The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC And Federal Reserve Adopt Joint Rules Implementing The Bank Exception For Broker-Dealers Under The 1934 Exchange Act

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TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 38-07
BANK INVESTMENT MANAGEMENT MEMBERS No. 2-07 RE: SEC AND FEDERAL RESERVE ADOPT JOINT RULES IMPLEMENTING THE BANK EXCEPTION FOR BROKER-DEALERS UNDER THE 1934 EXCHANGE ACT

As we previously advised you, in December 2006, the Securities and Exchange Commission and the Federal Reserve Board jointly proposed rules, known as Regulation R, to implement provisions in the 1999 Gramm-Leach-Bliley (GLB) Act that sought to provide for the functional regulation of banks engaging in broker-dealer activities. [1] In particular, the GLB Act replaced the provision in the Securities Exchange Act of 1934 that excluded all banks from regulation as broker-dealers with a more detailed provision that restricted the exclusion to those banks that limited their securities activities as set forth in the GLB Act. On September 24th, the SEC and Federal Reserve approved Regulation R, with an effective date of 60 days from the regulation's publication in the Federal Register. [2] The majority of the provisions in the Regulation appear not to directly impact investment companies. Those that may be of interest to investment companies are briefly summarized below.

I. Trust and Fiduciary Activities Exception

As amended by the GLB Act, Section 3(a)(4)(B)(ii) of the Exchange Act permits a bank, subject to certain conditions, to effect securities transactions in a trustee or fiduciary capacity without having to register as a broker. One of the conditions in this provision relates to the basis for which the bank is "chiefly compensated" for such transactions. Rule 721 defines the term "chiefly compensated" by reference to a bank's "relationship

compensation." As originally proposed, the term would have included any compensation the bank receives that consists of an administration fee, including a fee paid by an investment company for personal service, the maintenance of shareholder accounts or for other services (which are described in the third bullet below), or a fee based on a percentage of assets under management, including, without limitation:

- A fee paid by an investment company pursuant to a 12b-1 plan;
- A fee paid by an investment company for personal services or the maintenance of shareholder accounts; or
- A fee paid by an investment company based on a percentage of assets under management for any of the following services: (i) providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares; (ii) aggregating and processing purchase and redemption orders for investment company shares; (iii) providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company; (iv) processing dividend payments for the investment company; (v) providing sub-accounting services to the investment company for shares held beneficially; (vi) forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or (vii) receiving tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

The Institute's comment letter expressed concern within conditioning the definition of "relationship compensation" on the fees being paid by the investment company. As noted in our comment letter, the long-standing practice of the mutual fund industry is for such fees to be paid by the fund's administrator, transfer agent, primary distributor, or investment adviser, rather than by the fund itself. We are pleased to report that in the adopted version of Regulation R, the definition of "relationship compensation" in Rule 721 has been revised to reference the purpose for which the compensation is paid and eliminate any reference to the source of such compensation.

II. Exception for Sweep Accounts

Section 3(a)(4)(B)(v) of the Exchange Act excepts a bank from the definition of "broker" to the extent it "effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund." Rule 740, which was adopted as proposed, defines the term "no-load" for purposes of this provision to mean that the class or series of securities in which the bank effects transactions is not subject to a sales load or deferred sales load or to total charges for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts in excess of 0.25 of 1% of net assets annually. Consistent with NASD Rule 2830, certain specified charges are excluded when computing this amount. [3] Rule 740 also defines the following terms relevant to this exception by cross-referencing the definitions of these terms under the Investment Company Act of 1940: deferred sales load, money market fund, open-end company, and sales load.

III. Exemption for Banks Effecting Transactions in

Money Market Funds

Rule 741 implements the revisions to the Exchange Act that permit banks, without registering under the Act, to effect transactions on behalf of a customer in securities issued by a money market fund under certain conditions. This exemption is intended to recognize that banks have long offered sweeps and other services that invest customer funds in money market funds that would not qualify as no-load funds under NASD Rule 2830 or Rule 740, discussed above. To qualify for this new exemption, the bank must provide the customer, directly or indirectly, some other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under the Exchange Act. Examples of other products or services include an escrow, trust, fiduciary, or custody account, a deposit account, or a loan or other extension of credit.

As with the proposed version, the adopted version of Rule 741 allows banks to effect transactions only in securities of a registered money market fund. In addition, it provides that if the class or series of money market fund securities is not no-load, the bank may not characterize or refer to the class or series as no-load and the bank must provide the customer, not later than at the time the customer authorizes the bank to effect the transaction, a prospectus for the securities. Unlike the proposed version of this rule, the adopted version has been modified to permit a bank also to effect transactions under the exemption on behalf of another bank as part of a program for the investment or reinvestment of the deposit funds of, or collected by, the other bank. This revision is designed to permit banks to provide sweep services to other banks under the exemption, just as they may do under the sweep exception itself.

IV. Banks' Use of NSCC's Fund/SERV

Rule 775 permits banks to effect certain transactions through the National Securities Clearing Corporation's Mutual Fund Services (Fund/SERV) or directly with a fund's transfer agent without triggering registration under the Exchange Act. As originally proposed, the rule would have only permitted banks to effect transactions in mutual funds. As adopted, the rule has been expanded to also permit transactions in variable insurance contracts (i.e., annuities and variable life insurance products) that are funded by any federally registered "separate account" as defined in Section 2(a)(37) of the Investment Company Act. According to the Release adopting Regulation R, this expansion is intended to avoid needless disruptions and costs with respect to banks' transaction with customers in which interposing an executing broker-dealer would be inefficient, inconsistent with market practice, and unnecessary for investor protection.

To qualify for this exemption, the securities must not be traded on a national securities exchange or through the facilities of a national securities association or an interdealer quotation system. Also, the securities must either be distributed by a registered broker-dealer or the sales charge for the transaction must be no more than the amount a registered broker-dealer could charge pursuant to the rules of a registered securities association adopted under Section 22(b)(1) of the Investment Company Act. Finally, the transaction must be effected through the NSCC or directly with a transfer agent, an insurance company, or a separate account that is excluded from the definition of transfer agent under the Exchange Act.

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endnotes

[1] See Institute Memorandum to Bank Trust Recordkeeping Advisory Committee No. 37-06 and to Bank Investment Management Members No. 1-06 [No. 20709], dated December 20, 2006. In February 2007, the Institute filed a comment letter supporting adoption of proposed Regulation R but recommending a technical amendment to it. See Institute Memorandum to Bank, Trust and Recordkeeping Advisory Committee No. 6-07 and to Bank Investment Management Members No. 1-07 [No. 20878], dated February 16, 2007, which summarizes the Institute's comment letter.

[2] See Definition of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, SEC Release No. 34-56501 (Sept. 24, 2007, which is available on the SEC's website at: http://www.sec.gov/rules/final/2007/34-56501.pdf. The one exception to the Regulation's effective date is Section .781 of the Regulation, which exempts banks from the definition of the term "broker" until the first day of the bank's fiscal year commencing after September 30, 2008.

[3] Charges for the following would be excluded when determining a fund's no-load status: providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares; aggregating and processing purchase and redemption orders for investment company shares; providing beneficial owners with account statements showing their purchases, sales, and position in the investment company; processing dividend payments for the investment company; providing sub-accounting services to the investment company for shares held beneficially; forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.
