or supervisory services with respect to an account would depend upon the nature of the adviser's responsibilities. The greater the amount of day-to-day responsibility an adviser has, the more likely the adviser would be providing continuous and regular supervisory or management service.''); *see also* Item 2 of Part 1A of Form ADV.

[107] This approach is consistent with the OCC's view on a bank receiving a fee for providing investment advice. In describing its definition of ''fiduciary capacity,'' upon which the GLBA's definition of fiduciary capacity is based, the OCC indicated that, if the bank received a fee from the customer for investment advisory activities (regardless of whether or not the customer followed the advice) the account would be brought under the fiduciary umbrella because ''the customer has a reasonable expectation of receiving advice that is free of conflicts of interest.'' Final Rule; Fiduciary Activities of National Banks; Rules of Practice and Procedure, 61 FR 68543, 68545 (Dec. 30, 1996) (codified at 12 CFR 9.2(e)). However, if a customer is paying a minimal fee for ancillary investment advice, there is very little, if anything, the fiduciary umbrella is covering that can be protected by the fiduciary principles that are replacing the investor protection provided under the federal securities laws.

[108] These examples are taken, in part, from examples we have previously given to provide guidance on what accounts receive continuous and regular supervisory or management services and what accounts do not. *See* Item 2 of Part 1A of Form ADV. We have included only those examples that involve the giving of advice and do not involve providing management services.

[109] *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 187 (1963) (recognizing that investment advisers have historically been considered fiduciaries).

[110] *Id.* at 191–92, 194.

[111] *Id.* at 192–92, 194.

[112] *Id.* at 191–92, 194; *see also Laird* v. *Integrated Resources, Inc.,* 897 F.2d 826, 834 (5th Cir. 1990) (citing *Capital Gains* for proposition that an investment adviser has a fiduciary duty of utmost good faith and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients); *SEC* v. *Blavin,* 760 F.2d 706, 711–12 (6th Cir. 1985) (same).

[113] *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services,* Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987), 52 FR 38400 (Oct. 16, 1987).

consistent with the provisions of the Exchange Act.[114]

We invite comments on all aspects of this definition. Commenters also are encouraged to suggest alternative ways to evaluate whether a bank meets the definition of ''investment adviser if the bank receives a fee for its investment advice.''

3. Other Similar Capacity

The definition of fiduciary capacity also provides that a bank may qualify for the trust and fiduciary activities exception if it acts ''in any other similar capacity'' to the fiduciary relationships already described in the definition.[115] We have identified from uniform acts and codes several capacities that are not expressly set forth in the definition of fiduciary capacity that we believe are similar to the fiduciary capacities that are covered by the trust and fiduciary activities exception.[116]

For example, the Uniform Probate Code, which has been adopted in 18 states,[117] uses the term ''Personal Representative'' and similar successor titles in place of executor or administrator as the representative of a decedent. Under the Uniform Custodial Trust Act, which has been adopted in 14 states,[118] the terms that are used for fiduciaries who act for persons who have become incapacitated include ''Conservator'' and ''Custodial trustee.'' A bank would be eligible to act in any of these capacities under these uniform acts.

Exchange Act Section 3(a)(4)(D)(i) references only the capacity of a ''custodian under a uniform gift to minor act.'' In contrast, the Uniform Transfers to Minors Act, which has been adopted in 49 States and the District of Columbia,[119] uses both the terms ''Conservator'' and ''Custodian'' for fiduciaries that act for minors.[120] A bank would be eligible to act in either or both of these capacities for a minor under this uniform act.

We consider banks that act as fiduciaries in these representative capacities are acting in similar fiduciary capacities for purposes of the trust and fiduciary activities exception, provided that the other requirements of that exception are met. We invite comment on whether there are additional roles, functions, or relationships of banks that should be considered as being an ''other similar capacity'' for purposes of this exception.

As noted above, courts have raised serious questions regarding whether indenture trustees and trustees for tax-deferred accounts are fiduciaries. Thus, although we have provided legal certainty to permit them to operate within the exception, we do not believe that banks operating in a similar capacity to such exempted entities are necessarily acting in a fiduciary capacity. For example, an IRA custodian is virtually indistinguishable from an IRA trustee, but does not take on the ''trustee'' label. Thus, it is not eligible for the definitional exemption in Rule 3b–17(k).

4. Other Department That Is Regularly Examined By Bank Examiners For Compliance With Fiduciary Principles And Standards

To protect investors, Congress specifically required that the activities conducted by banks under the trust and fiduciary activities exception be ''rigorously and regularly examined by bank examiners.''[121] Because Congress believed that the ''examinations of bank trust departments are today rigorous in nature,'' these examinations would provide customers with ''some basic protections'' to mitigate the lack of federal securities law protections.[122]

While the bank trust department is the traditional center of bank fiduciary services, the trust and fiduciary activities exception recognizes that banks may effect transactions in a fiduciary capacity in bank departments other than the trust department, as long as those departments are ''regularly examined by bank examiners for compliance with fiduciary principles and standards.'' This condition is key in affording investors some protection when banks conduct activities under this exception.

Some banks place all of their fiduciary activities in the trust department, while others conduct them in different bank departments depending on the nature of the fiduciary service. As a result, the number and type of banking departments that are regularly examined by bank examiners for compliance with fiduciary principles and standards could easily vary from bank to bank. Because of this variance, we intend to rely primarily on the bank regulatory agencies in determining whether the activities are conducted in an area subject to examination by fiduciary examiners and examined on a regular basis.[123]

We also note that for a bank to be effecting securities transactions in compliance with the trust and fiduciary activities exception, the bank needs to ensure that all aspects of its role in effecting those transactions are conducted in a part of the bank that is regularly examined by bank examiners for compliance with fiduciary principles and standards. Effecting transactions in securities includes more than just executing trades or forwarding securities orders to a broker-dealer for execution. Generally, effecting securities transactions can include participating in the transactions through the following activities: (1) Identifying potential purchasers of securities; (2) screening potential participants in a transaction for creditworthiness; (3) soliciting securities transactions;[124] (4) routing or

[114] Exchange Act Section 3(b) [15 U.S.C. 78c(b)].

[115] Exchange Act Section 3(a)(4)(D)(iii) [15 U.S.C. 78c(a)(4)(D)(iii)].

[116] The National Conference of Commissioners of Uniform State Laws has worked for the uniformity of state laws since 1892. Today the Conference is recognized primarily for its work in securities law, commercial law, family law, probate and estates, law of business organizations, health law, and conflicts of law. *See* The National Conference of Commissioners of Uniform State Laws website at http://www.nccusl.org/uniformact_factsheets/uniformacts-fs-upc.htm.

[117] *Id.*

[118] *Id.*

[119] *Id.*

[120] The Uniform Transfers to Minors Act was developed in 1983, amended in 1986 and supersedes the Uniform Gifts to Minor Act (1956, amended 1965 and 1966), which was perceived to be inadequate to address all of the issues inherent in this area of the law. *See* The National Conference of Commissioners of Uniform State Laws, *Summary, Uniform Transfer to Minors Act,* available at http://www.nccusl.org/uniformact_summaries/uniformacts-s-uttma.htm.

[121] H.R. Rep. No. 106–74, pt. 3, at 165 (1999).

[122] *Id.* at 164–65.

[123] We note the use by the federal financial institutions' regulators of the Uniform Interagency Trust Rating System (''UITRS'') in evaluating financial institutions' fiduciary activities. In 1999, there were 3,034 banks and trust companies (both insured and uninsured) that were subject to reporting requirements of the Federal Financial Institutions Examinations Council regarding their trust assets. *See* http://www2.fdic.gov/structur/trust/99trustdata.html.

[124] Solicitation is one of the most relevant factors in determining whether a person is effecting transactions. *See, e.g., SEC* v. *Century Investment Transfer Corp.,* [1971–72 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,232 (S.D.N.Y. 1971) at 91,441–3 (entity acted as a broker by soliciting customers for securities transactions, among other things); *SEC* v. *National Executive Planners,* 503 F. Supp. 1066, 1073 (M.D.N.C. 1980) (where entity solicited clients actively and sold $4.3 million worth of securities, ''[c]learly, [the entity] was a broker-dealer as defined in the 1934 Act''); *see also* 15 David A. Lipton, *Broker-Dealer Regulation,* at 1.04[3][a] (1998) (''Solicitation is considered a badge of securities activity that would bring a person within the definition of broker''). As we have previously stated, ''no amount of disclosure in a prospectus can be effective to protect investors unless the securities are sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells.'' *See Persons Not Deemed To Be Brokers,* Exchange Act Rel. No. 20943, 49 FR 20512 (May 15, 1984). Solicitation includes any affirmative effort intended to induce transactional business for a broker-dealer and encompasses such activities as advertising and providing investment advice or recommendations intended to induce transactions that benefit or

matching orders, or facilitating the execution of a securities transaction; (5) handling customer funds and securities;[125] and (6) preparing and sending transaction confirmations (other than on behalf of a broker-dealer that executes the trades).[126] In other words, for purposes of qualifying for the trust and fiduciary activities exception, the bank must make sure that all of the key points in a transaction that it participates in are in a part of the bank that meets the examination conditions of the exception.

We invite comment on this discussion of this prong of the trust and fiduciary activities exception. We particularly invite commenters to provide information on the location within banks of activities related to effecting securities transactions in a trust or fiduciary capacity.

5. Chiefly Compensated

To qualify for the trust and fiduciary activities exception from the definition of broker, banks must meet certain compensation limits for transactions effected in a fiduciary capacity. First, banks must be ''chiefly compensated * * * on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers, or any combination of such fees.''[127] Second, this revenue must be consistent with fiduciary principles and standards.[128]

The first question that must be addressed, then, is how to determine when a bank is ''chiefly'' compensated. The term ''chiefly'' has not been previously defined in the federal securities or banking laws. In choosing the term, Congress not only expected us to interpret it, Congress also expected that our interpretation would limit a bank's ability to receive incentive compensation or similar compensation that could foster a ''salesman's stake'' in promoting a securities transaction.[129] In framing our definition of the term ''chiefly compensated,'' we have sought to apply the purposes of the GLBA so that the broker-dealer requirements of the federal securities laws apply to situations that could foster a salesman's stake in promoting securities transactions.[130] This definition is discussed below.

a. Account-By-Account Calculations. Determining when a bank is ''chiefly compensated'' requires, ultimately, a comparison of the different types of compensation that a bank receives. We considered several alternatives, but believe that the calculation to determine whether a bank is chiefly compensated by the statutorily enumerated fees should be done on an account-by-account basis. In our view, this calculation is consistent with assuring the protection of each investor and with determinations that trustees must make under state trust law.[131] Moreover, fiduciaries often use fee schedules, which should provide a basis to make an account level calculation of compensation.

We considered, alternatively, whether this calculation should be made on a transaction-by-transaction or customer-by-customer basis. We concluded, however, that these methods would be unnecessarily burdensome for banks, without providing significantly more protection for investors. We also considered whether the ''chiefly compensated'' calculation should be made across a bank's entire fiduciary department or on a business line basis. While a department or business line approach would provide administrative convenience to banks, we believe that adopting this approach as a guiding principle is inconsistent with the wording of the statute, which reads ''chiefly compensated *for such transactions.*'' (emphasis added). In referring to ''such transactions,'' the statute focuses on the compensation at the level at which the transactions occurred, which is the account level, and focuses on protection of investors making such transactions. Making the ''chiefly compensated'' calculation at the department or business line level would potentially allow a bank to primarily engage in a brokerage relationship, without investor protection, with a large number of customers if the compensation from the statutorily enumerated fees across the department or business line exceeded that from brokerage. Moreover, a department or line of business is difficult to define because lines of business vary from institution to institution.

Nonetheless, as discussed below, for administrative simplicity, we are adopting Rule 3a4–2, which provides an exemption to permit banks to compute compensation on the basis of their total fiduciary activities if sales compensation is less than 10% of relationship compensation for these total fiduciary activities.[132] To rely on this exemption, however, banks must have in place procedures that are reasonably designed to ensure compliance at certain key times in the life of the account with the condition that they be ''chiefly compensated'' by relationship compensation.

We believe this exemption reduces costs for many banks by avoiding account level calculations where most accounts are likely to satisfy the ''chiefly'' standard. This exemption also balances Congress's intent that brokerage relationships be administered in a broker-dealer with its desire that we not disturb traditional trust activities. Accordingly, we find that this exemption is necessary or appropriate in the public interest and is consistent with the protection of investors.[133]

b. Annual Computation. The account-by-account ''chiefly'' calculation should be conducted on a yearly basis. We

involve the solicitor. *See SEC* v. *Margolin,* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,025 (S.D.N.Y. 1992) at 94,517 (person acted as a broker by, among other things, advertising for clients); *see also* Letters re: *Attkisson, Carter and Akers* (June 17, 1998) (among other things, the person seeking relief from Section 15(a) of the Exchange Act would neither recommend nor endorse specific investments); *Charles Schwab and Co., Inc.* (Nov. 27, 1996) (same).

[125] *See, e.g.,* 15 David A. Lipton, *Id.* at 1.04[3] (having custody or control over the funds and securities of others is a badge of being a broker-dealer); *SEC* v. *Margolin,* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,025 (S.D.N.Y. 1992) (defendant was ''engaged in the business'' because he provided clearing services for the securities trading of his clients; other evidence of brokerage activity included receiving transaction-based compensation, advertising for clients, and possessing client funds and securities). However, where banks customarily hold securities for customers in accounts in other parts of the bank, these funds and securities may be accessed as part of a transaction covered by the trust and fiduciary exception.

[126] *See* 15 David A. Lipton, *Broker-Dealer Regulation, supra* note 124 at 1.04[3].

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

[128] *Id.*

[129] H.R. Rep. No. 106–74, pt. 3, at 164 (1999) (''The Commission is expected to interpret * * * the reference[ ] to 'chiefly' * * * so as to limit a bank's ability to receive incentive compensation or similar compensation that could foster a 'salesman's stake' in promoting a securities transaction.'').

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

[131] Generally, trust instruments and state trust laws allow trustee compensation on an account basis that is ''reasonable'' and ''not excessive.'' 1 Scott, *supra* note 91, Section 242 at 275. Moreover, we note that courts consider the cost of performing trustee services in determining the reasonableness of trustee compensation. *See, e.g., In re Powell,* 411 P.2d 162 (Wash. 1966) (stating that the ''universal'' standards needed to determine trustee compensation are: (1) The amount of risk and responsibility involved, (2) the time actually required of the trustee in the performance of the trust, (3) the size of the estate, (4) the amount of income received, and (5) the manual and overall services performed).

[132] We chose 10% as a threshold because we understand that many banks would fit within this exemption using that threshold.

[133] Exchange Act Sections 15(a)(2), 23(a)(1), and 36(a)(1) [15 U.S.C. 78o(a)(2), 78w(a)(1), and 78mm(a)(1)].

considered calculations on a more frequent basis, such as quarterly, but concluded that annual calculations would achieve the purposes of the provision with lower burdens for banks. The definition of ''chiefly compensated'' incorporates this concept by allowing banks to use a calendar year or other fiscal year consistently used by the bank for recordkeeping and reporting purposes.

c. A Flat Or Capped Per Order Processing Fee. A bank may count as one of its statutorily enumerated sources of compensation ''a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers.'' [134] New Rule 3b–17(b) defines this term as a fee that is no more than the amount a broker-dealer charged the bank for executing the transaction, plus the costs of any resources of the bank that are solely dedicated to transaction execution, comparison, and settlement for trust and fiduciary customers. Per transaction charges are a hallmark of a brokerage relationship, and Congress explicitly limited a bank trust department to cost recovery for these charges.[135]

These dedicated resources would include the salary of a bank trust department employee whose sole responsibility is working on a trading desk that is exclusively dedicated to executing and comparing trades for trust or fiduciary customers. These dedicated resources would also include information technology resources exclusively related to trade execution, comparison, and settlement for trust or fiduciary customers, such as trade execution and comparison software that links a bank trust department trading desk with broker-dealers.

In contrast, these dedicated resources would not include the cost of an employee's incentive based compensation related to the number, size, or value of trades executed. Such incentive payments typically do not reflect costs incurred to execute trades, but rather are inducements to encourage trades. These dedicated resources also would not include the cost of shared resources, general overhead allocation, or a return on capital.

If a per order processing fee exceeds the broker-dealer charges and the costs of dedicated resources, that entire fee would be excluded from the ''per order processing fee'' source of revenue. We also believe that brokerage commissions paid to execute trust and fiduciary transactions would not fall within the ''flat or capped per order processing fee'' definition if they result in cash rebates or soft dollar benefits to the bank other than for brokerage, research, or expenses covered by this definition.[136] Soft dollar benefits are, on their face, more than the cost of executing a trade.[137] However, commissions resulting in payments for general research and brokerage expenses of the trust department that are strictly within the safe harbor of Exchange Act Section 28(e) would not need to be deducted from the costs that are permitted to be passed through to customers.[138]

We note that, consistent with fiduciary principles and standards, banks may send trades to be executed by affiliated broker-dealers under the trust and fiduciary activities exception. However, banking regulators have recognized that sending trust customer trades to an affiliated broker-dealer raises issues regarding the bank's fiduciary obligation to its trust customers.[139] In addition, we note that fees charged to fiduciary accounts, including brokerage commissions, must be consistent with fiduciary principles. We intend to rely primarily on the banking regulators' supervision of whether these fees are in fact consistent with fiduciary principles.

d. ''Relationship Compensation,'' ''Sales Compensation,'' And ''Unrelated Compensation''. To calculate whether banks are ''chiefly compensated'' for effecting transactions in a manner consistent with the terms of the trust and fiduciary activities exception, we compare two categories of bank compensation related to transactions, which we call ''sales'' compensation and ''relationship'' compensation. ''Relationship'' compensation, which is based on the statutorily enumerated sources of compensation, must exceed ''sales'' compensation for the account to be ''chiefly compensated.'' We exclude other compensation not related to transactions in making the ''chiefly compensated'' calculation.[140]

i. Relationship Compensation. We have defined the term ''relationship compensation'' in Rule 3b–17(i) to include the eligible statutory fees, which are generally charged based on an account relationship. As defined in the rule, relationship compensation must be received directly from the customer or beneficiary, or directly from the assets of the trust or fiduciary account. An annual or administrative account fee, or an account fee that is based on a percentage of assets under management, received from these sources would be relationship compensation. We interpret a percentage of assets under management fee as a fee for the bank's managing or otherwise caring for the assets of a trust or fiduciary account. Assets under management fees would not include payments from other persons, such as investment companies, that are based on the amount of assets maintained by the bank's trust and fiduciary accounts with those other persons. We believe this interpretation is consistent with the intent of the trust and fiduciary activities exception.[141] In addition, relationship compensation would include a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities

[134] Exchange Act Section 3(a)(4)(B)(ii)(I) [15 U.S.C. 78c(a)(4)(B)(ii)(I)].

[135] We find that this definition is consistent with the provisions and purposes of the Exchange Act. *See* Exchange Act Section 3(b) [15 U.S.C. 78c(b)]; *see also* Exchange Act Section 23(a)(1) [15 U.S.C. 78w(a)(1)].

[136] The soft dollar safe harbor only applies to persons who exercise ''investment discretion with respect to an account.'' Exchange Act Section 28(e)(1) [15 U.S.C. 78bb(e)(1)]. The term ''investment discretion'' is defined in Exchange Act Section 3(a)(35) [15 U.S.C. 78c(a)(35)].

[137] Soft dollar arrangements are understood generally as arrangements under which products, services, or other economic benefits, other than the execution of securities transactions, are obtained by a money manager in exchange for the direction by the money manager of client brokerage transactions to a broker-dealer. Investment Advisers Act Rel. No. 1469, 60 FR 9750 (Feb. 21, 1995).

[138] We also note that bank trust departments that accept soft dollar payments for expenses other than brokerage and research do not fit within the Section 28(e) safe harbor. ''Brokerage and research services'' are defined in Section 28(e)(3) of the Exchange Act as: (1) Furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; (2) furnishing analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or (3) effecting securities transactions and performing functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith by rules of the Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant. Exchange Act Section 28(e)(3) [15 U.S.C. 78bb(e)(3)].

[139] The OCC has stated, for example, that the general rule followed by it is that national banks could only effect securities transactions through an affiliated discount broker-dealer if the transactions are performed on a non-profit basis. *See* OCC Trust Banking Circular 23 (Oct. 4, 1983). The OCC subsequently stated that ''[t]o the extent that TBC–23, ''Policy of the OCC with Respect to Trust Department Purchase of Securities Through Affiliated Discount Brokerage Companies,'' (Oct. 4, 1983) permitted affiliated brokerage transactions on a nonprofit basis, that policy is no longer in effect.'' *See* OCC Trust Interpretive Letter No. 273 (Sept. 23, 1992).

[140] We find that this definition is consistent with the provisions and purposes of the Exchange Act. *See* Exchange Act Section 3(b) [15 U.S.C. 78c(b)]; *see also* Exchange Act Section 23(a)(1) [15 U.S.C. 78w(a)(1)].

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

transactions for trustee and fiduciary customers.

ii. Sales Compensation. We also define the term ''sales compensation'' in Rule 3b–17(j) for purposes of determining whether a bank is ''chiefly compensated.''[142] Sales compensation includes: (1) A fee for effecting a transaction in securities that is not a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers; (2) compensation that if paid to a broker or dealer would be payment for order flow;[143] (3) a fee received in connection with a securities transaction or account, except for those finders' fees received pursuant to the networking exception in Exchange Act Section 3(a)(4)(B)(i);[144] (4) fees paid for an offering of securities that are not received directly from a customer or beneficiary, or directly from the assets of the trust or fiduciary account; (5) fees paid pursuant to a Rule 12b–1 plan under the Investment Company Act of 1940 (''Investment Company Act'');[145] and (6) ''service fees'' paid by an investment company for personal service or the maintenance of shareholder accounts.[146]

We understand that some banks acting as trustees or fiduciaries may charge customers an annual or asset-based fee that includes a specified number of securities transactions, or even unlimited trading on an irregular and occasional basis. If a bank charges an annual fee for effecting a certain number of securities transactions, this fee should be scrutinized to determine whether the fee is for transactions or fiduciary services. We believe that this approach is consistent with the statutory intent to separate compensation giving rise to sales incentives from non-sales oriented compensation. For example, if the bank effects transactions in a trustee or other fiduciary capacity where the bank is exercising investment discretion, in addition to offering trades for the annual fee, we believe the entire annual fee should be counted as relationship revenue. If a bank offers continuous and regular investment advice and a specified number of trades for a fee but separately charges for additional trades, we believe that the fees for combined advice/trading would be relationship revenues. The separate charges for trades, however, must be evaluated under the ''per order processing fee'' definition to determine their status. If the bank acts as an IRA trustee and offers a specified number of trades for a fee, this fee should be evaluated under the ''per order processing fee'' definition unless the fee permits an unlimited number of trades. If a fiduciary provides an unlimited number of transactions for an annual or assets under management fee, this fee would be considered relationship compensation.

Paying banks to distribute securities, such as when an investment company pays a bank to distribute its shares through Rule 12b–1 fees, creates a conflict of interest between the bank distributor and investors. Rule 12b–1 fees are fees for distributing investment company securities and not for managing investors' assets.[147] We view Rule 12b–1 fees as commissions, and in fact, these fees are often described as trail commissions.[148] Unlike fees for assets under management by the bank, which do not differ depending on the investment selected by the bank but are paid for the management role of the bank, the Rule 12b–1 fees differ based on the particular investment company securities in which the assets are invested and maintained. These differing fees create incentives to distribute particular investment company securities and raise conflicts between the bank and investors. Similarly, finders' fees create incentives for bank trust departments to solicit trust customers to engage in securities transactions with other entities.[149] It is precisely these divided loyalties or conflicts of interest faced by securities salesmen that drive much of broker-dealer regulation, and particularly rules governing securities practice standards.[150] Therefore, these fees are defined as sales compensation.

iii. Unrelated Compensation. Compensation that does not fall within the definitions of ''sales compensation'' or ''relationship compensation,'' we call ''unrelated compensation.'' Unrelated compensation should not be used to determine whether banks are ''chiefly compensated'' in a manner consistent with the terms of the trust and fiduciary activities exception. For example, unrelated compensation includes fees charged separately for any activity of the bank that is not related to securities

[142] We find that this definition is consistent with the provisions and purposes of the Exchange Act. *See* Exchange Act Section 3(b) [15 U.S.C. 78c(b)]; *see also* Exchange Act Section 23(a)(1) [15 U.S.C. 78w(a)(1)].

[143] 17 CFR 240.10b–10(d)(9).

[144] Exchange Act Section 3(a)(4)(B)(i) [15 U.S.C. 78c(a)(4)(B)(i)]. *See, e.g.,* NASD Rule 2420; NYSE Rule 345. *See also NASD Guide to Rule Interpretations,* III. Questions and Answers, A. Frequently Asked Interpretive Questions About NASD Rules and Regulations With Responses From Its Office of General Counsel, Question 1. (as of 9/12/2000) (NASD's Office of General Counsel stated that ''it is improper for a member or person to [pay finders' or referral fees to third parties that introduce or refer prospective customers to the member] unless the recipient is registered as a representative of an NASD member firm. * * *'' The NASD has consistently maintained that persons who introduce or refer prospective customers and receive compensation for such activities are engaged in the securities business for the member in the form of solicitation''); IV *NYSE Interpretation Handbook,* Rule 345, Employees—Registration, Approval, Records, at (a)(i)/02 (Compensation to non-registered persons) (''Rule 345(a) precludes members and member organizations from paying to non-registered persons compensation based upon the business of customers they direct to members or members organization if (a) the compensation is formulated as a direct percentage of the commissions or income generated, or * * * (d) such person regularly engages in activity which may be reasonably expected to result in the procurement of new customers or orders. * * *'').

[145] Rule 12b–1 under the Investment Company Act of 1940 [17 CFR 270.12b–1] allows investment companies to use their assets to finance sales related expenses. *See* Investment Company Act Rel. No. 11414, 45 FR 73898 (Nov. 7, 1980).

[146] Our definition is based on the NASD's definition of ''service fees.'' ''Service fees'' are distinguished from other fees because they relate to personal services provided to the customer, such as a registered representative providing information on investments. The NASD excludes from the term ''service fees'' fees paid to a transfer agent for performing shareholder services pursuant to its transfer agent agreement. The term ''service fees'' also does not include record keeping charges, accounting expenses, transfer costs, or custodian fees. Specific services not covered by the term ''services fees'' include: (1) Transfer agent and subtransfer agent services for beneficial owners of the funds' shares; (2) aggregating and processing purchase and redemption orders; (3) providing beneficial owners with statements showing their positions in the investment companies; (4) processing dividend payments; (5) providing subaccounting services for fund shares held beneficially; (6) forwarding shareholder communications, such as proxies, shareholder reports, dividend tax notices; and updating prospectuses to beneficial owners; and (7) receiving, tabulating, and transmitting proxies executed by beneficial owners. Unlike ''service fees,'' these other fees would be unrelated compensation rather than sales compensation. *See* NASD Rule 2830(b)(9); NASD Notice to Members 93–12 (1993) at Question 17 (explanation of term ''service fees'').

[147] *Id. See also* Investment Company Act Rel. No. 16244, 53 FR 3192 (Feb. 4, 1988); Exchange Act Rel. No. 30897, 57 FR 30985–02 (July 13, 1992).

[148] *See supra* note 146, regarding Rule 12b–1 fees.

[149] *See supra* note 144, regarding finders' fees.

[150] By way of contrast, such conflicts of interest are managed differently under the fiduciary principles that take the place of the protections of broker-dealer regulations for activities covered by the trust and fiduciary activities exception. For example, in 1983, the FDIC issued an opinion, which generally addressed the use of unaffiliated discount brokers, stating that bank trust departments ''should not share in any commission associated with the transactions'' for a trust customer. *See* FDIC General Counsel's Opinion No. 6, 48 FR 22989 (May 23, 1983). The FDIC subsequently stated that, in the absence of a statutory prohibition, and assuming no unusual facts, the sharing of commissions would not itself give rise to a breach of fiduciary obligations if ''(1) a trust instrument expressly authorizes the bank trustee to share in commissions generated by securities transactions effected on behalf of the account, and (2) the settlor of the trust entered into the authorization after full disclosure of the facts.'' *See* FDIC–84–10 (Apr. 3, 1984).

transactions, such as taking deposits, lending funds (including margin lending), managing non-securities assets, or providing other services that are not related to managing securities accounts pursuant to the trust and fiduciary activities exception. Unrelated compensation also includes compensation received pursuant to another exception under the GLBA, such as a fee received pursuant to the networking exception, except for a referral fee listed in that exception.[151]

In addition, unrelated compensation includes other compensation received by the bank, such as when the bank acts as an investment adviser, transfer agent, or custodian to an investment company, or receives administrative fees from an investment company, including payments for providing subtransfer agent, subaccounting, or administrative services for securities accounts.[152] As stated previously, where the customer is charged an annual or assets under management fee by a bank that meets the conditions of acting in a trustee or fiduciary capacity or as an investment adviser for a fee, the entire annual or assets under management fee would be relationship compensation. This would also be the case if the fee included compensation for an unlimited number of transactions, even though the investor may only effect a few transactions.

e. ''Chiefly Compensated'' Computation. To calculate whether it is ''chiefly compensated,'' Rule 3b–17(a) requires that a bank must first set aside any compensation received from an account that does not fall within the definitions of ''relationship compensation'' or ''sales compensation,'' in Rules 3b–17(i) and (j), respectively. In other words, the bank must set aside ''unrelated compensation.'' The bank then must identify the remaining compensation received from the account either as ''relationship compensation'' or ''sales compensation,'' again based on the definitions of those terms in Rule 3b–17. To meet the definition of ''chiefly compensated'' in Rule 3b–17(a) for this account, the bank's relationship compensation from the account must exceed its sales compensation for that account in the immediately preceding year, which can be either a calendar year or other fiscal year consistently used by the bank for recordkeeping and reporting purposes.[153]

A simple chart providing an example of the ''chiefly'' calculation is set forth below. This chart is based on a trust customer with $1,000,000 in trust assets, all of which are invested in investment company securities. In this chart, the bank trust department charges a $1,000 annual base fee plus 1.235% of the first $1,000,000 under management. For the $1,000 annual base fee, the bank provides continuous and regular investment advice and allows the customer to effect securities transactions on an occasional and irregular basis. Because the bank also provides fiduciary services in addition to trades for this fee, this fee would be relationship compensation. The 1.235% of assets under management fee is not related to the customer's self-directed trades, and therefore would be relationship compensation.[154] The bank also receives 41 basis points as sales compensation in the form of Rule 12b–1 fees from the investment company.

Bank A receives:	Relationship compensation for $1,000,000 in trust assets	Sales compensation for $1,000,000 in trust assets
Base fee $1,000	1,000	.....
Assets under management fee of 1.235%	12,350	.....
Rule 12b–1 fees		$4,100
Total	13,350	4,100

The account meets the ''chiefly compensated'' definition because the $13,350 in relationship compensation exceeds the $4,100 in sales compensation.

In defining ''chiefly compensated,'' we have taken a conservative approach by adopting a definition that requires that the ''relationship compensation'' simply exceed the ''sales compensation'' on an annual basis. This definition depends upon all of the imbedded definitions and interpretations, including our definitions of the terms ''relationship compensation,'' ''sales compensation,'' and ''flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers.'' In addition, the items included within each of the categories of compensation were carefully chosen in consideration of the test that simply requires that the ''relationship compensation'' exceed the ''sales compensation.'' We considered requiring a higher level of relationship compensation in interpreting this phrase as we did in interpreting ''predominantly'' with respect to the origination of asset-backed transactions in Rule 3b–18.[155] Requiring a higher level of relationship compensation, at least initially, also would have been consistent with the approach taken by the Federal Reserve as the revenue test for so-called section 20 subsidiaries developed.[156] We chose the more than 50% approach for the purposes of this interim final rule. We solicit comment on whether the chiefly test should be higher, such as 75% or 90%.

f. Rule 3a4–2—Exemption For Banks That Are Compensated By Relationship Compensation. We are particularly sensitive to the concerns expressed by banks regarding the compensation computations required under the trust and fiduciary activities exception. Therefore, we are adopting Rule 3a4–2 [157] to permit banks that are compensated almost entirely by relationship compensation to avoid making calculations on an account-by-account basis. We find that this exception is necessary or appropriate in the public interest and is consistent with the protection of investors.[158] It should minimize the costs and regulatory burdens on banks arising from the GLBA requirements relating to the trust and fiduciary compensation computations discussed above.

New Rule 3a4–2 exempts a bank from the definition of ''broker'' if it: (1) Complies with the trust and fiduciary activities exception, except for the ''chiefly compensated'' condition; (2) can demonstrate that sales compensation, as that term is defined in Rule 3b–17, received during the immediately preceding year for its total fiduciary activities is less than 10% of the total amount of relationship compensation, as that term is defined in

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

[152] For a complete list of payments included in this category, *see* NASD Notice to Members 93–12 (1993) at Question 17 (what does the term ''service fees'' include or exclude?). *See supra* note 146, regarding service fees.

[153] We find that this definition is consistent with the provisions and purposes of the Exchange Act. *See* Exchange Act Section 3(b) [15 U.S.C. 78c(b)]; *see also* Exchange Act Section 23(a)(1) [15 U.S.C. 78w(a)(1)].

[154] Even if this fee is related to the customer's self-directed trades, it would be relationship compensation if the customer effected the trades as part of the bank's fiduciary relationship.

[155] The word ''chiefly'' is defined as: (1) in chief, in particular; preeminently; especially, particularly; above all, most of all; and (2) (relative to others) principally, mainly, for the most part (usually with the force of ''mainly but not exclusively''). 3 J.A. Simpson & E.S.C. Weiner, *The Oxford English Dictionary* (2d ed. 1989).

[156] *See infra* at notes 276–78 (Section 20).

[157] 17 CFR 240.3a4–2.

[158] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1). *See* Exchange Act Section 3(b) [15 U.S.C. 78c(b)]; *see also* Exchange Act Section 23(a)(1) [15 U.S.C. 78w(a)(1)].

Rule 3b–17, received for its total fiduciary activities during the same year; (3) maintains procedures reasonably designed to ensure compliance with the definition of ''chiefly compensated'' with respect to a trust or fiduciary account: (i) When the account is opened, (ii) when the compensation arrangement for the account is changed, and (iii) when sales compensation received from the account is reviewed by the bank for purposes of determining an employee's compensation; and (4) complies with the requirement that resulting orders be executed through a broker-dealer (or in a cross trade).

A bank must first determine whether a trust or fiduciary account involves activities for which the bank relies on the trust and fiduciary activities exception. Compensation from accounts that do not hold securities would not be included in the 10% calculation because the definitions of relationship compensation and sales compensation are based on securities activities conducted under the trust and fiduciary activities exception. Similarly, compensation received by the bank for activities covered by another exception or exemption would not be included in the 10% calculation. Once a bank determines which accounts contain securities, which should be done at the same time as the 10% calculation, the bank can use the total compensation received from these accounts for the 10% calculation.

A simple chart providing an example of the 10% calculation is set forth below. The bank's total revenue is $1,000,000 from its trust and fiduciary accounts that contain securities. The bank acts as a personal trustee, and as an ERISA trustee. Asset under management and annual fees from its personal trusts and ERISA trusts are the bank's main source of revenue. The bank also receives sales compensation in the form of Rule 12b–1 fees and fees for executing trades that are not flat or capped per order processing fees.

Bank A receives:	Relationship compensation	Sales compensation
Personal trustee:		
a. Total annual and assets under management fees	$500,000	.....
b. Total 12b–1 fees	.....	$4,000
ERISA trustee:		
a. Total annual and assets under management fees	480,000	.....
b. Total non-flat or capped per order fees	.....	16,000
Total	980,000	20,000

The bank would meet the 10% calculation because its sales compensation, $20,000, is less than 10% of its relationship compensation, $980,000 ($20,000/$980,000 = 2%).

A second chart using the example of a bank acting as an indenture trustee illustrates the interaction of this exemption with other exemptions, statutory exceptions, and non-securities income. An indenture trustee receives income from five sources: annual fees, fees for effecting transactions in government securities that are not flat or capped per order fees, fees for non-securities related services, Rule 12b–1 fees for investing in no-load money market funds, and non-flat or capped per order fees for effecting transactions in securities that are not covered by another exception. Even though the bank is charging the indenture trusts transaction fees for government securities that are not flat or capped per order processing fees, these fees would count as unrelated compensation for purposes of the 10% calculation because the transactions are covered by the permissible securities transactions exception.[159] Similarly, the Rule 12b–1 fees for no-load money funds (which are sales compensation) would count as unrelated compensation for purposes of the 10% calculation because the bank is exempt for effecting transactions in no-load money funds when acting as an indenture trustee under Rule 3a4–3. Fees for non-securities related services would also be excluded from the 10% calculation as unrelated compensation.

Bank A receives:	Relationship compensation	Sales compensation	Unrelated compensation
Indenture trustee:			
a. Annual fees	$5,000,000	.....	.....
b. Non-flat or capped per order fees for gov't securities transactions	.....	.....	$5,000
c. Non-securities related fees	.....	.....	5,000
d. 12b–1 fees for no-load money funds	.....	.....	150,000
e. Non-flat or capped per order fees for other securities transactions	.....	50,000	.....
Total	5,000,000	50,000	160,000

The bank would meet the 10% calculation because its sales compensation, $50,000, is less than 10% of its relationship compensation, $5,000,000 ($50,000/$5,000,000 = 1%).

As discussed above, the bank must maintain procedures reasonably designed to ensure compliance with the chiefly compensated condition with respect to a trust or fiduciary account: (1) When the account is opened; (2) when the compensation arrangement for the account is changed; (3) and when sales compensation received from the account is reviewed by the bank for purposes of determining an employee's compensation. We do not believe that these procedures will be unduly burdensome to banks. Rather, the procedures need to be reasonably designed to ensure compliance with the definition of ''chiefly compensated'' with respect to a trust or fiduciary account in the three described situations. For new accounts, bank employees could project on a prospective basis whether an account, depending on the type and activity of the account, is likely to generate more of its revenue from relationship compensation than sales compensation. For existing accounts, bank employees could review whether an account, depending on the type and activity of the account, generated more of its revenue from relationship compensation than sales compensation.

In addition, under the compensation element of the requirement, the bank

[159] Section 3(a)(4)(B)(iii) of the Exchange Act [15 U.S.C. 78c(a)(4)(B)(iii)].

needs to maintain procedures for situations in which the bank uses sales compensation received from accounts in determining the compensation of an employee. The bank does not need these procedures if it only uses relationship compensation received from accounts in determining an employee's compensation.

If, after reviewing an account, a bank determines that the account either is likely to exceed the compensation limits or has done so in the past, the bank must follow its procedures to bring the account into compliance with the ''chiefly compensated'' definition. For example, a bank can do this by revising the compensation schedule or shifting the securities trades into the client's brokerage account.

We believe this exemption, which permits banks to avoid calculations on a continuous basis in much of their traditional trust business, is consistent with Congress' dual intents of not disturbing traditional trust activities and requiring securities business that has been conducted in the trust department to be administered in the future by a broker-dealer that is subject to the investor protections available under the federal securities laws.

g. Rule 3a4–3—Exemption From ''Chiefly Computation'' For Indenture Trustees. We are adopting Rule 3a4–3 [160] to provide an exemption to address the use of the trust and fiduciary activities exception from the broker registration for banks that serve as indenture trustees. As discussed previously, banks may serve as indenture trustees in accordance with the requirements of the TIA. The issuer of a bond indenture may be a state, a municipality, a quasi-public authority, a school, a church, or any organization that needs to raise cash through the sale of bonds. Bonds may be sold to the general public, to a limited investor group, or to a single investor such as an insurance company or governmental agency.

As a part of its duties as an indenture trustee, a bank also may invest otherwise idle cash in shares of money market investment companies or other securities, solely at the direction of the issuer of the bonds. Commonly, compensation that may be received from an investment company or its distributor for investments of mutual funds is considered when the terms of the trust indenture, including the bank's compensation, are negotiated.

The trust and fiduciary activities exception requires banks to compute for each trustee or fiduciary account whether the bank meets the ''chiefly compensated'' condition. A bank acting as a trustee under an indenture may not meet the condition that it receive more of its compensation from relationship compensation than from sales compensation because of fee structures individually negotiated with the issuers. Therefore, we are adopting, in Rule 3a4–3, an exemption from the definition of broker for banks acting in the narrow role of indenture trustees investing in no-load money market funds.

Rule 3a4–3 provides that, if a bank, acting in its capacity as a bond indenture trustee, complies with all of the conditions of the trust and fiduciary activities exception, other than the compensation condition, the bank is exempt from the definition of the term ''broker'' solely for effecting transactions as an indenture trustee in no-load money market funds.[161] Granting banks acting as indenture trustees an exemption to directly place idle cash in a no-load money market fund, an investment vehicle with a constant net asset value per shares and without a sales load, does not create any serious risk of abuse. In addition, the limit in the exemption to no-load, money market funds is consistent with the sweep accounts exception, which provides that a bank may invest depositors' funds through a sweep program without being considered a broker as long as the bank limits its sweep program to no-load, money market funds. Also, granting such an exemption relieves banks acting as indenture trustees of the task of continually watching the maturity of an instrument with the draw schedule of a project financed by bond proceeds. Therefore, we find that this exception is necessary or appropriate in the public interest and is consistent with the protection of investors.[162]

h. Solicitation of Comment. We invite comment on the definition of ''chiefly compensated,'' including whether other methods of calculation would accurately assess whether a bank is meeting the ''chiefly compensated'' condition, consistent with the investor protection concerns that we have expressed. We also request comment on whether we set the threshold test for being ''chiefly compensated'' too low and whether we should consider raising that test to a higher level, such as 75% or 90%. In addition, we request comment on whether the definition of ''chiefly compensated'' also should be changed to require a higher relative amount of ''relationship compensation'' in the event that any of the underlying definitions were to be changed.

Further, we seek comment on the definition of ''a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers.'' In particular, we are interested in whether we have struck an appropriate balance between accuracy and simplicity by permitting banks to pass on costs of resources exclusively dedicated to trustee and fiduciary transactions, but not pass on the proportional allocations of costs of shared resources. If proportional allocations of costs were permitted, would the record keeping costs exceed the benefits of permitting the allocations? We also solicit comment on both exemptions, and are especially interested other ways to exempt banks that receive small amounts of sales compensation and whether a line of business calculation is feasible.

In addition, some banking industry representatives have told us that banks may charge one comprehensive fee for several accounts of an individual or members of one family. We seek comment on how to treat clusters of accounts for which a bank may charge a single fee attributable to all of the accounts in that cluster. We also seek comment on how to determine a nexus among such accounts to consider the scope of any additional relief that may be necessary.

C. Sweep Accounts Exception

Section 3(a)(4)(B)(v) of the Exchange Act[163] provides an exception from the definition of broker for sweep account activities. Under the exception, a bank will not be considered a broker if it ''effects transactions as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund.'' The sweep accounts exception is intended to continue to allow banks to sweep funds into no-load money market funds without having to register as broker-dealers.

Payments by investment companies of asset-based fees to distributors of their securities create a conflict of interest for the brokers and banks that are distributing these shares. The sweep account exception protects sweep customers from conflicts of interest

[160] 17 CFR 240.3a4–3.

[161] The term ''money market fund'' is defined in Rule 3b–17(e).

[162] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1). *See* Exchange Act Section 3(b) [15 U.S.C. 78c(b)]; *see also* Exchange Act Section 23(a)(1) [15 U.S.C. 78w(a)(1)].

[163] 15 U.S.C. 78c(a)(4)(B)(v).

created by compensation arrangements by limiting banks that are not registered as broker-dealers to sweeping deposit accounts into no-load, money market funds that pay minimal distribution fees. In addition, the sweep accounts exception's limitation to no-load money market funds results in limited risks to bank customers because of the constant net asset value of the funds, the absence of a sales load, and the minimal distribution fees that funds may pay to the banks.

The term ''no-load'' is not defined in the GLBA or in the federal securities laws. Historically, the term ''no-load'' was viewed as meaning that neither investors in the fund, nor the fund itself, bore the costs of distributing the fund's shares, including making payments to broker-dealers.[164] The Commission's adoption in 1980 of Investment Company Act Rule 12b–1, which for the first time permitted funds to use their assets to finance distribution expenses, created some confusion as to the meaning of the term.[165] To address this confusion, the National Association of Securities Dealers, Inc. (''NASD'') adopted Rule 2830(d)(4), which describes what a ''no-load'' investment company is. Rule 2830(d)(4) allows an NASD member broker-dealer to describe an investment company as being ''no-load'' or as having ''no sales charge'' if the investment company does not have a front-end or deferred sales charge, and if its total charges against net assets to provide for sales related expenses and/or service fees do *not* exceed 0.25 of 1% of average net assets per annum.[166]

Although the rules of the NASD expressly apply only to the conduct of NASD member broker-dealers and their associated persons, our Division of Investment Management has endorsed the NASD's definition of ''no load'' regardless of whether an investment company is associated with an NASD member. We believe that the NASD's definition of ''no load in NASD Rule 2830(d)(4) is reasonable, and we have adopted this definition in Rule 3b–17(f). This definition should help clarify the sweep accounts exception.

We also are adopting a definition of ''money market fund.'' Specifically, Rule 3b–17(e) defines that term as an open-end management investment company registered under the Investment Company Act that is regulated as a money market fund pursuant to Rule 2a–7 under the Investment Company Act. Rule 3b–17(f) provides that an investment company registered under the Investment Company Act is ''no-load'' if: (1) Purchases of the investment company's securities are not subject either to a sales load (as that term is defined in Section 2(a)(35) of the Investment Company Act) or a deferred sales load (as that term is defined in Rule 6c–10 under the Investment Company Act); and (2) its total charges against net assets that provide for sales or sales promotion expenses[167] and for personal services or the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually and are disclosed in the mutual fund's prospectus.[168]

A bank can meet the conditions of the sweep accounts exception contained in Exchange Act Section 3(a)(4)(B)(v) if it invests customer assets through its sweep program in money market funds that meet the definition contained in new Rule 3b–17(e). All charges against fund assets that fall within the definition count toward the 0.25 of 1% limit, whether they are disclosed as an item in the fund's fee table or as part of the fund's miscellaneous or aggregate expenses.

Rule 3b–17(f) gives effect to the ''no-load money market fund'' condition of the sweep account exception by reflecting current industry and public understanding of what ''no-load'' means. The rule would not prevent a bank from directly charging its customers for the bank's sweep services, because such direct charges would have no effect on whether the fund is a ''no-load'' fund. The rule also would not prevent a bank from sweeping accounts into a money market fund that charges more than 0.25 of 1% of net assets under its Rule 12b–1 plan, provided that it charges a total of no more than 0.25 of 1% of the fund's net assets for sales or sales-related expenses and fees for personal service or the maintenance of the shareholder accounts.[169]

We find that our definitions of the terms ''no-load'' and ''money market fund'' used in the sweep accounts exception are consistent with the provisions and puroses of the Exchange Act.[170]

D. Safekeeping And Custody Activities Exception

Exchange Act Section 3(a)(4)(B)(viii) provides an exception from the definition of broker for certain safekeeping and custody activities.[171] Under the exception, a bank will not be considered a ''broker'' because, as part of customary bank activities, it engages in certain specified types of safekeeping and custody services with respect to securities on behalf of its customers.[172]

Traditionally, activities that have been identified as the type of activity requiring broker-dealer registration include, among other things, executing securities transactions and holding customer funds and securities.[173] The

[164] *See* Investment Company Act Release No. 15431 (June 13, 1988), 53 FR 23258.

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

[166] NASD Rule 2830(d)(4) specifically states that a member broker-dealer may *not* ''describe an investment company as being ''no-load'' or as having ''no sales charge'' if the investment company has a front-end or deferred sales charge *or its total charges against net assets to provide for sales related expenses and/or service fees exceed .25 of 1% of average net assets per annum.*'' (emphasis added). *See* Exchange Act Release No. 30897 (July 7, 199), 57 FR 30985–02 (July 13, 1992). NASD Rule 2830(d)(4) was formerly classified as Article III, Section 26(d)(3) of the NASD Rules of Fair Practice. *See* Exchange Act Release No. 36698 (Jan. 11, 1996), 61 FR 1419 (Jan. 19, 1996).

[167] Rule 12b–1 under the Investment Company Act [17 CFR 270.12b–1] provides that an investment company may make payments with respect to the distribution of shares of the investment company securities as long as, among other things, those payments are made pursuant to a written plan. Payments made by a fund pursuant to Rule 12b–1 must be disclosed in the fund's prospectus. *See* Item 8(b) of Form N–1A. In practice, however, fees paid pursuant to a Rule 12b–1 plan sometimes also may relate to types of services other than distribution-related services.

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

[169] Accordingly, banks relying on the sweep accounts exception should ensure that any money market fund included in the bank's sweep program that discloses Rule 12b–1 fees in its prospectus that exceed 0.25 of 1% of the fund's net assets does not use more than 0.25 of 1% of the fund's net assets to pay for sales or sales promotion expenses and personal services or the maintenance of shareholder accounts. A bank could satisfy this obligation by using only money market funds that hold themselves out as no-load funds or by obtaining written confirmation from the money market fund that it is a no-load fund before including the fund in its sweep program.

[170] Exchange Act Section 3(b) [15 U.S.C. 78c(b)].

[171] 15 U.S.C. 78c(a)(4)(B)(viii).

[172] Exchange Act Section 3(a)(4)(B)(viii)(aa–ee).

[173] *See, e.g.,* 15 David A. Lipton, *supra* note 124, at 1.04[3] (having custody or control over the funds and securities of others is a badge of being a broker-dealer); *SEC* v. *Margolin*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,025 (S.D.N.Y. 1992) (defendant was ''engaged in the business'' because he provided clearing services for the securities trading of his clients; other evidence of brokerage activity included receiving transaction-based

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safekeeping and custody exception makes clear that banks, as part of customary banking activities, may hold customer funds and securities without being considered a broker if, except with respect to government securities, they do not act as a carrying broker.[174]

In addition, the safekeeping and custody exception explicitly allows banks that hold securities for their customers, on behalf of their customers, to exercise warrants or other rights, facilitate the transfer of funds or securities in connection with the clearance and settlement of the customers' transactions, effect securities lending or borrowing transactions when the securities are in the custody of the bank, invest cash collateral pledged in connection with securities lending or borrowing transactions, and facilitate the pledging or transfer of securities that involve the sale of those securities.[175] Moreover, banks may provide custody and related administrative services to IRAs, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plans without being considered a broker.[176]

Securities trades conducted under the safekeeping and custody exception must still be executed in compliance with Exchange Act Section 3(a)(4)(C). Exchange Act Section 3(a)(4)(C) requires banks that accept orders to the extent they engage in transactions under a specified safekeeping and custody function either to transmit orders to be executed to a registered broker-dealer or to internally cross those orders. Exchange Act Section 3(a)(4)(C) ensures that when investors purchase or sell securities through banks under the trust and fiduciary activities exception, safekeeping and custody exception, and certain stock purchase plans exception, registered broker-dealers, rather than unregulated market intermediaries, ultimately execute those transactions.

Exchange Act Section 3(a)(4)(C) does not require all orders to purchase and sell a security to be sent to a registered broker-dealer. To read the section otherwise would mean that a bank would always be required to purchase or sell the underlying securities through a registered broker-dealer in connection with, for example, an investor's exercise of rights or warrants. This would preclude a bank from filling an investors' exercise of rights or warrants by delivery of shares from the issuer—a commonly used method. However, if a bank does purchase or sell the underlying securities in the open market, Exchange Act Section 3(a)(4)(C) requires banks either to execute the transactions through a registered broker-dealer or internally to cross the trade. Furthermore, Exchange Act Section 3(a)(4)(C) should not be read to permit a bank to accept orders for the purchase or sale of securities in situations not specifically provided for under the safekeeping and custody exception. In this regard, it does not expand a bank's ability to accept orders for the purchase or sale of securities without registering as a broker-dealer.

Congress also did not intend the safekeeping and custody activities exception to allow banks to engage in broader securities activities.[177] For example, although the safekeeping and custody exception permits banks to provide custody and related administrative services to IRAs and various benefit plans,[178] as one of the limited securities-related activities that can be conducted under the safekeeping and custody activities exception, the exception does not allow banks, under the rubric of providing these ''related administrative services''[179] to accept orders to purchase and sell securities.

The point at which orders are accepted from customers and routed for execution represents a critical juncture for an investment decision and results in the consummation of the sale. Therefore, it is important that the customer protections, such as employee sales practice and training requirements,

compensation, advertising for clients, and possessing client funds and securities).

[174] 15 U.S.C. 78c(a)(4)(B)(viii)(II). A bank acting as a carrying broker facilitates the transfer of funds and securities associated with the clearance and settlement of securities and related margin lending on behalf of a broker-dealer and executes trades for itself and its customers. A carrying broker relationship is distinguished from a custody relationship by the fact that the bank is selected and its systems are utilized primarily by the broker-dealer rather than primarily by the customer. In a situation where the broker-dealer arranges for a substantial majority of its customers to use bank custody or deposit services of a bank, a carrying broker relationship may be established particularly if the bank performs clearance and settlement functions that the broker-dealer cannot perform economically or efficiently. In contrast, a bank would not be a carrying broker when it acts as custodian for a customer of a broker-dealer and responds to customer directions to deliver securities against payment or cash against receipt of securities.

[175] Exchange Act Section 3(a)(14) provides, ''[t]he terms ''sale'' and ''sell'' each include any contract to sell or otherwise dispose of.'' Similarly, Exchange Act Section 3(a)(13) provides, ''[t]he terms ''buy'' and ''purchase'' each include any contract to buy, purchase, or otherwise acquire.'' Courts have read this language broadly. For example, the Supreme Court has stated that a transaction does not need to involve cash to constitute a sale of securities for purposes of the anti-fraud provisions of the Exchange Act. *Gelles* v. *TDA Industries*, 44 F.3d 102, 104 (2d Cir. 1994) (citing *SEC* v. *National Securities, Inc.*, 393 U.S. 453 (1969)). Moreover, neither delivery nor the passing of title is required for the transaction to be considered a ''sale'' for these purposes. The pledge of stock is a ''sale'' within the meaning of Section 2(3) of the Securities Act. *Rubin* v. *United States*, 449 U.S. 424 (1981). The Court stated that although full title to the pledged securities were not transferred, the transaction nonetheless could be a sale. In the Court's view, the ''inchoate but valuable interest'' transferred by a pledge (*i.e.*, the right to absolute title and ownership in the event of a default) was an ''interest in a security'' within the meaning of Section 2(3) of the Securities Act. 449 U.S. at 429–30.

[176] 15 U.S.C. 78c(a)(4)(B)(viii)(ee). *See* H.R. Rep. No. 106–74, pt. 3, note 9 above, at 169 (1999) (''Many of the activities permitted under the safekeeping and custody exception are incidental to activities that banks perform today.'').

[177] *See* H.R. Rep. No. 106–74, pt. 3, at 169 (1999) (''This exception is not intended to allow banks to engage in broader securities activities.'').

[178] We note that securities in retirement plans, including IRAs, are not immune to the sales practice abuses and fraudulent conduct that the rules of the SROs and securities laws are designed to address. The NASD has brought several enforcement actions for unsuitable recommendations and unauthorized trading in IRA accounts. *See, e.g., In re Frederick C. Heller,* 1991 NASD Discip. LEXIS 115 (Aug. 26, 1991) (registered representative engaged in excessive and unauthorized trading in an IRA account); *In re Paul D. Baune,* 1994 NASD Discip. LEXIS 17 (Aug. 4, 1994) (registered representative violated the NASD's suitability rule by recommending illiquid limited partnerships for the IRA account and non-IRA account of an elderly widow); *In re William J. Lucadamo et al.,* 1997 NASD Discip. LEXIS 35 (May 20, 1997) (registered representative made unsuitable recommendations and engaged in unauthorized trading in IRA accounts). In addition, a pension plan administrator was permanently enjoined from, among other things, violating Sections 10(b), 15(a), and 17(a) of the Exchange Act for acting as an unregistered broker-dealer and misappropriating customer funds, some of which were held at a custodial bank. *See Securities and Exchange Commission* v. *Qualified Pensions Inc. et al.,* Civil Action No. 95–1746 (LFO) (D.D.C. July 2, 1997), Litigation Releases No. 15403, 64 S.E.C. Docket 2280 (July 2, 1997) and No. 14680, 60 S.E.C. Docket 1086 (Oct. 5, 1995). *See also In re Bankers Pension Services, Inc.,* Exchange Act Rel. No. 37567 (Aug. 14, 1996) (order instituting a public administrative proceeding, making findings, and imposing a cease-and-desist order); *In re Transcorp Pension Services, Inc.,* Exchange Act Rel. No. 37278 (June 4, 1996) (order instituting a public administrative proceeding, making findings, and imposing a cease-and-desist order); *First Philadelphia Corp.,* 50 SEC 360 (1990) (allocation of shares in a ''hot issue'' to a custodial account for the benefit of securities firm's president's son).

[179] Although the term ''related administrative services'' is not defined in the securities laws, in the broker-dealer industry, administrative services generally are considered to be those services that are labeled as ''clerical and ministerial.'' Clerical and ministerial activities include, for example, mechanical tasks such as bookkeeping and record keeping, performing calculations, and data processing functions. Accepting general orders to buy and sell securities, however, is not a ''clerical and ministerial'' activity. *Cf. Exchange Services, Inc.* v. *S.E.C.,* 797 F.2d 188, 190 (4th Cir. 1986) (The court determined that the SEC was not being arbitrary and capricious when it relied, as a reason to deny an exemption, on NASD's policy that anyone taking orders from the public must register.). A person accepting general securities orders must, at a minimum, register as an assistant representative for order processing with the NASD. *See generally* NASD Rules 1041 and 1042 (listing registration requirements, and limits on the activities of, assistant representatives).

that flow from broker-dealer registration and application of the federal securities laws apply at this juncture.[180] Accepting orders necessarily involves communication with customers. The risks inherent in communication with customers relating to securities transactions—sales practice abuses and customer confusion—as well as related order taking risks, are risks that the securities laws are uniquely designed to address. Accepting orders to buy and sell securities also implicates concerns traditionally covered by the federal securities laws and the requirement of best execution.[181] For these reasons and the others discussed above, we have determined that ''custody'' or ''related administrative services'' do not include accepting orders from investors to purchase or sell securities. In particular, we do not believe that by its terms the safekeeping and custody exception covers a bank that accepts orders from investors to purchase or sell securities other than those specifically permitted in the exception, such as with respect to securities lending and borrowing or investing collateral.

We are supported in our conclusion by a comprehensive reading of the GLBA broker exceptions. An interpretation that banks engaged in safekeeping and custody services may accept orders without being required to register as broker-dealers would contradict the comprehensive statutory scheme of limited brokerage exceptions with the attendant conditions that Congress established for banks to be able to effect securities transactions without any of the investor protections available under the federal securities laws.[182]

Bankers have asserted that the custody exception was intended to preserve all ''customary'' activities involving custody accounts. This exception, however, just like the other exceptions from broker-dealer registration, was not designed to protect from the federal securities laws every existing bank brokerage activity. Prior to the passage of the GLBA, banks could operate a brokerage business without any conditions and still be excepted from broker-dealer registration. By replacing the blanket exception with specific exceptions, the GLBA limited the range of excluded bank securities activities. Therefore, the terms of a specific exception and the purpose of the exceptions must be examined to determine what bank securities activities were, in fact, excepted. This determination cannot be made merely based on an assumption that all ''customary'' bank securities activities were excepted.

Although we conclude that the safekeeping and custody activities exception allows banks to accept only those orders specifically permitted in the exception, we are creating two exemptions to permit banks to accept orders from investors for the purchase and sale of securities under limited circumstances in a safekeeping and custody capacity. Rule 3a4–4 provides that small banks may effect transactions in investment company securities in customers' tax-deferred custody accounts. In addition, Rule 3a4–5 provides that banks may accept orders for securities for safekeeping and custody accounts where the bank is not compensated for these transactions. The bank, however, may pass on the broker-dealer's charge for executing the transactions. As discussed below, we find that these exceptions are consistent with the public interest and the protection of investors.[183]

1. Rule 3a4–4—Exemption For Small Bank Custodians Effecting Transactions In Investment Company Securities For Tax-Deferred Custody Accounts

To permit small banks to continue assisting IRA customers to invest in investment company securities under conditions designed to foster a passive sales environment, new Rule 3a4–4 [184] provides that, under certain conditions, a small bank [185] is exempt from the definition of the term ''broker'' under Section 3(a)(4) of the Exchange Act solely for effecting transactions in securities of an investment company in a tax-deferred account [186] for which the bank acts as custodian under the safekeeping and custody activities exception, or as trustee under the trust and fiduciary activities exception.

We have been advised that small banks offering tax-deferred custody accounts may not have an affiliated broker-dealer or networking arrangements with registered broker-dealers. In 1996—the last year for which data was available—over 90% of banks used registered broker-dealers to effect securities transactions as brokers.[187]

[180] A critical aspect of the federal securities laws is the protection of investors that is accomplished not only through our rules, but also through investor protection conditions imposed by SROs on registered entities and their personnel.

[181] The duty of best execution requires a broker-dealer to seek the most advantageous terms reasonably available under the circumstances for a customer's transaction. The duty of best execution derives from the common law duty of loyalty, which obligates an agent to act exclusively in the principal's best interest. When a broker-dealer acts as agent on behalf of a customer in a transaction, the agent is under a duty to exercise reasonable care to obtain the most advantageous terms for a customer. Restatement 2d Agency Sec. 424 (1958). Traditionally price has been the predominant factor in determining whether a broker-dealer has satisfied its best execution obligations. Exchange Act Release No. 34902, 59 FR 55006 (1994). We also have stated that broker-dealers should consider at least six additional factors: (1) The size of the order; (2) the speed of execution available on competing markets; (3) the trading characteristics of the security; (4) the availability of accurate information comparing markets and the technology to process such data; (5) the availability of access to competing markets; and (6) the cost of such access. *See, e.g.,* Second Report on Bank Securities Activities, at 97–98, n.233, as reprinted in H.R. Rep. No. 145, 95 Cong., 1st Sess. 233 (Comm. Print 1977).

[182] If banks were allowed to effect transactions for compensation as custodians, they would be subject to fewer requirements than banks effecting transactions for investors under other exceptions contained in the GLBA amendments to Exchange Act Section 3(a)(4). Congress created at least three specific exceptions to permit banks to effect securities transactions with retail investors—as part of networking arrangements with broker-dealers; pursuant to the trust and fiduciary exception; and as registered transfer agents for issuer plans. To read the term ''administrative services'' to include accepting orders for the purchase and sale of securities would mean that banks acting as custodians would be subject to significantly fewer limits than banks that effect transactions with investors in these three situations. In short, an expansive reading of the word ''administrative services'' would circumvent the conditions of all of the other exceptions that restrict banks' ability to become active brokerage distribution channels outside of the investor protections of the federal securities laws.

[183] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1)]; *see also* Exchange Act Sections 15(a)(2) and 23(a)(1) [15 U.S.C. 78o(b)(2) and 78w(a)(1)].

[184] 17 CFR 240.3a4–4. Of course small bank trustees for tax-deferred accounts that are effecting transactions in investment company securities and that are acting as custodian may alternatively rely on this exemption.

[185] We define the term ''small bank'' as a bank with less than $100 million in assets as of December 31 of both of the prior two calendar years, and since December 31 of the third prior calendar year has not been, an affiliate of a bank holding company or a financial holding company that as of December 31 of both of the prior two calendar years had consolidated assets of more than $1 billion. The $100 million in assets cut-off was derived from The Small Business Administration, Small Business Size Regulations. 13 CFR 121.201; *see also* 66 FR 10212 (citing 13 CFR 121.201).

[186] A ''tax deferred account'' is defined as those accounts described in Sections 401(a), 403, 408, and 408A under Subchapter D and in Section 457 under Subchapter E of the Internal Revenue Code of 1986.

[187] *See* Testimony of Andrew C. Hove, Jr., Acting Chairman Federal Deposit Insurance Corporation, on Financial Modernization before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, United States House of Representatives, July 17, 1997, where he said:

Second, the vast majority of insured institutions already use registered broker/dealers for sales of nondeposit investment products. Recent surveys, including the FDIC's 1996 survey of nondeposit investment product sales practices, have found that very few banks—less than 300 out of 10,000—sell such products using their own employees under the present exemption from registration as a broker/dealer. Thus, most of those selling nondeposit investment products at banks and thrifts already are registered representatives of broker/dealers subject to the regulatory oversight of the Securities and

Continued

Nevertheless, small banks without broker-dealers might occasionally accept unsolicited orders for investment company securities from customers in these tax-deferred accounts.

Because the IRC requires tax-deferred accounts to be held by a custodian or trustee, investors often hold these accounts with banks. To avoid unnecessarily disrupting this service in small banks that do not have an affiliate or networking arrangement with a broker-dealer, we provide an exemption from the definition of broker for small banks with under $100 million in assets as of December 31 of both of the two prior years.[188] Such a bank may also not be an affiliate of a bank holding company or financial holding company with more than $1 billion in consolidated assets in the two prior calendar years.[189] Under this exemption, small banks may effect transactions in investment company securities for customers' tax-deferred custody accounts and receive compensation for these securities transactions, subject to a revenue limit. This exemption does not apply to banks that do not meet the definition of ''small banks'' because these banks can more easily affiliate with a broker-dealer or develop a networking arrangement with a registered broker-dealer.[190]

Because this exemption is designed to allow the bank to effect transactions in securities as an accommodation to its customers, the bank must not be affiliated with a broker or dealer or have a networking arrangement with a broker or dealer to effect transactions in securities for the bank's customers. Similarly, a bank employee effecting transactions under this exemption must not be an associated person of a broker or dealer, must primarily perform duties for the bank other than effecting transactions in securities for customers, and must not receive incentive compensation for such transactions. In effecting transactions under this exemption, the bank also must execute the order through a broker-dealer (or in a cross transaction).[191]

In addition, the bank may solicit transactions only through certain limited activities. First, a bank may deliver only advertising and sales literature about an investment company's securities that is prepared by the registered broker-dealer that is the principal underwriter of the investment company, or prepared by the investment company that is not an affiliated person of the bank, as defined in Section 2(a)(3) of the Investment Company Act.[192] The requirement to use sales literature prepared by a broker-dealer that complies with the NASD's advertising rules is designed to protect investors from representations about investments that could not be made by a registered broker-dealer. Second, banks may respond to questions from potential purchasers of securities, but the bank must limit its answers to information contained in the registration statement for the investment company security or sales literature prepared by the investment company security's principal underwriter that is a registered broker-dealer. Third, a bank may advertise its trust activities, but only as permitted under the advertising conditions of the trust and fiduciary activities exception.[193] Finally, banks may notify their existing customers that they accept orders for investment company securities in conjunction with solicitations related to their other activities concerning tax-deferred accounts.

We are concerned that this exemption could be used primarily as a means to market proprietary investment company securities without the protections available under the federal securities laws. Thus, to meet the conditions of the exemption in Rule 3a4–4, a bank that sells investment company securities of affiliated persons must make available to the tax-deferred account the securities of similar investment companies that are not affiliated persons of the bank.[194] Investment companies with similar characteristics would be investment companies with similar investment objectives and strategies, such as two global equity funds. We solicit comment on whether we need to define further the term ''similar characteristics.''

Finally, the bank's compensation related to effecting transactions in securities pursuant to this exemption[195] must be less than 3% of its annual revenue.[196] This exemption is provided to permit small banks to accept the occasional investor order to purchase and sell investment company securities for tax-deferred accounts. We have chosen the 3% revenue limit consistent with this intent.

We expect small banks effecting transactions in securities under the terms of this exemption to be offering brokerage services solely as an accommodation to their customers. We do not intend for this exemption to be used to allow an unregistered sales force to market widely securities without complying with the requirements of the federal securities laws, such as licensing, advertising, and other sales practice standards, and continuing education requirements. The conditions a bank must meet to qualify for this exemption reflect this purpose.

In adopting this exemption, we have carefully balanced the administrative convenience to investors of submitting orders to small bank custodians that do not have arrangements with broker-dealers to interact with these customers, with the loss of the protections afforded to those investors under the federal securities laws. We also have considered that small broker-dealers do not have a similar exemption from the application of the federal securities laws. Nonetheless, in this limited situation, we believe that the exemption for small banks is appropriate.

We have imposed a 3% annual revenue limit under this exemption and imposed conditions to limit banks' solicitation of investors to ensure a passive securities distribution channel because none of the protections available to investors under the federal securities laws are available in this situation. We solicit comment on whether this exemption poses a burden on competition for broker-dealers that do not have a similar exemption. We also solicit comment on whether this exemption is necessary and consistent

Exchange Commission and securities industry self-regulatory organizations, such as the National Association of Securities Dealers (NASD).

[188] Because a new bank, bank holding company, or financial holding company would have no assets in either one or both of the two prior years, it would qualify for the exemption for at least the period of time in which had no assets.

[189] We chose $1 billion to indicate small bank holding companies or financial holding companies because the Federal Reserve Board has previously categorized these companies as ''small, noncomplex bank holding companies'' for the purpose of determining the type of supervisory review that they receive. *See* 1999 Federal Reserve Annual Report at 122.

[190] Banks cannot structure arrangements with networking broker-dealers or affiliated broker-dealers in which the custody department becomes the carrying broker for the affiliates or networking broker-dealers. *See* Section 3(a)(4)(B)(viii)(II) of the Act [15 U.S.C. 78c(a)(4)(B)(viii)(II)].

[191] Section 3(a)(4)(C) of the Exchange Act [15 U.S.C. 78c(a)(4)(C)]. The bank also may use the NSCC's Mutual Fund Services, including Fund/SERV to execute the order, pursuant to Rule 3a4–6.

[192] *Id.*

[193] Exchange Act Section 3(a)(4)(B)(ii)(II) [15 U.S.C. 78c(a)(4)(B)(ii)(II)].

[194] Investment Company Act Section 2(a)(3) [15 U.S.C. 80a–2(a)(3)].

[195] The term ''compensation related to effecting transactions in securities pursuant to this exemption'' means the total annual compensation received for effecting transactions in securities pursuant to this exemption, including fees received from investment companies for distribution.

[196] Revenue is defined as the annual total net interest income and noninterest income from the bank's four most recent Reports of Condition and Income or any successor reports required to be filed by the bank's appropriate federal banking agency.

with the protection of investors under the federal securities laws.

2. Rule 3a4–5—Exemption for Bank Custodians Placing Orders as an Accommodation to Customers

New Rule 3a4–5 [197] is broader than Rule 3a4–4 in that it is available to all banks for the full range of securities. However, the exemption builds upon the passive sales conditions developed in Rule 3a4–4 by also prohibiting receipt by the bank of any transaction-related compensation.

Rule 3a4–5 exempts a bank from the definition of the term ''broker'' solely for effecting transactions in securities in an account for which the bank acts as custodian under the safekeeping and custody activities exception if the bank meets certain conditions. Specifically, the bank may not directly or indirectly receive any compensation for effecting such transactions. We also impose the same limitations on soliciting orders, and other conditions, as apply to small banks effecting transactions for investors under Rule 3a4–4. The bank also must comply with the order execution condition in Exchange Act Section 3(a)(4)(C).[198]

We believe that the exemption balances the intent of not unnecessarily disrupting bank securities activities with the intent to require active and compensated securities sales operations to be subject to the federal securities laws as required by the GLBA. It will allow existing custody customers to maintain their relationships with their banks to the extent the service of effecting securities transactions is provided as a true accommodation. However, because the protection of the securities laws will not be available, nor will fiduciary standards be applicable, the exemption contains strict compensation limits on the bank and its employees. For example, the bank may not receive sales compensation, as that term is defined in Rule 3b–17. The bank, however, may pass on the broker-dealer's charge for executing the transaction. Thus, under the exemption, if a bank charges an annual or assets under management custodial fee, it must charge the same custody fee to an investor who engaged in many securities transactions as it would to one who engaged in only a few securities transactions or none at all. A bank must also charge the same custody fees regardless of whether the investor invested in proprietary investment company securities or investment company securities sponsored by unaffiliated broker-dealers. These conditions are consistent with our intent to permit banks in their custody capacity to accept investors' orders for the purchase or sale of securities, while limiting to a passive securities distribution channel brokerage that does not carry the investor protections found in the federal securities laws.

We solicit comment on whether this exemption is necessary, and consistent with the protection of investors under the federal securities laws. We also request comments on the exemptions that we have provided for banks that engage in certain securities activities. Are there other areas or lines of business of the banks where an exemption may be appropriate if there are sufficient investor protection obligations? Are there conditions that may be imposed in those circumstances to limit solicitation of securities brokerage and compensation that could address our investor protection concerns?

III. Discussion of Other Exceptions From Broker

A. Affiliate Transactions Exception

Exchange Act Section 3(a)(4)(B)(vi) excepts from the definition of broker a bank that ''effects transactions for the account of any affiliate (as defined in section 2 of the Bank Holding Company Act) [199] of the bank.'' [200] Questions have arisen regarding this exception, particularly in light of one of the exemptions from broker-dealer registration found in Exchange Act Rule 15a–6.[201]

The affiliate exception applies to banks effecting trades for the accounts of affiliates of the bank, excluding registered broker-dealers or affiliates engaged in merchant banking. The exception was provided because affiliates were not deemed to need the protections of broker-dealer registration. The exception does not cover a bank effecting trades with non-affiliated customers, even when the customer transaction also is effected as part of a trade involving an affiliate. A separate exception is necessary for the customer side of the trade.

Exchange Act Rule 15a–6 provides an exemption from U.S. broker-dealer registration for certain foreign broker-dealers.[202] Subsection (a)(4)(i) of Rule 15a–6 [203] allows a foreign broker-dealer to effect transactions in securities with or for a U.S. registered broker-dealer or bank acting in a broker-dealer capacity as permitted by U.S. law. If a foreign broker-dealer or bank is an affiliate of a U.S. bank acting in a broker-dealer capacity permitted by U.S. law, the foreign broker-dealer or bank can rely on Rule 15a–6(a)(4)(i) to effect transactions in securities with or for such U.S. bank without registering in the United States as a broker-dealer. Moreover, in these transactions with its foreign affiliate, the U.S. bank could rely on the affiliate transactions exception.[204] However, if the foreign broker-dealer or bank seeks to have direct contact with customers of the U.S. bank, the foreign entity may not avail itself of the exemption in Rule 15a–6(a)(4)(i). Similarly, the U.S. bank could not rely on the affiliate transactions exception to avoid any registration requirements arising out of its role in the foreign broker-dealer's or bank's dealings with its customers.

B. De Minimis Exception and RULE 3a5–1

Exchange Act Section 3(a)(4)(B)(xi) [205] excepts from the definition of broker banks that effect no more than 500 securities transactions, other than transactions that qualify for one of the other statutory exceptions. A transaction in which the bank is acting as an agent for a customer would count as one transaction toward the 500-transaction limit. Questions have arisen, however, as to whether banks can rely on this exception if they engage in ''riskless'' principal transactions.[206]

In the context of permissible bank activity under the Glass-Steagall Act, the OCC has interpreted ''riskless''

[197] 17 CFR 240.3a4–5.

[198] 15 U.S.C. 78c(a)(4)(C). The bank also may use the Fund/SERV system to execute orders in investment company securities, pursuant to Rule 3a4–6.

[199] Bank Holding Company Act Section 2(k) [12 U.S.C. 1841(k)] defines affiliate to mean ''any company that controls, is controlled by or that is under common control with another company.''

[200] 15 U.S.C. 78c(a)(4)(B)(vi).

[201] 17 CFR 240.15a–6.

[202] 17 CFR 240.15a–6. Rule 15a–6 and other exemptions from registration remain viable after the passage of the GLBA to the extent that the conditions of such exemptions can be met. Even when the GLBA permits a bank to engage in securities-related activities without itself registering as a broker-dealer, a broker-dealer engaged in the business of effecting transactions for such bank still must register absent an exemption or other exclusion from the requirements of the Exchange Act. For instance, this would be the case for a foreign broker-dealer that handles trades for a bank under Exchange Act Section 3(a)(4)(C). Moreover, foreign banks do not enjoy the bank exemptions because they do not fall within the definition of bank in Exchange Act Section 3(a)(6).

[203] 17 CFR 240.15a–6(a)(4)(i).

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

[205] 15 U.S.C. 78c(a)(4)(B)(xi) [15 U.S.C. 78c(a)(4)(B)(xi)].

[206] ''Riskless'' principal transactions are generally described as trades in which, after receiving an order to buy (or sell) from a customer, the broker-dealer purchases (or sells) the security from (or to) another person in a contemporaneous offsetting transaction. *See* Exchange Act Rule 10b–10(a)(2)(ii)(A) [17 CFR 240. 10b–10(a)(2)(ii)(A)]; Exchange Act Rel. No. 33743 (Mar. 9, 1994) at n.11.

principal activity as equivalent to agency activity.[207] Nevertheless, under the securities laws, ''riskless'' principal transactions involve dealer activity because entities that engage in ''riskless'' principal transactions as a matter of course would be involved in the business of buying and selling securities for their own accounts, even if the risk associated with the transactions is minimal or non-existent.[208] In light of the differing interpretations regarding ''riskless'' principal transactions, we have determined to adopt Rule 3a5–1 to exempt banks from the definition of dealer provided that the number of ''riskless'' principal transactions and agency transactions engaged in by a bank does not exceed 500 transactions per year.[209] We believe that this exemption provides relief to banks in an area that may have been understood to have been covered by the *de minimis* exception because of the differing legal interpretations under the banking and securities laws. This exemption, however, does not expand the number of transactions permitted under the statutory exception. Rather, this is a technical exemption to clarify that banks may act as a riskless principal, as well as an agent, and meet the terms of the *de minimis* exception.

Rule 3a5–1 provides that a bank is exempt from the definition of the term ''dealer'' solely for engaging in riskless principal transactions if the number of such riskless principal transactions combined with transactions in which the bank is acting as an agent for a customer under the *de minimis* exception do not exceed 500 transactions. A ''riskless principal transactions'' is defined as a transaction in which, after having received an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer.

For purposes of Rule 3a5–1 and the *de minimis* exception, riskless principal transactions should be counted toward the 500-transaction limit in the following manner. First, a transaction in which the dealer bank is acting as a riskless principal intermediary between a broker-dealer and a non-broker-dealer customer would count as one trade toward the 500-transaction limit. Second, a transaction in which the dealer bank is acting as a riskless principal intermediary between two non-broker-dealer customers would count as two trades toward the 500-transaction limit. We have included this methodology in Rule 3a5–1(b), which explicitly provides that for purposes of the 500-transaction limit ''a riskless principal transaction counts as: (1) Two transactions if neither transaction comprising the riskless principal transaction is with a broker or dealer; or (2) one transaction if either transaction comprising the riskless principal transaction is with a broker or dealer.''

We believe this methodology is consistent with the *de minimis* exception to the definition of ''broker.'' Specifically, a broker acts as an agent for a customer in executing securities transactions. Because riskless principal transactions are in many respects equivalent to transactions effected on agency basis for customers, we determined to focus on transactions between banks and customers that are similar to agency transactions. Transactions between banks and broker-dealers appear in many respects to be transactions between principals. We therefore determined not to count transactions with broker-dealers for purpose of this exemption.

We request comment on whether riskless principal transactions should be counted as provided in Rule 3a5–1 for purposes of the *de minimis* exception. Should this exception be limited to instances where a broker or dealer is the counterparty to a particular transaction? Are there other specific types of transactions that should be specially accounted for in determining the *de minimis* exception?

IV. Rule 3b–18—Definitions of Terms Used in Asset-Backed Exception to Dealer

Exchange Act Section 3(a)(5)(A) defines the term ''dealer'' generally as ''any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise * * *'' Exchange Act Section 3(a)(5)(B)[210] provides an exception for any ''person that buys or sells securities for such person's own account, either individually or in a fiduciary capacity, but not as a part of a regular business.'' Prior to the passage of the GLBA, the Exchange Act completely excepted banks from the definition. However, the Glass-Steagall Act generally prohibited banks from acting as underwriters or dealers of corporate securities and certain other types of securities. The GLBA retained the general prohibition on bank underwriting and dealing in corporate securities and certain other types of securities but repealed the Exchange Act's blanket exception for banks acting as dealers. The GLBA replaced the blanket exception with four specific exceptions for certain securities activities that a bank may engage in without being considered a dealer.[211] The four exceptions are for: (1) Permissible securities transactions;[212] (2) investment, trustee, and fiduciary transactions;[213] (3) asset-backed transactions;[214] and (4) transactions in identified banking products.[215] The permissible securities transactions exception allows banks to buy and sell permissible securities, which include commercial paper and exempted securities. The second exception permits banks to buy and sell securities for investment purposes for the bank or for the accounts for which the bank acts as a trustee or fiduciary. The third exception is discussed below. The fourth exception permits the bank to buy and sell identified banking products, which include deposit accounts, letters of credit issued by a bank, and loans made by a bank. We view the first, second, and fourth exceptions as not needing additional clarification by rule at this time. However, we do solicit comment on whether there are any issues surrounding the interpretation of these three exceptions of which we should be aware and as to which we should provide guidance.

The third exception allows banks to issue and sell certain asset-backed securities.[216] Under this exception banks are permitted to issue or sell

[207] The OCC stated that, ''riskless principal activities are the legal and economic equivalent of permissible brokerage activities inasmuch as riskless principal brokerage is conducted in a manner consistent with the express terms of section 16,'' of the Glass-Steagall Act. *See* OCC Interpretive Letter No. 371 (June 13, 1986).

[208] *See* Securities Exchange Act Section 3(a)(5). In connection with amendments to Rule 10b–10, however, the Commission stated that ''riskless'' principal transactions are in many respects equivalent to transactions effected on an agency basis. *See Securities Confirmations,* Exchange Act Rel. No. 15219 (Oct. 6, 1978), 43 FR 47495 (Oct. 6, 1978).

[209] We find that this exception is necessary and appropriate in the public interest and consistent with the protection of investors. *See* Exchange Act Sections 15(a)(2), 23(a)(1), and 36(a)(1) [15 U.S.C. 78o(a)(2), 78w(a)(1), and 78mm(a)(1)].

[210] 15 U.S.C. 78c(a)(5)(B) [15 U.S.C. 78c(a)(5)(B)].

[211] Exchange Act Section 3(a)(5)(C) [15 U.S.C. 78c(a)(5)(C)].

[212] Exchange Act Section 3(a)(5)(C)(i) [15 U.S.C. 78c(a)(C)(i)].

[213] Exchange Act Section 3(a)(5)(C)(ii) [15 U.S.C. 78c(a)(C)(ii)].

[214] Exchange Act Section 3(a)(5)(C)(iii) [15 U.S.C. 78c(a)(C)(iii)].

[215] Exchange Act Section 3(a)(5)(C)(iv) [15 U.S.C. 78c(a)(C)(iv)].

[216] Exchange Act Section 3(a)(5)(C)(iii) [15 U.S.C. 78c(a)(5)(c)(iii)].

specified securities to qualified investors through a grantor trust or other separate entity without being considered a dealer. The specified securities generally must be originated by the bank and backed by the obligations of the bank's customers. We have identified several issues under this exception that require clarification. We are adopting Rule 3b–18 to assist banks in structuring their activities in accordance with the new asset-backed transaction exception.[217]

The exception to the definition of dealer registration for banks engaging in asset-backed issuance and sale transactions specifically provides that a bank may ''engage in the issuance or sale to qualified investors, through a grantor trust or other separate entity, of securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any such obligations predominantly originated by: (1) The bank; (2) an affiliate of any such bank other than a broker or dealer; or (3) a syndicate of banks of which the bank is a member, if the obligations or pool of obligations consist of mortgage obligations or consumer-related receivables.'' [218]

This language makes it clear that Congress intended to create a narrow dealer exception for banks that engage in the issuance and sale of securities based on assets created by the bank itself and sold only to qualified investors. Congress' intent to limit this exception to bank-generated underlying assets is shown by the language found at the conclusion of the section that requires any of the obligations to be ''predominantly originated'' by the group consisting of the bank and its affiliates. In the case of mortgage obligations and consumer-related receivables, the limitation is expanded to permit a syndicate of banks that includes the issuing bank to originate the obligations or pool of obligations.

Moreover, the legislative history indicates that this exception should be limited to syndicates in which the bank is more than an insignificant member. It states that, ''[t]he Committee expects this provision shall be interpreted so that the bank will [have] not less than ten percent of the assets in the syndicate or pool of obligations.'' [219] This interpretation generally limits the availability of the underwriting exception to asset-backed transactions predominantly originated by the bank that is underwriting the transaction, or involving syndicates where that bank is not an insignificant member. In addition, the exception requires the asset-backed securities to be placed into a grantor trust or other separate entity.

The exception by its terms does not cover repurchases by the bank of the asset-backed securities after they have been originated and issued; rather, the terms of the exception cover the issuance or sale of asset-backed securities. Thus, the exception permits a bank to create, underwrite, and issue asset-backed securities predominantly originated by the bank and its affiliates. This exception does not permit the bank to be a dealer by regularly repurchasing and reselling the asset-backed securities that it issues. A bank may purchase these securities for investment purposes, so long as the bank is not acting as a dealer.[220]

We note that this is the only exception that permits this type of securitized transaction. The exception to the definition of dealer for banks buying or selling identified banking products [221] does not permit the packaging of securities for sale in an asset-backed transaction.[222]

We are clarifying several terms in the asset-backed securities exception to assist banks in understanding how this section applies to their asset-backed securities activities. Specifically, Rule 3b–18 defines the terms ''affiliate,'' ''consumer-related receivable,'' ''member of a syndicate of banks,'' ''obligation,'' ''originated,'' ''pool,'' ''predominantly originated,'' and ''syndicate of banks'' as used in this exception. We find that these definitions are consistent with the provisions and purposes of the Exchange Act.[223]

First, in defining the term ''predominantly,'' which modifies the term ''originated,'' we looked to other sections of the GLBA in which the term is used. Section 103(n) of the GLBA uses the term ''predominantly'' to modify ''financial'' and to allow analysis of whether nonfinancial activities and affiliations may be retained.[224] Section 103(n)(2) of the GLBA expressly provides that a firm is predominantly engaged in financial activities when at least 85% of the annual gross revenues of the consolidated company derive from financial activities, excluding any revenue from banks. To be consistent, we are applying the same numerical test found in Section 103(n)(2) of GLBA for loan product originations for the purpose of the asset-backed securities exception from the definition of dealer.

Therefore, for the purpose of the asset-backed transaction exception, Rule 3b–18(g) defines ''predominantly originated'' so that a bank may engage in the issuance or sale of asset-backed securities without registration as a dealer if at least 85% of the obligations underlying the securities were originated by the bank or its affiliates, other than its broker-dealer affiliates, or any permitted syndicate of which the bank is more than an insignificant member. Specifically, the bank, its affiliates, or any such syndicate must have originated 85% of the obligations in any pool as measured by the value of the obligations. We considered and

[217] *Id.*

[218] Exchange Act Sections 3(a)(5)(C)(iii)(I), (II), and (III) [15 U.S.C. 78c(a)(C)(iii)(I), (II), and (III)].

[219] *See* H.R. Rep. No. 106–74, pt. 3, at 171 (1999).

[220] Exchange Act Section 3(a)(5)(C)(ii) [15 U.S.C. 78c(a)(C)(ii)]. In contrast, a bank also may deal in government securities, such as securities of the Federal National Mortgage Association (''Fannie Mae'') and the Federal Home Loan Mortgage Corporation (''Freddie Mac''). Exchange Act Sections 3(a)(5)(C)(II) (exception from ''dealer'' for exempted securities) [15 U.S.C. 78c(a)(5)(C)(II)], 3(a)(12)(A) (exempted security defined) [15 U.S.C. 78c(a)(12)(A)], and 3(a)(42)(B) and (C) (government securities defined) [15 U.S.C. 78c(a)(42)(B) and (C)].

[221] Section 206 of the GLBA defines the term ''identified banking product'' as:

''(1) a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank;

''(2) a banker's acceptance;

''(3) a letter of credit issued or loan made by a bank;

''(4) a debit account at a bank arising from a credit card or similar arrangement;

''(5) a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold—

''(A) to qualified investors; or

''(B) to other persons that—

''(i) have the opportunity to review and assess any material information, including information regarding the borrower's creditworthiness; and

''(ii) based on such factors as financial sophistication, net worth, and knowledge and experience in financial matters, have the capability to evaluate the information available, as determined under generally applicable banking standards or guidelines; or

''(6) any swap agreement, including credit and equity swaps, except that an equity swap that is sold directly to any person, other than a qualified investor (as defined in section 3(a)(54) of the Securities Act of 1934) shall not be treated as an identified banking product.'' 15 U.S.C. 78c note.

[222] Exchange Act Section 3(a)(5)(C)(iv) [15 U.S.C. 78c(a)(5)(C)(iv)].

[223] Exchange Act Section 3(b) [15 U.S.C. 78c(b)].

[224] Bank Holding Company Act Section 4(n)(2) [12 U.S.C. 1843(n)(2)].

rejected also having banks apply the predominantly originated test to the number and dollar amount owing on the obligations as well as the value in an asset-backed transaction pool. We rejected this more extensive test as too burdensome for any increased reliability that it might offer. We invite comment on this definition.

Many of the definitions we are adopting are intended to shed light on the financial terms used in the exception and avoid ambiguities without delving into complex financial issues that may not be relevant to the analysis of whether a bank would be considered a dealer. Thus, the definitions should be relatively straightforward and uncomplicated. In defining the terms, we have looked to generally understood meanings and the interpretations of the other financial participants, including regulators.

For instance, Rule 3b–18(e) provides that ''originated'' means initially making and funding an obligation.[225] Thus, to count as an obligation originated by the bank or its affiliates, the bank and its affiliates must be the initial lender as shown both by creating and supplying the money for a loan. Rule 3b–18(d) provides that ''obligation'' means any note, draft, acceptance, loan, lease, receivable, or other evidence of indebtedness that is not a security issued by a person other than the bank.[226]

Rule 3b–18(a) defines the term ''affiliate'' by using the same definition found in Section 509 of the GLBA and Section 2 of the Bank Holding Company Act.[227] This definition states that affiliate means ''any company that controls, is controlled by, or is under common control with another company.'' Rule 3b–18(h) defines the term ''syndicate of banks'' to mean a group of banks that acts jointly, on a temporary basis, to loan money in one or more bank credit obligations.[228]

The asset-backed transaction exception allows ''consumer-related receivables'' to be originated by a syndicate of banks of which a bank is a member, as well as being originated by the bank itself or an affiliate of the bank, other than a broker-dealer.[229] Rule 3b–18(b) defines ''consumer-related receivable,'' as any obligation incurred by any natural person to pay money arising out of a transaction in which the money, property, insurance, or services (being purchased) are primarily for personal, family, or household purposes.[230]

Rule 3b–18(g) defines a ''pool'' as more than one obligation or type of obligation grouped together to provide collateral for a securities offering.[231] Finally, we note that the term ''qualified investor'' is defined in Section 3(a)(54) of the Exchange Act, as amended by Section 207 of the GLBA. This definition limits the universe of purchasers of asset-backed securities to a more sophisticated group when there is not a registered broker-dealer underwriting the securities offering.

We invite comment on these definitions, including whether there are any alternate definitions of these terms that would be more appropriate for the purposes of this specific functional exception to the definition of dealer. We also invite comment on whether the 85% test for ''predominantly originated'' and whether calculating the ''predominantly originated by'' test based on the value of the obligations is a workable approach, or whether other means of determining ''predominantly'' should be considered. Commenters also are requested to give their views on whether there are any other definitions or interpretations that should be added, or issues that should be considered to enhance the clarity of this exception.

V. Rule 3a4–6—Exemption To Permit Execution of Investment Company Securities Through NSCC'S Mutual Fund Services

We have been asked whether banks may purchase and redeem shares of open-end investment companies through NSCC's Mutual Fund Services,[232] including Fund/SERV, and still comply with Exchange Act Section 3(a)(4)(C). NSCC's Mutual Fund Services provide an automated system to participants to process transactions in investment company securities. Fund/SERV centralizes order entry, confirmation, registration, and settlement of purchases and redemptions of investment company securities. NSCC's Mutual Fund Services are available to investment companies, broker-dealers, banks, trust companies, and other financial institutions that have been accepted for membership in NSCC.

Exchange Act Section 3(a)(4)(C) requires banks to execute through a registered broker-dealer (or internally cross) securities transactions effected pursuant to the trust and fiduciary activities exception, safekeeping and custody exception, or certain stock purchase plans exception.[233] Banks that use NSCC's Mutual Fund Services to execute transactions in investment company securities may not use a registered broker-dealer to execute these transactions, depending on whether the NSCC arrangement is with the principal underwriter or the transfer agent of the investment company. Therefore, some banks require an exemption from the trade execution requirements of Exchange Act Section 3(a)(4)(C) to continue to use NSCC's Mutual Fund Services while complying with exceptions and exemptions from the definition of broker. We are adopting this exemption to allow banks to continue to execute transactions in shares of open-end investment companies through NSCC's Mutual Fund Services because NSCC's Mutual Fund Services simplify and automate the process for purchasing and redeeming investment company securities without raising investor protection concerns. This exemption is available only to banks that process orders through a service of a registered clearing agency subject to our supervision and regulation. We find that this exception is necessary or appropriate in the public interest and consistent with the protection of investors.[234]

VI. Rule 15a–7—Extentions of Time

We have received a number of requests from representatives of banks for an extension of time to comply with

[225] *See, e.g.,* John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* 422 (5th ed. 1998); Glenn G. Munn, updated by F.L. Garcia, *Encyclopedia of Banking and Finance* 743 (8th ed 1983); and Yahoo! Financial Glossary at http://dir.yahoo.com/Business_and_Economy/Finance_and_Investment/Reference_and_Guides/Glossaries.

[226] *See, e.g., Dictionary of Finance and Investment Terms, Id.*, at 405; John F. Marshall, *Dictionary of Financial Engineering,* 122 (2000); and *Encyclopedia of Banking and Finance, Id.* at 728.

[227] Exchange Act Section 3(a)(4)(B)(vi) adopts the definition of ''affiliate'' found in Bank Holding Company Act Section 2(k) [12 U.S.C. 1841(k)]. Both definitions are the same.

[228] *See, e.g., Dictionary of Finance and Investment Terms, supra* note 225 at 555; *Encyclopedia of Banking and Finance, supra* note 225, at 907; Yahoo! Financial Glossary, *supra* note 225; *see also Federal Deposit Insurance Corporation Regional Outlook, First Quarter 1999,* at 19, citing American Bankers Association, *Banking Terminology,* 3rd ed., 1989, p. 435.

[229] Exchange Act Section 3(a)(5)(C)(iii)(I–III) [15 U.S.C. 78c(a)(5)(C)(iii)(I–III)].

[230] Adapted from 1989 Fed. Res. Interp. Ltr. Lexis 283 (Aug. 1, 1989).

[231] *See e.g., Dictionary of Financial Engineering, supra* note 226, at 117; *Yahoo! Financial Glossary supra* note 225.

[232] NSCC is a clearing agency registered pursuant to Section 17A of the Exchange Act [15 U.S.C. 78q–1].

[233] 15 U.S.C. 78c(a)(4)(B)(ii), (iv), and (viii).

[234] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1); *see also* Exchange Act Sections 15(a)(2) and 23(a)(1) [15 U.S.C. 78o(a)(2) and 78w(a)(1)].

the broker-dealer provisions of the GLBA.[235] These requests indicate that a number of banks will not have completed the process of shifting certain necessary securities activities to a registered broker-dealer by May 12, 2001, to avoid being considered a broker or dealer subject to registration requirements. They also request time to adapt to the guidance provided by the Commission regarding these provisions. We recognize the time concerns that banks have raised. Because banks have historically enjoyed an exception from broker-dealer regulation, we believe they may need additional time to more fully comply with the GLBA amendments and these rules. Accordingly, we are adopting Rule 15a–7, which provides two conditional exemptions from broker-dealer registration to allow additional time for banks to make the necessary arrangements either to register or to comply with a specific functional exception to the definitions of broker or dealer. We find that these exemptions are necessary or appropriate in the public interest and consistent with the protection of investors.[236]

First, Rule 15a–7(a) exempts until October 1, 2001 banks that would otherwise be required to register as a broker or dealer because the bank's securities activities do not fit within the exceptions to the definitions of broker or dealer. Second, Rule 15a–7(b) exempts until January 1, 2002, banks that would be a broker solely because their compensation arrangements—either for the bank or for its employees—do not meet the compensation conditions of a particular exception or exemption.[237] This would include effecting transactions in a money market fund that does not qualify as no-load under the sweeps exception.

VII. Rule 15a–8—Exemption for Contracts Entered Into by Banks Before 2003 From Being Considered Void or Voidable

We recognize that banks may need to adjust their procedures to shift their securities activities to registered broker-dealers or to comply with the conditions of the specific functional exceptions or exemptions to the definitions of broker and dealer. We also are aware that there may be instances where, despite having reasonable procedures in place, a bank may inadvertently fail to meet the terms and conditions of the specific functional exceptions upon which it is relying. This could result in the bank engaging in securities activities in violation of the registration requirements of Exchange Act Section 15 and the rules promulgated under that section.

Exchange Act Section 29(b)[238] provides that any contract made in violation of the Exchange Act or Exchange Act rules shall be void as regards the rights of any person who made or engaged in the performance of any such contract.[239] Occasionally, private parties have invoked this remedy, which is purely equitable in nature,[240] in instances involving broker-dealer registration violations by the opposite party.[241]

As explained above, the amended Exchange Act contains numerous broker-dealer definitional provisions that apply only to banks, which were previously excepted from broker-dealer regulation. Because of this history, we believe that banks may have unique issues in complying with these definitional provisions. It is, therefore, appropriate to provide a transitional period before these provisions fully apply. Therefore, to provide certainty to banks while they become fully familiar with the operation of the exceptions, we are adopting Rule 15a–8.[242] This rule provides an exemption for contracts entered into by banks before January 1, 2003 from being considered void or voidable by reason of Exchange Act Section 29 because a bank that is a party to the contract violated the registration requirements of Section 15(a) of the Exchange Act or any applicable provision of this Act and the rules and regulations thereunder based solely on a bank's status as a broker or dealer when the contract was created. We expect the banks are already working to come into full compliance with the functional regulation provisions of the GLBA. Banks may, however, have inadvertent, technical violations as they become accustomed to the new regulatory requirements. This exemption is designed to recognize the unique compliance problems that many banks have by preventing any inadvertent failures by banks to meet the conditions of the functional exceptions from triggering potential rescission under Exchange Act Section 29 during this transitional period.

We note that this provision does not relieve banks of the obligation to register as a broker or dealer if their securities activities do not fit within a specific functional exception or exemption. We also note that banks' securities activities continue to be subject to the antifraud provisions of the federal securities laws, irrespective of the bank's lack of registration or failure to comply with the provisions of the Exchange Act and the rules thereunder that otherwise apply to banks based on their status as broker-dealers. We, therefore, find that this exemption is consistent with the

[235] Letter from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers, to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 15, 2001); Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura Unger, Acting Chairman, Commission (Mar. 13, 2001); Letter from Sarah A. Miller, Director, Center for Securities, Trust and Investments, American Bankers Association, to Laura Unger, Acting Chairman, Commission (February 28, 2001).

[236] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1); *see also,* Exchange Act Sections 15(a)(2) and 23(a)(1) [15 U.S.C. 78o(a)(2) and 78w(a)(1)].

[237] Banks should be aware that the definitions of broker and dealer do not include any exceptions for banks acting as municipal securities dealers. Banks acting as municipal securities dealers are still required to be registered under Exchange Act Section 15B [15 U.S.C. 78o–4] and to comply with requirements of the Exchange Act applicable to municipal securities dealers.

[238] 15 U.S.C. 78cc(b).

[239] Exchange Act Section 29(b) does not make the contract automatically a nullity. Rather, the contract is voidable at the option of the innocent party. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 387 (1970). In this manner, ''interests of the victim are sufficiently protected by giving him the right to rescind; to regard the contract as void where he has not invoked the right would only create the possibility of hardships to him or others without necessarily advancing the statutory policy of disclosure.'' *Id.* at 388.

[240] *Id.* at 388; *see also Occidental Life Ins. Co.* v. *Pat Ryan and Assoc.*, 496 F.2d 1255, 1267 (4th Cir.), *cert. denied,* 419 U.S. 1023 (1974) (principles of equity, like estoppel and waiver, apply to actions brought under Exchange Act Section 29(b)).

[241] *See Boguslavsky* v. *Kaplan*, 159 F.3d 715, 722 (2nd Cir. 1998) (under the liberal pleading standard accorded pro se litigants, an investor properly presented an identifiable claim for rescission under Exchange Act Section 29(b) in asserting that the firm opeated without director of compliance and thus was not properly registered as securities broker-dealer); *Regional Properties, Inc.* v. *Financial and Real Estate Consulting Co.*, 752 F.2d 178, 182 (5th Cir. 1985) (subject to equitable defenses, real estate developers were entitled to rescind agreement with broker to structure and market limited partnership interest where broker had failed to register as required by the Exchange Act); *Regional Properties* v. *Financial and Real Estate Consulting Co.*, 678 F.2d 552, 557, 566–67 (5th Cir. 1982) (recognizing that Exchange Act Section 29(b) provides for a private, equitable cause of action for the rescission of a contract where the securities broker was unlicensed); *Eastside Church of Christ* v. *National Plan, Inc.*, 391 F.2d 357, 362 (5th Cir.)., *cert. denied*, 393 U.S. 913 (1968) (churches could void a transaction with broker under Exchange Act Section 29(b) because the broker was unregistered); *Couldock and Bohan, Inc.* v. *Societe Generale Securities, Corp.*, 93 F. Supp. 2d 220, 233 (D. Conn. 2000) (a contract violating broker registration requirements of the Exchange Act is voidable at the option of the innocent party under Exchange Act Section 29(b)).

[242] 17 CFR 240.15a–8.

public interest and the protection of investors.[243]

We request comment on the appropriateness of this temporary exemption from Exchange Act Section 29(b).

VIII. Rule 15a–9—Exemption for Savings Associations and Savings Banks

We are granting an exemption from the definitions of ''broker'' and ''dealer'' for savings associations and savings banks [244] on the same terms and conditions that banks are excepted or exempted from broker-dealer registration.[245] Savings associations and savings banks are not ''banks'' as defined in Exchange Act Section 3(a)(6).[246] Accordingly, they have not had the same general exception from broker-dealer registration for securities transactions as banks have had. Savings associations and savings banks have typically established networking arrangements with broker-dealers.[247]

Now that the general exception for banks has been replaced, and the differences between banks and savings associations have narrowed;[248] it seems reasonable to afford savings associations and savings banks the same type of exemptions. Moreover, insured savings associations are subject to a similar regulatory structure and examination standards as banks.[249] We find that extending the exemption for banks to savings associations and savings banks is necessary or appropriate in the public interest and is consistent with the protection of investors.[250]

In addition, the existence of some of the bank exceptions from broker-dealer registration, such as the trust and fiduciary activities exception, the safekeeping and custody exception, and the sweep accounts exception, that may suggest registration is necessary for certain limited conduct, create legal uncertainty for savings associations and savings banks engaging in such activities. The exemption will allow savings associations and savings banks that are governed by a similar regulatory structure to operate under the same terms and conditions as banks. We emphasize, however, that consistent with functional regulation, savings associations and savings banks, as well as banks, using the trust and fiduciary activities, safekeeping and custody, or stock purchase plan exceptions, must execute securities transactions through registered broker-dealers or internally cross their trades. We note that the OTS, the FDIC, or the Federal Financial Institutions Examinations Council may adopt recordkeeping requirements.[251] We solicit comment on whether there is a need for us to propose regulations to assure parallel recordkeeping requirements. We also request comment on all aspects of this exemption as well as whether it should be extended to any other entities.

IX. Rule 30–3—Delegation of Authority

We are amending Rule 30–3 of our Rules of Organization and Program Management [252] by adding new paragraph (a)(72) to Rule 30–3 to delegate to the Director of the Division of Market Regulation authority to review and, either unconditionally or on specified terms and conditions, to grant or deny to banks, savings associations, and savings banks exemptions from the broker-dealer registration requirements,[253] pursuant to the authority provided in Section 15 and Section 36 of the Exchange Act.[254] The delegation of authority to the Division is designed to conserve our resources by permitting Division staff to grant or deny exemptions where appropriate and in a timely manner. We expect the staff to submit to us novel and complex requests for exemption.

X. Procedural Matters

A. Administrative Procedures Act And Request For Comments

The Administrative Procedures Act (''APA'') permits an agency to issue a rule without prior notice and comment upon a finding of good cause, or if the rule is interpretive, a general statement of policy, or a rule of agency organization, procedure, or practice.[255] The APA also permits an agency to issue a rule without delaying its effective date for 30 days from the date of publication if the agency finds good

[243] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1)].

[244] This exemption requires savings associations and savings banks to have deposits insured by the FDIC under the FDIA and to not be operated for the purpose of evading the provisions of the Exchange Act. 12 U.S.C. 1811 *et seq.*

[245] Nevertheless, savings associations and savings banks that are municipal securities dealers must register and be regulated as municipal securities dealers pursuant to Exchange Act Section 15B [15 U.S.C. 78o–4]. Banks must also register pursuant to Exchange Act Section 15B. Exchange Act Section 3(a)(34)(A) [15 U.S.C. 78c(a)(34)(A) provides that the ''appropriate regulatory agency'' of a municipal securities dealer that is a bank regulated by the OCC, the Federal Reserve, or the FDIC is the agency that already regulates the bank. Exchange Act Section 3(a)(34)(A)(iv) [15 U.S.C. 78c(a)(34)(A)(iv)] designates the Commission as the appropriate regulatory agency in the case of all other municipal securities dealers, which includes savings associations and savings banks that are municipal securities dealers.

[246] *See* Letter re: *AmeriFed Federal Savings Bank* (Jan. 18, 1990). The OTS is the appropriate federal regulator for savings associations, which include federally chartered savings banks, and the FDIC is the appropriate federal regulator for state-chartered savings banks as it is for all state-chartered banks that are not members of the Federal Reserve System. 12 U.S.C. 1813(q); *see also,* Investment Company Act Rel. No. 13666, *Status of Savings and Loan Associations Under the Federal Securities Laws; Advance Notice of Possible Commission Action,* 49 FR 6383 (December 19, 1983).

[247] *See, e.g.,* Chubb Letter, *supra* note 38.

[248] *See FDIC Banking Review,* Volume 10, No., 1 pp. 3–18 (June 1997).

[249] *See e.g.,* 12 U.S.C. 1828(c), dealing with the regulatory responsibilities of the banking agencies regarding mergers of insured depository institutions; 12 U.S.C. 1828(i), governing the statutory requirements for a reduction in stock capital; 12 U.S.C. 1828(m), governing activities of savings associations and their subsidiaries; 12 U.S.C. 1818(e), governing insured depository institutions removal and prohibition authority; 12 U.S.C. 1831m, governing early identification of needed improvements in financial condition; and 12 U.S.C. 1831o, governing prompt corrective action. In each of these instances, the OTS has exactly the same regulatory authority as do the federal banking agencies with regard to the banks under their jurisdiction.

The FDIC also must approve the applications of savings associations and savings banks for deposit insurance. 12 U.S.C. 1815. The FDIC receives a notice every time a savings association or savings bank establishes or acquires a new subsidiary or commences a new activity. 12 U.S.C. 1828(m). The FDIC also has additional regulatory and examination authority over these insured depository institutions in its role as the insurer of their deposits, just like it does over state and national banks. 12 U.S.C. 1820. The FDIC also reviews the activities of state chartered savings associations and state chartered banks, including savings banks, whenever they engage in activities that are not permissible for federally chartered savings associations or national banks, respectively. 12 U.S.C. 1831e and 1831a, respectively.

[250] Exchange Act Section 36(a)(1) [15 U.S.C. 78mm(a)(1).

[251] *See* 12 U.S.C. 1828(t).

[252] *See* 17 CFR 200.30–3(a), which is entitled ''Delegation of authority to Director of Division of Market Regulation.''

[253] Section 15(a) generally requires a broker or dealer to register with us prior to effecting, inducing, or attempting to induce securities transactions.

[254] This delegation of authority does not apply to banks seeking exemptions from registration as a municipal securities dealer under Exchange Act Section 15B [15 U.S.C. 78o–4], which regulates the activities of municipal securities dealers. Banks that act as municipal securities dealers are still required to comply with the requirements of the Exchange Act applicable to non-bank municipal securities dealers. Savings associations and savings banks are required to comply with the requirements applicable to bank municipal securities dealers but by the terms of the exemption in Rule 15a–9 are exempted from complying with those requirements if they comply with rules applicable to bank municipal securities dealers.

[255] The APA provides that prior notice and comment is not required: ''(A) [for] interpretive rules, general statements of policy, or rules of agency organization, procedure, or practice; or (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefore in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.'' 5 U.S.C. 553(b)(A) and (B).

cause and publishes its finding with the rule, or if the rule is not substantive.[256]

For the reasons discussed below, we find that there is good cause for issuing Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, 3b–17, 3b–18, 15a–7, 15a–8 and 15a–9 under the Exchange Act without prior notice and comment and without a delayed effective date. We also find that the amendment to Rule 30–3 of our Rules of Organization and Program Management relates solely to agency organization, procedure, or practice, and is not a substantive rule. Accordingly, we are issuing the amendment without prior notice and comment and without a delayed effective date.

As the banking regulators found with respect to certain of their regulations under the GLBA,[257] we find good cause for issuing Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, 3b–17, 3b–18, 15a–7, 15a–8 and 15a–9 without notice and comment or a delayed effective date. We make this finding for the following reasons: (1) The short time available between the time members of the banking community requested specific guidance as to the meaning of certain provisions of the GLBA and the date on which those provisions become effective; (2) the amount of input we already have received from the industry on the issues addressed by the rules; (3) the fact that the rules do not impose any new obligations in addition to those created by the GLBA, but rather provide guidance as to the meaning of certain provisions of that statute or provide exemptive relief consistent with the intent of those provisions; and (4) the interim nature of the rules, which come after discussions with the industry, and which invite further comment, with possible revision of the rules in light of those comments.

Although Congress enacted the GLBA in November 1999, members of the banking community more recently requested specific guidance as to the meaning of certain key terms used in the GLBA amendments to the definitions of ''broker'' and ''dealer'' and as to the application of those terms to certain activities. The GLBA does not require us to engage in rulemaking in this area, and we initially anticipated that we could work with banks on an individual basis to address their particular concerns. In recent weeks, however, we have received a significant number of inquiries regarding how we interpret some of the key terms in the new definitions. Based on these inquiries, we now believe that it is necessary to provide guidance in the form of rulemaking before the effective date of May 12, 2001.

We recently received many requests for guidance and certain relief by letter. Several of the letters asked us to delay implementing the GLBA amendments to the definitions of ''broker'' and ''dealer.''[258] One of the letters expressed the writer's view on how the trust and fiduciary activities exception applied to conduct by indenture trustees and requested an exemption for this conduct from the statute.[259] A different letter from the same writer asked how the trust and fiduciary activities exception applied to banks acting as trustees for certain benefit plans and self-directed IRAs.[260] A separate letter by the same writer asked whether certain investment management services offered by bank trust departments.[261] Another letter asked that we extend the exceptions to the definitions of ''broker'' and ''dealer'' to thrifts.[262] Still other letters noted that the term ''no-load'' was not defined in the GLBA and inquired if we interpreted the term in the same manner as the NASD's definition of that term.[263] In addition, Commission staff has had numerous discussions with industry members during the past few weeks concerning the GLBA amendments. These requests and discussions persuaded us that immediate guidance concerning the scope of the functional exceptions to the definitions of ''broker'' and ''dealer'' added by the GLBA is imperative.

The industry requests not only clarified the need for immediate rulemaking, but also provided us with valuable information in drafting the rules. In this regard, Commission staff has received critical input from the banking industry through frequent discussions with staff from banks and industry associations, as well as banking regulators. Our staff has traveled throughout the country to determine what, if any, regulatory issues are of concern to industry members in light of the GLBA amendments. In addition, we initiated a dialogue with the affected industries by soliciting inquiries, participating in industry conferences, and conducting question and answer sessions. Finally, we reviewed information provided to Congress by industry sources, including the American Bankers Association, at the time the GLBA was enacted. As a result, we have received much of the input and information that we would expect to receive from commenters during a pre-effective comment period.

The rules we have adopted in response to industry concerns do not impose any new obligations beyond those created by the statute. Rules 3b–17 and 3b–18 are primarily definitional and are designed to clarify certain terms used in the functional exceptions to the definitions of ''broker'' and ''dealer'' added by the GLBA although the definitions of trustee in Rule 3b–17 is also exemptive in nature. Six of the rules, Rules 3a4–2, 3a4–3, 3a4–4, 3a4–

[256] The APA provides that publication of a substantive rule must be made not less than 30 days prior to its effective date, except ''(1) a substantive rule which grants or recognizes an exemption or relieves a restriction; (2) interpretive rules and statements of policy; or (3) otherwise provided by the agency for good cause found and published with the rule.'' 5 U.S.C. 553(d).

[257] *See* Interim Final Rule with Request for Comments, Repurchases of Stock by Recently Converted Savings Associations, Mutual Holding Company Dividend Waivers, 65 FR 43088 (July 12, 2000), comment period extended, 65 FR 60095 (Oct. 10, 2000) (OTS); Joint Interim Final Rule with Request for Comments, Bank Holding Companies and Changes in Bank Control, 65 FR 16460 (Mar. 28, 2000) (Board of Governors of the Federal Reserve System (Federal Reserve and Treasury); Interim Final Rules with Request for Comment, Activities and Investments of Insured State Banks, 65 FR 15526 (Mar. 23, 2000), Final Rule, 66 FR 1018 (Jan. 5, 2001) (FDIC); Interim Final Rule with Request for Comments, Financial Subsidiaries, 65 FR 14819 (Mar. 20, 2000) (Federal Reserve); Joint Interim Final Rule with Request for Comments, Financial Subsidiaries, 65 FR 15050 (Mar. 20, 2000) (Treasury and Federal Reserve); Interim Final Rule with Request for Comments, Application of Sections 23A and 23B of the Federal Reserve Act to Derivative Transactions with Affiliates and Intraday Extensions of Credit to Affiliates, 66 FR 24229 (May 11, 2001) (Federal Reserve).

[258] *See, e.g.*, Letter from Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers, to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 15, 2001); Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 13, 2001); Letter from Robert M. Kurucza, General Counsel, Bank Securities Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 12, 2001); Letter from Sarah A. Miller, Director, Center for Securities, Trusts, and Investments, American Bankers Association, to Laura S. Unger, Acting Chairman, Commission (Feb. 28, 2001).

[259] Letter from Melanie L. Fein, Counsel, Federated Investors, Inc., to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 30, 2001).

[260] Letter from Melanie L. Fein to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 13, 2001).

[261] Letter from Melanie L. Fein to Robert L. D. Colby, Deputy Director, and Catherine McGuire, Associate Director and Chief Counsel, Division of Market Regulation, Commission (Mar. 7, 2001).

[262] Letter from Scott M. Albinson, Managing Director, OTS, to Annette L. Nazareth, Director, Division of Market Regulation, Commission and Paul F. Roye, Director, Division of Investment Management, Commission (Mar. 20, 2001).

[263] Letter from Barry Harris, Chair, Bank Retail Broker-Dealer Committee, Securities Industry Association, to Laura S. Unger, Acting Chairman, Commission (Mar. 13, 2001); Letter from Senator Phil Gramm, U.S. Senate Committee on Banking, Housing, and Urban Affairs, to Arthur Levitt, Chairman, Commission (Feb. 6, 2001).

5, 3a4–6, 3a5–1, and the definition of trustee in Rule 3b–17, provide exemptive relief for certain practices or activities where we have determined that an exemption is consistent with the intent of a functional exception. Rules 15a–7 and 15a–8 provide additional exemptive relief to banks to give them sufficient time to adjust their securities activities to comply with the new regulatory scheme of the GLBA. Finally, Rule 15a–9, extends the banks' exceptions and exemptions from the definitions of ''broker'' and ''dealer'' to savings associations and savings banks.

Accordingly, these rules do not expand the obligations of banks under the new statutory definitions of ''broker'' and ''dealer.'' Rather, they provide guidance and relief to banks that have not previously been subject to our jurisdiction. They either clarify the Commission's interpretation of certain statutory definitions or provide exemptive relief from those definitions. In our view, the limited scope of the rules reduces the need for pre-issuance comment.

Finally, we note that these are interim rules. While the rules will become effective on May 11, 2001, we are interested in receiving written comments on the rules within 60 days after the date they are published in the **Federal Register**. We will carefully examine the comments that we receive, and we will revise or amend the rules as necessary in light of those comments.

Because of the immediate need for guidance on the GLBA amendments to the definitions of ''broker'' and ''dealer'' prior to the May 12, 2001 statutory effective date, the input we have received from the industry, the limited scope of the rules, and the fact that the rules are interim in nature, we find, consistent with the APA, that good cause exists to issue these interim final rules without notice and comment and without a delayed effective date.

Although we have dispensed with notice of proposed rulemaking for the reasons set out above, we are soliciting written comments on the rules within 60 days after their publication in the **Federal Register**. We will consider carefully those comments and make changes to the rules as necessary.

We seek comments on the interpretations and the exemptions set forth in this release. In addition to the requests for comments throughout the release, we seek comment on the following: (1) Whether these rules operate to regulate the banks' broker-dealer operations in the same manner as broker-dealers subject to our jurisdiction prior to the exclusion of a bank from the definition of a broker or dealer; and (2) whether the fiduciary principles triggered by these interim final rules create a standard of conduct or disclosure by banks to which other registered broker-dealers may not be subject. Commenters should also address whether there are any legal or policy reasons why the we should consider different approaches or exemptions, including but not limited to: (1) A description of the issue to be addressed; (2) a description of the necessity of any alternate approach suggested; and (3) a recommendation as to how to remedy the problem identified, if any, as well as the feasibility of adopting and enforcing such remedy. Commenters should, where possible, provide us with empirical data and/or describe specific actions the commenter would suggest we take.

B. Paperwork Reduction Act

These interim final rules do not impose recordkeeping or information collection requirements, or other collections of information that require approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.* Accordingly, the Paperwork Reduction Act does not apply.[264]

C. Consideration of Costs and Benefits

1. Introduction

When the broker-dealer registration provisions of the GLBA become effective, many banks will need to restructure aspects of their securities-related business to comply with the new statutory requirements.[265] The interim final rules, which will become effective May 11, 2001, define statutory terms and provide banks with conditional exemptions. While these rules may affect how the banks' restructuring occurs, we believe that most of the restructuring will stem from the statute and not from the rules themselves.

Moreover, the extent to which banks need to restructure may be limited by the way they already do business.[266] The majority of banks conduct most of their securities activities through registered broker-dealers that are already regulated by the Commission.[267] Indeed, in 1995, the General Accounting Office ''estimated that approximately 87 percent of all sales of securities on bank premises are effected by SEC-regulated broker-dealers.'' [268] The FDIC confirmed the findings of the GAO in 1997, explaining that very few banks sold securities directly using unregistered bank employees.[269]

In considering the potential costs and benefits of these interim final rules, we have considered the historical securities activities of banks, and how those activities have expanded in recent years. We also have considered the decisions many banks will face in determining how to best restructure their businesses to comply with the new requirements of the GLBA. Finally, we have identified specific costs and benefits, and requested comment on additional costs or benefits that may stem from these interim final rules.

[264] We would expect banks, as a matter of good business practice, to be able to demonstrate that they meet the terms of a particular exemption. We also note that Section 203 of the GLBA specifically requires the bank regulators to promulgate recordkeeping requirements. Banks affected by the GLBA should already be aware of these specific GLBA requirements. *See, e.g., ''Gramm-Leach-Bliley Deadlines Draw Near: Be Aware, Prepared''*, Information Access Company, Mar. 1, 2001 (noting that to comply with GLBA ''push-out'' provisions, or to fall within an exemption in the GLBA, banks must ''maintain records that will clearly indicate that the trust department securities activities fall within the exemptions. * * * While banking regulators will provide guidance on the nature any types of records they will ask banks to maintain, there are a few steps banks can take immediately to ensure compliance with the new rules.'').

[265] Banks had been excepted from the definitions of ''broker'' and ''dealer'' under the Exchange Act since 1934. Until recent years, banks' ability to engage in securities activities had been constrained by federal banking laws. As these constraints lessened, banks have engaged in a broader range of securities activities.

[266] Banks have had varying reasons for choosing to conduct securities activities through a separate entity. For example, some banks believed that their securities activities had greater marketing credibility with a registered securities sales force. Separation of these activities also permitted banks to pay bank and securities sales teams differential compensation. *See* John L. Douglas, *Banking Organizations: Structural and Other Considerations Involving Non-Banking Activities*, 1 N.C. Banking Inst. 59, March 1997 (giving reasons why certain activities may be moved outside of the bank, including ''compensation concerns may result in shifting highly commissioned salespeople out of the bank in order to avoid jealousies or salary complaints''); *see also* Michael G. Capatides, *A Guide to the Capital Markets Activities of Banks and Bank Holding Companies* (Mar. 1, 1993) at 154 (although banks may act as private placement agents directly, banks establish separate entities for ''operational convenience as well as the desire to develop an investment bank environment with a stand alone compensation plan'').

[267] *Reform Law Leaves Some Doubters*, Am. Banker, November 8, 2000 (noting that ''many banks and securities firms had already merged via regulatory loopholes.'')

[268] *See* U.S. General Accounting Office, Report to Congressional Requesters: *Bank Mutual Sales Practices and Regulatory Issues* GAO/GGD–95–210, at p. 52 (Sept. 1995); U.S. General Accounting Office, Report to Congressional Requesters: *Banks' Securities Activities—Oversight Differs Depending on Activity and Regulator*, GAO/GGD–95–214, at p. 25 (Sept. 1995).

[269] *See* Testimony of Andrew C. Hove, Jr., Acting Chairman, Federal Deposit Insurance Corporation on Financial Modernization Before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, United States House of Representatives, July 17, 1997, *supra* at note 187.

2. Banks' Securities Activities Before the GLBA

The Glass-Steagall Act, the Bank Holding Company Act and its 1970 amendment [270] restricted banks' ability to engage in many businesses, including the securities business.[271] As a result, commercial and investment banking [272] in the U.S. were separated for over 60 years.

The GLBA repealed Sections 20 and 32 of the Banking Act of 1933.[273] Section 20 forbade affiliations between commercial banks and securities firms that were ''engaged principally'' in the investment banking business.[274] Section 32 prohibited persons involved ''in any aspect of the investment banking business'' from serving as an officer, director, or employee of a bank that was a member of the Federal Reserve System.[275]

Prior to their repeal, however, these prohibitions had already eroded over time. In 1987, Section 20 of the Glass-Steagall Act was significantly liberalized, with the regulatory expansion of bank holding companies' abilities to underwrite corporate debt and equity through their registered broker-dealer affiliates (known as ''Section 20'' affiliates).[276] The Federal Reserve established a revenue test to determine if a Section 20 affiliate was ''engaged principally'' in underwriting and dealing.[277] That revenue test created an incentive for banks to shift permissible securities activities into affiliated broker-dealers.[278]

Commercial banks also benefited from using broker-dealers to effect securities transactions. Commercial banks entered the brokerage business by licensing operating subsidiaries as registered broker-dealers. In 1996, the OCC permitted national banks to own majority interests in certain operating subsidiaries that engaged in activities that were impermissible for national banks.[279] In the case of securities activities, these operating subsidiaries were required to register as broker-dealers.[280] Subsequent national bank operating subsidiary approvals included underwriting and dealing in municipal revenue bonds and corporate debt securities.[281]

We have studied aggregate data showing that, while banks' traditional activities (described as the financing of loans with deposits) have been declining, banks' non-traditional activities (described as fee-generating activities, including underwriting, cash management, and custody services) have been rising.[282] In addition to the bank securities activities described above, these non-traditional activities would include the provision of trust and investment services to high net worth individuals.[283]

In sum, banks today may engage in a wide range of securities activities arising from their roles as custodians of fiduciaries, as well as separately for a fee. Banks engage in these activities either directly or through affiliated broker-dealers. These activities include brokerage and dealing, as well as

[270] The Bank Holding Company Act is codified at 12 U.S.C. 1841 *et seq.*

[271] Congress placed a large amount of blame for the Great Depression on commercial banks' securities activities conducted through ''so-called bank securities 'affiliates.' '' As a result, Congress enacted the Glass-Steagall Act in an attempt to achieve the complete separation of commercial and investment banking. Jonathan R. Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall,* 33 Emory L.J. 1, 3 (Winter 1984).

[272] Section 16 is codified at 12 U.S.C. 24 (Seventh); Section 20 is codified at 12 U.S.C. 377; Section 21 is codified at 12 U.S.C. 378; and Section 32 is codified at 12 U.S.C. 78.

[273] Public Law 106–102, Section 101 repealing Section 20 (12 U.S.C. 377) and Section 32 (12 U.S.C. 78) of the Banking Act of 1933. The GLBA retains Sections 16 and 21 of the Banking Act of 1933. 12 U.S.C. 24 (Seventh); 12 U.S.C. 377. Section 16 prohibits national banks from underwriting, selling, or dealing in securities, except for certain bank-eligible securities such as U.S. government securities. *See*, 12 U.S.C. 24 (Seventh); *see also* 12 U.S.C. 335 at 5(c) (applying Glass-Steagall Act Section 16 restrictions to state-chartered banks in the Federal Reserve System). However, Section 16 excludes from its prohibitions securities transactions in which the bank acts as agent for its customers, considered agency activity. Under state law, insured state banks generally may act as agent for their customers although insured state banks are prohibited from engaging as principal in any activities that are not permissible for national banks unless the state banks comply with applicable capital standards and the FDIC has determined that the activity will not pose a significant risk to the appropriate insurance fund. Federal Deposition Insurance Corporation Improvement Act of 1991, Pub. L. 102–242, Title III, Section 303, 12 U.S.C. 1831a. Section 21, also still in effect, prohibits investment banks from offering checking or savings accounts. 12 U.S.C. 378a.

[274] 12 U.S.C. 377. The Supreme Court interpreted the term ''engaged principally'' to mean that bank affiliates could engage in some ineligible activities so long as they were not the primary activities. *Board of Governors* v. *Agnew*, 329 U.S. 441, 447–49 (1947). The FDIC's interpretation that section 21 did not apply to subsidiaries of state nonmember banks and thus that these subsidiaries could engage in underwriting securities was upheld by the U. S. Court of Appeals for the D.C. Circuit in 1987. *Investment Company Institute* v. *FDIC*, 815 F.2d 1540 (D.C. Cir. 1987).

[275] 12 U.S.C. 78.

[276] The Federal Reserve initially approved bank holding company subsidiaries to underwrite municipal revenue bonds, mortgage related securities of investment quality on 1–4 family residential and large denomination commercial paper as long as the underwriting revenue from these activities did not exceed five percent of the subsidiary's gross revenue of average calculated on a two year period. *See* Orders Issued Under Section 4 of the Bank Holding Company Act, Citicorp, J.P. Morgan and Co. Inc., Bankers Trust New York Corp., Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities, 73 Fed. Res. Bull. 473, 485 (1987).

[277] As noted above, Section 20 prohibited a member bank from affiliating with a securities firm if the securities firm was ''principally engaged'' in underwriting and dealing.

[278] The revenue test distinguished between ''bank eligible'' securities (that is, securities that a bank itself would be allowed to underwrite or deal in) and ''bank ineligible'' securities. ''Bank eligible'' securities included government securities, as well as any securities issued in private placements. ''Bank ineligible'' securities were any securities that were not ''bank eligible.'' Under the test, a bank was permitted to affiliate with a securities firm as long as the securities firm did not derive more than 5% of its gross revenues from bank-ineligible securities. In 1989, the Federal Reserve raised this restriction to 10 percent of total revenues (and later increased it again, effective in 1997 to 25 percent), and increased the types of securities allowed to include debt securities, including sovereign debt securities, corporate debt, convertible debt securities, securities issued by a trust or other vehicle secured by or representing interests in debt obligations and equity securities. *See Review of Restrictions on Director, Officer and Employee Interlocks, Cross-Marketing Activities, and the Purchase and Sale of Financial Assets Between a Section 20 Subsidiary and an Affiliated Bank or Thrift*, 61 FR 57679, 57683 (Nov. 7, 1996); *see also* 75 Fed. Res. Bull. 192 (1989). Investment banking income derived from ''bank eligible securities,'' such as U.S. government securities and general obligation municipal bonds that banks were expressly allowed to deal in under section 16 of Glass-Steagall, were not counted as securities for the purpose of calculating the revenue limit. Riskless principal and private placement securities activities also were not deemed to be ''ineligible'' securities for these purposes. *Bankers Trust New York Corporation*, 75 Fed. Res. Bull. 829 (1989). Thus, under the test, the more gross revenue the Section 20 subsidiary derived from bank eligible securities, the more income they could also derive from bank ineligible securities. In other words, bank holding companies had an incentive to ensure that bank eligible securities activities were handled in a Section 20 broker-dealer subsidiary, rather than in the bank itself. *See generally Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities*, 61 FR 68750, 68752 (Dec. 30, 1996).

[279] 12 CFR 5.34, 61 FR 60342 (Nov. 27, 1996); Comptroller News Releases NR 96–129 (Nov. 20, 1996) (''Questions and Answers on Part 5''); NR 96–128 (Nov. 20, 1996) (''Part 5 Fact Sheet'').

[280] The exceptions from the Exchange Act definitions of ''broker'' and ''dealer'' are only available to the bank itself. *See supra* note 10, regarding current definitions of ''broker'' and ''dealer.''

[281] Comptroller Conditional Approval No. 262 (Dec. 11, 1997) (approval to Zion's First National Bank to engage through an operating subsidiary in underwriting and dealing in municipal revenue bonds); Comptroller Conditional Approval No. 331 (November 3, 1999) (approval to National Bank of Commerce to engage through an operating subsidiary in underwriting and dealing in corporate bonds, dealing in and privately placing trust preferred securities and buying and selling collateralized mortgage obligations).

[282] Economists describe the common characteristic of nontraditional activities as being that they produce fee income rather than interest income. Kevin Rogers and Joseph F. Sinkey, Jr., An Analysis of Nontraditional Activities at U.S. Commercial Banks, 1 Review of Financial Economics, Jan. 1, 1999, at 25. Commercial banks' non-interest income has risen from 30% in 1988 to 43% in 2000. FDIC, Trends in Commercial Bank Income and Expense 1988–2000 available at http://www2.fdic.gov/qbp/2000dec/ctrends.html.

[283] *Id.*

effecting private placements and riskless principal transactions.

Once the broker-dealer registration provisions of the GLBA become effective, banks that engage in the securities activities described above will need to determine whether they can continue to engage in those activities in the same way, or whether they will need to restructure their businesses to comply with the new statutory requirements. The interim final rules adopted today are designed to provide banks with guidance in this process. The new definitions should clarify the parameters of the new statutory exemptions from the definitions of broker and dealer. In addition, the interim final rules provide banks with additional specific exemptive relief.

As always, we are mindful of the costs imposed by our rules. We believe the rules are consistent with Congress's intent in enacting the GLBA. Congress determined that all securities activities should be functionally regulated to ensure investor protection, regardless of the entity in which the activities occur. Thus, the majority of regulatory costs arise from Congress's determination that amendment of the Exchange Act was necessary in light of the liberalization of banking laws, such as Glass-Steagall. Otherwise banks that engaged in underwriting corporate securities would be subject to a fragmented securities regulatory scheme.

Banks that fall outside the scope of one of the exceptions enumerated by Congress in amended Exchange Act Sections 3(a)(4) and 3(a)(5), as further refined through these interim final rules, may incur costs from the GLBA. Even banks that have existing relationships with registered broker-dealers may incur costs in connection with discrete lines of securities business that have nonetheless been conducted directly by those banks. These costs could relate to restructuring their business operations, to transferring their non-excepted securities business to registered broker-dealers, or to entering into networking arrangements with registered broker-dealers. As noted earlier, most of banks' securities activities are currently effected by SEC regulated broker-dealers. In the following section, we outline some of the choices banks may have in determining how they can best comply with the new requirements of the GLBA as well as the interim final rules.

3. Options for Compliance With the GLBA Under the Statute in Light of These Interim Final Rules

Banks will have a number of preliminary decisions [284] in determining how to comply with these interim final rules and the amended definitions of broker and dealer under the Exchange Act.[285] While most banks already conduct their securities activities through registered broker-dealers, the GLBA may require some banks to shift some securities activities formerly conducted internally to registered broker-dealers.

A bank that engages in securities activities that are not covered by an exception in the GLBA definitions of broker and dealer may choose to shift those activities to a registered broker-dealer. The registered broker-dealer could be a broker-dealer with which the bank already has a relationship. Alternatively, the bank could enter into a new relationship. One form of relationship could be contractual—that is, a bank could enter into a third-party brokerage arrangement with a registered broker-dealer. Alternatively, a bank could choose to register an affiliate as a broker-dealer.

If a bank registers a broker-dealer affiliate, the bank has additional choices. A banking group may register a broker-dealer affiliate that is a subsidiary of the bank holding company or a financial holding company. Alternatively, a bank may register a broker-dealer that is an operating or financial subsidiary of the bank. In all cases when a bank uses a registered broker-dealer, a bank may effect securities transactions using bank employees who also are associated persons of the registered broker-dealer.[286] Most non-bank registered broker-dealers must also become members of the Securities Investor Protection Corporation.[287]

As a final option, a bank that wishes to act as a broker-dealer may register with the Commission and with at least one SRO. To begin the registration process, a broker-dealer completes the uniform form for broker-dealer registration, Form BD. The completed Form BD is submitted to the Central Registration Depository (CRD), which is operated by the NASD. Broker-dealers seeking to become members of the NASD must also provide certain information. This includes a detailed business plan, as well as descriptions of their financial controls, their communications and operational systems, their supervisory systems and written procedures, their recordkeeping systems, and their continuing education plans. The NASD conducts in-person membership interviews with all applicants. Approval for membership with the NASD is contingent upon the submission of a written membership agreement. Broker-dealers also must register their personnel. Registration of personnel is accomplished by submitting a Form U–4 and a fingerprint card. Registered personnel also need to successfully complete qualification examinations. We believe, however, that most banks will not utilize this final alternative, finding it impracticable due to the disparate capital and customer protection regulatory requirements [288] applicable to banks and securities firms, including employment prohibitions.[289]

[284] Banking and Financial Services Policy Report, Volume 19 (Oct. 2000), ''Banks as Securities Lending Agents: To Register or Not as a Broker'' (discussing decisions to be made by bank upon determination of GLBA to banks' own securities activities).

[285] Barbara A. Rehm, *No Merger Wave, But Money Saved*, The American Banker, Nov. 7, 2000, at 1, noted that most banks would continue to do business as usual, except that the bank, would no longer require specific ''loopholes to sell insurance or underwrite securities.'' The article further noted that the biggest change for the banking industry was ''it put an end to 20 years of battling over who could do what.''

[286] Broker-dealers may also have to register with the states in which they do business.

[287] The Securities Investor Protection Act of 1970 created the Securities Investor Protection Corporation (SIPC). 15 U.S.C. 78aaa, *et seq.* SIPC is a nonprofit membership corporation funded by its member securities broker-dealers. Most broker-dealers (excluding broker-dealers whose business is limited to the following: Distributing shares of mutual funds, selling variable annuities, providing investment advice, or selling United States Government securities) registered with the Commission are automatically members of SIPC. SIPC provide investors with certain protections in the event of a bankruptcy or loss of securities by a broker-dealer.

[288] For unsecured receivables, such as a commercial loan, a bank is generally required to reserve an amount of capital equal to as much as 8% of the loan amount. In contrast, a broker-dealer would be required to reserve an amount of capital equal to 100% of unsecured loan. For certain fully secured loans, such as a margin loan, a bank would be required to reserve as capital up to 8% of the loan. A broker-dealer, however, would not be required to reserve capital for the loan, provided the account meets regulatory margin requirements. To remain in capital compliance, a bank registered as a broker-dealer would need to meet the greater of the banking or securities regulatory capital requirements for credit risk. Also, the customer protection rule applicable to broker-dealers that requires customer assets to be held separately from proprietary assets would be virtually impossible for a bank to comply with it if it accepts customer deposits (the core business of commercial banking). Therefore, in most cases, it would be prohibitively expensive for a bank to engage in traditional banking activity, such as unsecured lending, and for a broker-dealer to conduct traditional securities activities, such as extending margin loans.

[289] Dual employees who are registered representatives for a bank have certain obligations created by SRO rules. For example, transactions for bank customers must comply with NASD Rule 3040

We, therefore, expect that most banks will either enter into networking arrangements or create broker-dealer affiliates.

We are setting forth below additional benefits and costs that we believe arise from the promulgation of these interim final rules. We note, however, that due to the multitude of banking charters that distinguish a ''trust bank'' from a ''commercial bank'' from a ''savings and loan,'' we have delegated authority to the Division of Market Regulation to consider and to process a bank's or savings and loan's request for additional relief not encompassed within either these interim final rules or the GLBA.

a. Benefits. We believe that these interim final rules will provide legal certainty for banks in connection with their determination of whether they meet the terms and conditions for an exception to the definitions of broker and dealer under the Exchange Act. By adopting specific objective criteria, with particular dollar limitations, business activities, and time conditions, we have provided banks with a basis to assess accurately if and when they may need to register as broker-dealers.

As discussed earlier, the GLBA replaced the general exception for banks from the definitions of broker and dealer with specific functional exceptions for certain bank securities activities. These interim final rules clarify exceptions to these amended definitions by defining key terms used in the new functional exceptions.

Moreover, Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, and the definition of trustee in Rule 3b–17 provide targeted exemptions for certain banks from these new definitions of broker and dealer. Banks that meet the provisions of those exemptions need not transfer their non-excepted securities business to registered broker-dealers.

Rule 15a–7 extends the date for banks to comply with the requirements of the exceptions. This alleviates the need for banks to apply individually to us for specific relief. To promote certainty in commercial markets as to the legal validity of contracts, Rule 15a–8 conditionally exempts banks temporarily from risk of rescission rights under Exchange Act Section 29. Finally, new Rule 15a–9 exempts savings associations and savings banks from the terms ''broker'' and ''dealer'' under Exchange Act Sections 3(a)(4) and 3(a)(5) on the same terms and conditions that apply to banks.

These interim final rules were written in response to requests from the banking industry for guidance. By clarifying terms in the GLBA, these interim final rules provide legal certainty to banks seeking to conform their business activities to the exceptions from the definitions of broker and dealer. This, in turn, will assist banks in planning their ongoing business operations. In the event they need additional time, we have provided temporary exemptions from compliance with the new terms.

These interim final rules, including the temporary exemptions from registration as a broker-dealer and the temporary exemption from liability under Section 29 for banks that would have been required to register as a broker-dealer, will enable banks to plan and structure their business operations to fully comply with the statute. This latter exemption, in particular, will eliminate costs that banks might have otherwise incurred from actions to rescind securities transactions during the transition to compliance with the new GLBA requirements.

In addition, Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, and the definition of trustee capacity in Rule 3b–17 exclude certain bank activities from the scope of the GLBA's amended definition of broker-dealer. They, therefore, provide relief to banks from potential costs they might incur in registering as a broker-dealer, registering an affiliate as a broker-dealer, or entering into a third-party brokerage arrangement with a broker-dealer. These costs could include engaging securities counsel, registering as a broker-dealer, paying personnel to study for and pass applicable securities examinations, and joining a SRO. Indeed, Rules 3b–17 and 3b–18, and the four limited exemptions, clarify the permissible activities in which banks may engage without triggering the statutory requirement to register as a broker or dealer under the Exchange Act after May 12, 2001. As noted earlier, most of banks' securities business is currently effected through SEC-registered broker-dealers. Consequently, we do not anticipate that banks will derive a large benefit from this rulemaking in relation to their current securities business.

However, failure to adopt these interim final rules could result in additional costs. Without the certainty and uniformity these interim final rules provide, banks would have more difficulty planning and operating their existing businesses in compliance with the GLBA. This, in turn, could result in disruption of their securities business. In addition, banks could be subject to regulatory costs if their activities were later determined to fall outside of the scope of the GLBA's exceptions.

In addition, the extension of time in Rule 15a–7, and exemptions in Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, and the definition of trustee capacity in Rule 3b–17 benefit banks that may not otherwise be able to comply with the statutory deadline of GLBA. Most banks that need additional time to restructure their operations may rely on these temporary exemptions and not need to seek individual relief from our staff. Banks seeking individual relief may request a specific exemption from us.

b. Costs. We believe that, regardless of how a bank chooses to comply with the GLBA in light of these interim final rules, it will likely incur certain costs. We believe, however, that almost all of these costs will be necessary because of the statutory change and not because of the interim final rules.

Interim final Rules 3b–17 and 3b–18 are intended to clarify the meanings of certain terms in the exceptions to the definitions of broker and dealer, as amended by the GLBA. Although they are not intended to impose costs on any market participant, we expect that some banks may experience some *de minimis* costs from the determination of how to best comply with the GLBA. In ascertaining this *de minimis* impact, we reviewed the number of banks that are already heavily involved in securities-related activities.

Some banks seeking to meet the exceptions to broker-dealer registration could incur *de minimis* administrative costs. For instance, Rule 3b–17 provides an objective test for determining whether a bank is ''chiefly compensated'' through securities activities as excepted by Exchange Act Section 3(a)(4)(B)(ii). Banks seeking to qualify for this particular exception will need to undertake a financial accounting review to determine their compliance with this objective compensation test. Some banks may already keep and analyze the data required to perform this analysis in accordance with their customary audit and reporting procedures under applicable banking regulations. It is possible, however, that some banks may

that restricts the ability of any person associated with a member to participate in a ''private securities transaction,'' which is defined as ''any securities transactions outside the regular course or scope of an associated person's employment with a member,'' subject to limited exceptions. NASD Rule 3040 requires broker-dealers to review all transactions in which a registered representative participates, including transactions where the registered representative acts as an investment adviser. The registered broker-dealer must develop and maintain a record keeping system ''to enable the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions. NASD Notice to Members 96–33.

need to supplement their existing accounting or financial procedures and activities to perform this calculation on an annual basis. Moreover, some banks may incur similar costs in calculating compensation on an account-by-account basis.

Banks also may need to make limited software changes to make the ''chiefly compensated'' calculation.[290] Because of the differences in banks' existing computer systems, the types of account information resident in those systems, and the range of ways in which they may choose to alter those systems, we cannot estimate this cost with specificity. We believe, however, that the costs of computer alterations could include the cost of purchasing new computer hardware, as well as new computer software. Banks also could incur the costs of personnel time to re-program software. As noted previously, almost all of these costs arise from the functional regulation mandated by the GLBA and not from these interim final rules.

We also expect that many banks may incur costs for legal and other professional accounting review. Many banks will utilize their in-house counsel, accountants, and compliance officers. Banks that have provided cost information have estimated their in-house legal resources to range from $75.00 to $125.00 an hour as a composite rate based upon the yearly salary of in-house counsel. Estimates of legal counsel review time include the hours spent by in-house counsel on review and compliance with the GLBA. Discussions with banks offering services impacted by the GLBA indicate that some banks have estimated the review time of attorneys to fall within the range of 30 to 60 hours. We expect that most banks affected by the functional regulation provisions of the GLBA will either use in-house counsel or bank officers for this review. We believe that most of these costs arise from the requirements of GLBA rather than from our interim final rules.

Some banks may choose to utilize outside counsel, either exclusively or as a supplement to in-house resources. We estimate these costs as the high end of the in-house range.

If a bank affiliates with a registered broker-dealer or enters into a third-party brokerage arrangement, it may also incur certain other costs. In making these changes, the costs arise from the statutory language of the GLBA, which removed the exception banks had for certain securities operations. These costs could include, for example, the cost of training, examining, and licensing associated persons of the bank as registered representatives of the broker-dealer. In addition, banks may incur additional expenses to establish a relationship with a broker-dealer or to inform their customers of their changes in operating procedures. Since most banks operate their securities related business through broker-dealers registered with us, we believe that these costs, if any, would be quite small.

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

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

In accordance with our responsibilities under Section 3(f) of the Exchange Act, we have considered both the protection of investors and whether the interim final rules will promote efficiency, competition, and capital formation in determining whether they are consistent with the public interest.[291] In addition, Section 23(a)(2) of the Exchange Act [292] requires us, in adopting rules under the Exchange Act, to consider the anticompetitive effects of such rules, if any, and to refrain from adopting a rule that will impose a burden on competition not necessary or appropriate in furthering the purpose of the Exchange Act.

We do not believe that the interpretations, definitions, and exemptions will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act or Congress's intent to impose functional regulation upon banks that conduct a brokerage business outside a statutory exception in the GLBA. These interim final rules define terms in the statutory exceptions to the definitions of broker and dealer added to the Exchange Act by Congress in the GLBA, and provide guidance to banks as to the appropriate scope of those exceptions. These interim final rules, therefore, do not impose any additional competitive burdens on banks engaging in a securities business, other than those imposed through by Congress through functional regulation in the GLBA.

The conditional exemptions from broker-dealer registration granted through these interim final rules permit banks more time to fully comply with the statutory requirements of GLBA and therefore do not impose any burden on banks seeking to avail themselves of those limited exemptions.

We do not believe that the new definitional rules will adversely affect capital formation. Nothing in the interim final rules is intended to adversely affect banks' compliance with the GLBA. Banks that alter their securities-related activities in accordance with the GLBA will continue to be able to provide securities services to their customers. In enacting the GLBA, Congress determined that functional regulation was appropriate—that is, when a bank was conducting a securities business outside of the enumerated exceptions, that bank should be registered as a broker-dealer. In the interest of protecting the public and ensuring orderly markets, Congress determined that banks, with a broad securities business, should be subject to the same regulatory oversight as broker-dealers conducting the same types of activities. These interim final rules promote Congress' intent.

Since these interim final rules define statutory exceptions mandated by Congress and provide temporary exemptive relief for banks unable to comply with certain of the exceptions by the effective date of GLBA, we do not believe that the rules impose any extra-statutory adverse effects on efficiency, competition, or capital formation.[293] Once Congress passed the GLBA, Congress determined that regulation of banks conducting a securities operation outside of certain exceptions was necessary and appropriate and in the public interest.

We are, however, interested in receiving comments regarding the effect of these interim final rules on efficiency, competition, and capital formation. We will consider those comments in making

[290] Depending on the number of accounts in the bank, the accounts affected by the definition of ''chiefly compensated,'' and the number of accounts resident, a bank may need to customize its computer software to match the bank's specific accounts and data.

[291] 15 U.S.C. 78c(f).

[292] 15 U.S.C. 78w(a)(2).

[293] Indeed, these rules actually enhance competition by providing relief to savings associations and savings banks as well as ''commercial banks.'' Letter from Scott M. Albinson, Managing Director, OTS, to Annette L. Nazareth, Director, Division of Market Regulation, Commission and Paul F. Roye, Director, Division of Investment Management, Commission (Mar. 20, 2001).

any changes to the interim final rules as necessary.

We also solicit comment on the potential effect of these interim final rules on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

E. Summary of Regulatory Flexibility Analysis

We have prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with the Regulatory Flexibility Act (''RFA'') [294] regarding the interim final rules under the Exchange Act that define certain terms in the GLBA's amendments to Sections 3(a)(4) and 3(a)(5) of the Exchange Act and provide exemptions from broker-dealer registration for certain banks and savings and loan associations.[295] The following summarizes the IRFA:

Rules 3b–17 and 3b–18 are intended to provide banks with guidance on how to interpret the exceptions to the definitions of broker and dealer in Sections 3(a)(4) and 3(a)(5) of the Exchange Act. This guidance is intended to assist banks in structuring their securities activities so as to continue to fit within the exceptions for their securities activities, as well as to provide more certainty as to when broker-dealer registration would be required if they choose to engage in more extensive securities activities. Rule 15a–7 provides certain limited time periods for banks to determine whether they should register as broker-dealers or restructure certain of their securities activities so as to continue to be exempted from registration. Rule 15a–8 temporarily exempts banks from liability under Exchange Act Section 29 by providing that no contract into which a bank enters before January 1, 2003 will be void or considered voidable because the bank violates the registration requirements of Exchange Act Section 15(a) or any rule under the Exchange Act based solely on the bank's status as a broker-dealer. New Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, and the definition of trustee capacity in Rule 3b–17 provide exemptive relief that permits banks that meet the conditions in the exemptions to continue to effect brokerage transactions for customers in specified circumstances without registering as broker-dealers under the Exchange Act.

Specifically, Rules 3a4–2 and 3a4–3 provide that, under certain conditions, banks will not be deemed to be brokers under the trust and fiduciary activities exception if the bank fails to satisfy the compensation requirement, as long as the bank complies with the other requirements of the exception. Rule 3a4–4 conditionally exempts small banks effecting transactions in investment company securities for tax-deferred custody accounts. Rule 3a4–5 conditionally exempts banks effecting transactions in securities for tax-deferred custody accounts. Rule 3a4–6 permits banks to process transactions in investment company securities through the NSCC's Mutual Fund Services, including Fund/SERV. Rule 3a5–1 provides that a bank will not be considered a dealer if it engages in riskless principal transactions as long as the number of those transactions, combined with any agency transactions effected by the bank, is less than 500. The definition of trustee capacity makes clear that banks acting as indenture trustees and trustees for tax-deferred ERISA and IRA accounts will be eligible for the trustee exception if they meet its requirements.

Some banks affected by these interim final rules would fall under the definition of small entities for purposes of the Regulatory Flexibility Act (''RFA''). As discussed more fully in the IRFA, unlike for broker-dealers and other entities that historically have been subject to our jurisdiction, we do not have a definition of ''small entity bank'' for purposes of the RFA. The banking regulators have defined small entities for purposes of the RFA to include banks with less than $100 million in assets.[296] For purposes of this analysis, we have used the banking regulators' definition of small entity. According to information from the FDIC, there are approximately 8,375 FDIC-insured commercial banks; of these, 4,922 are small entity banks with less than $100 million in assets.[297] As explained more fully below, one of the interim final rules provides only small entity banks with an exception from the definition of broker. All of the other rules apply equally to all banks. Thus, all banks could be affected by the interim final rules.

The clarification of statutory terms set out in Rules 3b–17 and 3b–18 provide additional guidance to all banks in connection with their determination of whether they fall within the terms and conditions for the exceptions to the definitions of broker and dealer under the Exchange Act as amended by the GLBA. These interim final rules provide uniform definitions that will enable banks to accurately assess whether they are subject to our jurisdiction. The extensions of time in Rule 15a–7 give limited relief to certain banks that cannot comply with the GLBA provisions by the statutory effective date of May 12, 2001.

In addition, Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a5–1, and the definition of trustee capacity in Rule 3b–17 provide exemptions from the definitions of broker and dealer under the amended Exchange Act. Rule 3a4–4 benefits small entity banks that may not readily have access (through affiliation or otherwise) to a registered broker or dealer to establish a networking arrangement meeting the criteria of the GLBA, and that maintain custody accounts for the convenience of their customers. Under this interim final rule, small banks may engage in minor securities transaction activities as an accommodation to their customers in limited circumstances and still fall outside of the definition of broker under the Exchange Act.

Rules 3a4–2, 3a4–3, 3a4–4, 3a4–6, 3a5–1 and the definition of trustee capacity in Rule 3b–17 are not limited to small entity banks, but rather exempt all banks. Rules 3a4–2 and 3a4–3 are discussed above. The definition of trustee capacity makes clear that banks acting as indenture trustees and trustees for tax-deferred ERISA and IRA accounts will be eligible for the trustee exception if they meet the other requirements of the trust and fiduciary activities exception.

As definitional and exemptive rules, the interim final rules should not have a significant regulatory impact on banks, including small entity banks. Moreover, we do not anticipate that the rules will impose any additional recordkeeping requirements on banks other than recordkeeping currently required under

[294] 5 U.S.C. 601 *et seq. See also* 5 U.S.C. 603 (requiring the preparation of an IRFA).

[295] Although the requirements of the RFA are not applicable to rules adopted under the Administrative Procedures Act's good cause exception, *see* 5 U.S.C. 601(2) (defining ''rule'' and notice requirements under the APA), we nevertheless prepared an Initial Regulatory Flexibility Analysis because we may supplant the interim final rules with final rules.

[296] *See* Joint Release of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, ''Interagency Guidelines Establishing Standards for Safeguarding Customer Information and Rescission of Year 2000 Standards for Safety and Soundness,'' 65 FR 39471 (June 26, 2000).

[297] *See* FDIC, Statistics on Banking, available at http://www.fdic/gov/bank/statistical/statistics/0009/cbrc01a.html. There may be additional banks that fall within the Exchange Act's definition of ''bank'' under Section 3(a)(6) that may be subject to GLBA that are not reflected in these figures. For example, U.S.-licensed branches and agencies of foreign banks may not be included in the FDIC's tally because they typically are not insured. Nevertheless, we do not believe that any such omissions are material to the analysis set forth in the IRFA.

applicable banking statutes and regulations.

As described in the IRFA, we have considered and will continue to consider alternatives to the interim final rules that would accomplish our stated objectives. These objectives are to implement the Congressional requirement to provide for functional regulation of securities activities, to provide banks with clear guidance on whether they are subject to broker-dealer registration, and to provide exemptive relief to banks that require additional time to restructure their business operations to comply with the GLBA.

Congress did not exempt small entity banks from the application of the GLBA. Because the interim final rules are intended to provide guidance to all banks that are subject to the GBLA, it would not be appropriate to exempt small entity banks from operation of these interim final rules. Nevertheless, because we recognize that small banks may not have established networking relationships with broker-dealers for purposes of the GLBA amendments, we have provided an exemption for small entities that maintain custody accounts through Rule 3a4–4.

Because Rules 3b–17 and 3b–18 are definitional and clarify the securities-related activities in which banks may engage without registering as broker-dealers, these interim final rules must apply to all banks engaged in securities brokerage activities. Accordingly, providing different compliance and reporting requirements under, or exemptions from any of the requirements pursuant to, these rules for small entities would not be practicable or promote the purposes of functional regulation adopted by Congress.

The new interim final rules and exemptions provide banks with more legal certainty and additional flexibility in determining how to structure their operations to comply with the provisions of the GLBA. This flexibility benefits all banks, including small entity banks, that wish to continue to provide securities activities without being required to shift those securities activities to registered broker-dealers.

As noted in the IRFA, we encourage the submission of written comments with respect to any aspect of the IRFA. Comment is specifically is requested on the costs of compliance with these rules and suggested alternatives that would accomplish the objectives of these rules. Comments received will be considered in the preparation, if required, of a Final Regulatory Flexibility Analysis.

A copy of the IRFA may be obtained from Nancy Appel, Attorney, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001; (202) 942–0073.

XI. Statutory Authority

The Commission is amending Title 17, Chapter II of the Code of Federal Regulations by amending Section 200.30–3, and by adding, as interim final rules, Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, 3a5–1, 3b–17, 3b–18, 15a–7, 15a–8, and 15a–9 [Sections 240.3a4–2, 240.3a4–3, 240.3a4–4, 240.3a4–5, 240.3a4–6, 240.3a5–1, 240.3b–17, 240.3b–18, 240.15a–7, 240.15a–8, and 240.15a–9, respectively] pursuant to authority set forth in Sections 3(b), 15, 23(a), and 36 of the Exchange Act (15 U.S.C. 78c(b), 78o, 78w(a), and 78mm, respectively).

XII. Text of Rules and Rule Amendments

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies), Organization and functions (Government agencies).

17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

Text of Amendment

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

Subpart A—Organization and Program Management

1. The authority citation for Part 200, subpart A, continues to read, in part, as follows:

Authority: 15 U.S.C. 77s, 78d–1, 78d–2, 78w, 78*ll*(d), 78mm, 79t, 77sss, 80a–37, 80b–11, unless otherwise noted.

* * * * *

2. Section 200.30–3 is amended by adding paragraph (a)(72) to read as follows:

§ 200.30–3 Delegation of authority to Director of Division of Market Regulation.

* * * * *

(a) * * *

(72) Pursuant to Sections 15(a)(2) and 36 of the Act (15 U.S.C. 78o(a)(2) and 78mm), to review and, either unconditionally or on specified terms and conditions, to grant or deny exemptions to any bank, savings association, or savings bank from the broker-dealer registration requirements of Section 15(a)(1) of the Act (15 U.S.C. 78o(a)(1)) or any applicable provision of this Act (15 U.S.C. 78c *et seq.*) and the rules and regulations thereunder based solely on such bank's, savings association's, or savings bank's status as a broker or dealer.

* * * * *

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

3. 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, 78f, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

4. Sections 240.3a4–2, 240.3a4–3, 240.3a4–4, 240.3a4–5, and 240.3a4–6 are added to read as follows:

§ 240.3a4–2 Exemption from the definition of ''broker'' for bank calculating compensation for effecting transactions in fiduciary accounts.

(a) A bank that meets the conditions for exception from the definition of the term ''broker'' under Section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)), except for 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)), is exempt from the definition of the term ''broker'' under Section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely for effecting transactions in securities pursuant to Section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)) if:

(1) The bank can demonstrate that sales compensation, as defined in § 240.3b–17(j), received during the immediately preceding year is less than 10% of the total amount of relationship compensation, as defined in § 240.3b–17(i), received during that year;

(2) The bank maintains procedures reasonably designed to ensure compliance with 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)) with respect to a trust or fiduciary account:

(i) When the account is opened;

(ii) When the compensation arrangement for the account is changed; and

(iii) When sales compensation, as defined in § 240.3b–17, received from the account is reviewed by the bank for

purposes of determining an employee's compensation; and

(3) The bank complies with Section 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(C)).

(b) For purposes of this section, the term *year* means either a calendar year or other fiscal year consistently used by the bank for recordkeeping and reporting purposes.

§ 240.3a4–3 Exemption from the definition of ''broker'' for bank effecting transactions as an indenture trustee in a no-load money market fund.

A bank that meets the conditions for exception from the definition of the term ''broker'' under Section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)), except for 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)), is exempt from the definition of the term ''broker'' under Section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely for effecting transactions as an indenture trustee in a no-load money market fund, as defined in § 240.3b–17(f) and § 240.3b–17(e), respectively.

§ 240.3a4–4 Exemption from the definition of ''broker'' for small bank effecting transactions in investment company securities in a tax-deferred custody account.

(a) A small 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)) solely for effecting transactions in securities of an open-end management investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) in a tax-deferred account for which the bank acts as custodian under Section 3(a)(4)(B)(viii) of the Act (15 U.S.C. 78c(a)(4)(B)(viii)) if:

(1) The bank is not associated with a broker or dealer and does not have an arrangement with a broker or dealer to effect transactions in securities for the bank's customers;

(2) Any bank employee effecting such transactions:

(i) Is not an associated person of a broker or dealer;

(ii) Primarily performs duties for the bank other than effecting transactions in securities for customers; and

(iii) Does not receive compensation for such transactions from the bank, the executing broker or dealer, or any other person related to:

(A) The size, value, or completion of any securities transaction;

(B) The amount of securities-related assets gathered; or

(C) The size or value of any customer's securities account;

(3) The bank complies with Section 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(C));

(4) The bank makes available to the tax-deferred account the securities of investment companies that are not affiliated persons, as defined in Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)), of the bank and that have similar characteristics to the securities of investment companies made available that are affiliated persons;

(5) The bank does not solicit securities transactions except through the following activities:

(i) Delivering advertising and sales literature for the security that is prepared by the registered broker-dealer that is the principal underwriter of an open-end management investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), or prepared by an open-end management investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) that is not an affiliated person, as defined in Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)), of the bank;

(ii) Responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser; provided, however, that the content of such responses is limited to information contained in a registration statement for the security of an investment company filed under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) or sales literature prepared by the investment company security's principal underwriter that is a registered broker-dealer;

(iii) Advertising of trust activities, if any, permitted under Section 3(a)(4)(B)(ii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(II)); or

(iv) Notifying its existing customers that it accepts orders for investment company securities in conjunction with solicitations related to its other activities concerning tax-deferred accounts; and

(6) The bank's annual compensation related to effecting transactions in securities pursuant to this exemption is less than 3% of its annual revenue.

(b) *Definitions.* For purposes of this section:

(1) The phrase *compensation related to effecting transactions in securities pursuant to this exemption* means the total annual compensation received for effecting transactions in securities pursuant to this exemption, including fees received from investment companies for distribution.

(2) The term *networking arrangement* means a contractual or other written arrangement with a broker or dealer to effect transactions in securities for the bank's customers.

(3) The term *principal underwriter* has the meaning given in Section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29)).

(4) The term *revenue* means the total annual net interest income and noninterest income from the bank's most recent Consolidated Reports of Condition and Income (Call Reports) or any successor forms the bank is required to file by its appropriate Federal banking agency (as defined in Section 3 of the FDIA (12 U.S.C. 1813).

(5) (i) The term *small bank* means a bank that:

(A) Had less than $100 million in assets as of December 31 of both of the prior two calendar years; and

(B) Is not, and since December 31 of the third prior calendar year has not been, an affiliate of a bank holding company or a financial holding company that as of December 31 of both of the prior two calendar years had consolidated assets of more than $1 billion.

(ii) For purposes of this paragraph (b)(5) the terms *affiliate, bank holding company,* and *financial holding company* have the same meanings as given in the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

(6) The term *tax-deferred account* means those accounts described in Sections 401(a), 403, 408, and 408A under Subchapter D and in Section 457 under Subchapter E of the Internal Revenue Code of 1986 (26 U.S.C. 1 *et seq.*).

§ 240.3a4–5 Exemption from the definition of ''broker'' for banks effecting transactions in securities in a custody account.

(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)) solely for effecting transactions in securities in an account for which the bank acts as custodian under Section 3(a)(4)(B)(viii) of the Act (15 U.S.C. 78c(a)(4)(B)(viii)) if:

(1) The bank does not directly or indirectly receive any compensation for effecting such transactions;

(2) Any bank employee effecting such transactions:

(i) Is not an associated person of a broker or dealer;

(ii) Primarily performs duties for the bank other than effecting transactions in securities for customers;

(iii) Does not receive compensation for such transactions related to:

(A) The size, value, or completion of any securities transaction;

(B) The amount of securities-related assets gathered; or

(C) The size or value of any customer's securities account; and

(iv) Does not receive compensation for the referral of any customer to the broker or dealer;

(3) The bank complies with Section 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(C));

(4) The bank makes available to the account the securities of investment companies with similar characteristics that are not affiliated persons, as defined in Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)), of the bank, if the bank makes available the securities of investment companies that are affiliated persons, as defined in Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)); and

(5) The bank does not solicit securities transactions except through the following activities:

(i) Delivering advertising and sales literature for the security that is prepared by the registered broker-dealer that is the principal underwriter of an investment company, or prepared by an investment company that is not an affiliated person, as defined in Section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(3)), of the bank;

(ii) Responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser of the security; provided, however, that the content of such responses is limited to information contained in a registration statement for the security filed under the Securities Act of 1933 (15 U.S.C. 77a *et seq.*) or sales literature prepared by the principal underwriter that is a registered broker-dealer;

(iii) Advertising of trust activities, if any, permitted under Section 3(a)(4)(B)(ii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(II)); and

(iv) Notifying its existing customers that it accepts orders for securities in conjunction with solicitations related to its other custody activities.

(b) For purposes of this section, the term *principal underwriter* has the meaning given in Section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29)).

§ 240.3a4–6 Exemption from the definition of ''broker'' for banks that execute transactions in investment company securities through NSCC Mutual Fund Services.

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 solely for transactions in investment company securities effected through the National Securities Clearing Corporation's Mutual Fund Services.

5. Section 240.3a5–1 is added to read as follows:

§ 240.3a5–1 Exemption from the definition of ''dealer'' for bank engaged in riskless principal transactions.

(a) A bank is exempt from the definition of the term ''dealer'' solely for engaging in riskless principal transactions if the number of such riskless principal transactions during a calendar year combined with transactions in which the bank is acting as an agent for a customer pursuant to Section 3(a)(4)(B)(xi) of the Act (15 U.S.C. 78c(a)(4)(B)(xi)) during that same year do not exceed 500 transactions.

(b) For purposes of the 500-transaction limit in paragraph (a) of this section, a riskless principal transaction counts as:

(1) Two transactions if neither transaction comprising the riskless principal transaction is with a broker or dealer; or

(2) One transaction if either transaction comprising the riskless principal transaction is with a broker or dealer.

(c) For purposes of this section, the term *riskless principal transaction* means a transaction in which, after having received an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer.

6. Sections 240.3b–17 and 240.3b–18 are added to read as follows:

§ 240.3b–17 Definitions of terms used in Section 3(a)(4) of the Act.

For purposes of Section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)):

(a) The term *chiefly compensated* means that the ''relationship compensation'' received by a bank from a trust or fiduciary account exceeds the ''sales compensation'' received by the bank from such account during the immediately preceding year, which is either a calendar year or other fiscal year consistently used by the bank for recordkeeping and reporting purposes.

(b) The term *flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers* means a fee that is no more than the amount a broker-dealer charged the bank for executing the transaction, plus the costs of any resources of the bank that are exclusively dedicated to transaction execution, comparison, and settlement for trust and fiduciary customers.

(c) The term *indenture trustee* means any trustee for an indenture to which the definition given in Section 303 of the Trust Indenture Act of 1939 (15 U.S.C. 77ccc) applies, and any trustee for an indenture to which the definition in Section 303 of the Trust Indenture Act of 1939 (15 U.S.C. 77ccc) would apply but for an exemption from qualification pursuant to Section 304 of the Trust Indenture Act of 1939 (15 U.S.C. 77ddd).

(d) The term *investment adviser if the bank receives a fee for its investment advice* means a bank that has a relationship with the customer paying the fee in which the bank:

(1) Provides, in return for the fee, continuous and regular investment advice to the customer's account that is based upon the individual needs of the customer; and

(2) Under state law, federal law, contract, or customer agreement owes a duty of loyalty, including an affirmative duty to make full and fair disclosure to the customer of all material facts relating to conflicts.

(e) The term *money market fund* means an open-end management investment 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 § 270.2a–7 of this chapter.

(f)(1) The term *no-load* in the context of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) means:

(i) Purchases of the investment company's securities are not subject to a sales load, as that term is defined in Section 2(a)(35) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(35)), or a deferred sales load, as that term is defined in § 270.6c–10 of this chapter; and

(ii) The investment company's total charges against net assets for sales or sales promotion expenses and personal service or the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually and are disclosed in the money market fund's prospectus.

(2) For purposes of paragraph (f)(1) of this section, charges for the following will not be considered charges for personal service or for the maintenance of shareholder accounts:

(i) Transfer agent and subtransfer agent services for beneficial owners of the investment company shares;

(ii) Aggregating and processing purchase and redemption orders;

(iii) Providing beneficial owners with statements showing their positions in the investment companies;

(iv) Processing dividend payments;

(v) Providing subaccounting services for investment company shares held beneficially;

(vi) Forwarding shareholder communications, such as proxies, shareholder reports, dividend and tax notices, and updating prospectuses to beneficial owners; or (vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners.

(g)(1) The term *nominal one-time cash fee of a fixed dollar amount* means a payment in either of the following forms that meets the requirements of subparagraph (2):

(i) A payment that does not exceed one hour of the gross cash wages of the unregistered bank employee making a referral; or

(ii) Points in a system or program that covers a range of bank products and non-securities related services where the points count toward a bonus that is cash or non-cash if the points (and their value) awarded for referrals involving securities are not greater than the points (and their value) awarded for activities not involving securities.

(2) Regardless of the form of payment, the payment may not be related to:

(i) The size, value, or completion of any securities transaction;

(ii) The amount of securities-related assets gathered;

(iii) The size or value of any customer's bank or securities account; or

(iv) The customer's financial status.

(h) The term *referral* means a bank employee arranging a first securities-related contact between a registered broker-dealer and a bank customer, but does not include any activity (including any part of the account opening process) related to effecting transactions in securities beyond arranging that first contact.

(i) The term *relationship compensation* means any compensation received by a bank in connection with activities for which the bank relies on an exception under Section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)) that is received directly from a customer or beneficiary, or directly from the assets of the trust or fiduciary account, and consists solely of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management fee, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust and fiduciary accounts, or any combination of such fees.

(j) The term *sales compensation* means any compensation received by a bank in connection with activities for which the bank relies on an exception under Section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)) that:

(1) Is a fee for effecting a transaction in securities that is not a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers;

(2) Is compensation that if paid to a broker or dealer would be payment for order flow, as defined in § 240.10b–10;

(3) Is a finders' fee received in connection with a securities transaction or account, except a fee received pursuant to Section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i));

(4) Is a fee paid for an offering of securities that is not received directly from a customer or beneficiary, or directly from the assets of the trust or fiduciary account;

(5) Is a fee paid pursuant to a Rule 12b–1 plan under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*); or

(6) Is a fee paid by an investment company for personal service or the maintenance of shareholder accounts, except a fee that is not part of a Rule 12b–1 plan under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) for:

(i) Transfer agent and subtransfer agent services for beneficial owners of shares in the investment company;

(ii) Aggregating and processing purchase and redemption orders;

(iii) Providing beneficial owners with statements showing their positions in the investment companies;

(iv) Processing dividend payments;

(v) Providing subaccounting services for shares in the investment company held beneficially;

(vi) Forwarding shareholder communications, such as proxies, shareholder reports, dividend and tax notices, and updating prospectuses to beneficial owners; or

(vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners.

(k) The term *trustee capacity* in Section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)) includes an indenture trustee or a trustee for a tax-deferred account described in Sections 401(a), 408, and 408A under subchapter D and in Section 457 under subchapter E of the Internal Revenue Code of 1986 (26 U.S.C. 1 *et seq.*).

§ 240.3b–18 Definitions of terms used in Section 3(a)(5) of the Act.

For purposes of Section 3(a)(5)(C) of the Act (15 U.S.C. 78c(a)(5)(C):

(a) The term *affiliate* means any company that controls, is controlled by, or is under common control with another company.

(b) The term *consumer-related receivable* means any obligation incurred by any natural person to pay money arising out of a transaction in which the money, property, insurance, or services (being purchased) are primarily for personal, family, or household purposes.

(c) The term *member of a syndicate of banks* means a bank that is a participant in a syndicate of banks and contributes no less than 10% of the money loaned by the syndicate.

(d) The term *obligation* means any note, draft, acceptance, loan, lease, receivable, or other evidence of indebtedness that is not a security issued by a person other than the bank.

(e) The term *originated* means initially making and funding an obligation.

(f) The term *pool* means more than one obligation or type of obligation grouped together to provide collateral for a securities offering.

(g) The term *predominantly originated* means that the bank or its affiliates, not including any broker or dealer affiliates, originated no less than 85% of the value of the obligations in any pool. For this purpose, the bank and its affiliates include any financial institution with which the bank or its affiliates have merged but does not include the purchase of a pool of obligations or the purchase of a line of business.

(h) The term *syndicate of banks* means a group of banks that acts jointly, on a temporary basis, to loan money in one or more bank credit obligations.

7. Section 240.15a–7, 240.15a–8, 240.15a–9 are added to read as follows:

§ 240.15a–7 Exemption from the definitions of ''broker'' or ''dealer'' for banks for limited period of time.

(a) A bank is exempt from the definitions of the term ''broker'' under Section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) and the term ''dealer'' under Section 3(a)(5) of the Act (15 U.S.C. 78c(a)(5) until October 1, 2001; and

(b) 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 January 1, 2002, for activities that meet the conditions of an

exception or exemption for banks from the definition of the term ''broker'' except for those conditions of Section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) and the rules thereunder relating to compensation of the bank or its employees.

§ 240.15a–8 Exemption for banks from Section 29 liability.

No contract entered into before January 1, 2003 shall be void or considered voidable by reason of Section 29 of the Act (15 U.S.C. 78cc) 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 any applicable provision of the Act (15 U.S.C. 78a *et seq.*) and the rules and regulations thereunder based solely on the bank's status as a broker or dealer when the contract was created.

§ 240.15a–9 Exemption from the definitions of ''broker'' and ''dealer'' for savings associations and savings banks.

Any savings association or savings bank that has deposits insured by the Federal Deposit Insurance Corporation under the FDIA (12 U.S.C. 1811 *et seq.*), and is not operated for the purpose of evading the provisions of the Act (15 U.S.C. 78a *et seq.*), is exempt from the definitions of the terms ''broker'' and ''dealer'' under Sections 3(a)(4) and 3(a)(5) of the Act (15 U.S.C. 78c(a)(4) and 15 U.S.C. 78c(a)(5)), based solely on the savings association's or savings bank's status as a broker or dealer on the same terms and under the same conditions that banks are excepted or exempted, provided that if a savings association or savings bank acts as a municipal securities dealer, it shall be considered a bank municipal securities dealer for purposes of the Act (15 U.S.C. 78a *et seq.*) and the rules thereunder, including the rules of the Municipal Securities Rulemaking Board.

By the Commission.

Dated: May 11, 2001.

Margaret H. McFarland,

Deputy Secretary.

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