The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 13563

May 30, 2001

SEC ADOPTS INTERIM FINAL RULES RELATING TO THE REGULATION OF BANKS AS BROKER-DEALERS UNDER THE '34 ACT

[13563] May 30, 2001 TO: ADVISORY GROUP ON BANKING ISSUES BANK INVESTMENT MANAGEMENT MEMBERS No. 2-01 BANK AND TRUST ADVISORY COMMITTEE No. 4-01 RE: SEC ADOPTS INTERIM FINAL RULES RELATING TO THE REGULATION OF BANKS AS BROKER-DEALERS UNDER THE '34 ACT Effective May 11, 2001, the Securities and Exchange Commission adopted on an interim final basis a variety of rules to implement provisions in the Gramm-Leach-Bliley Act (the "GLB Act") that provide functional exceptions for banks from the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 (the "Exchange Act") and to provide additional exemptions.1 These rules were adopted in response to questions from banks regarding the interpretation of these new exceptions. In addition to adopting these rules on an interim basis, the Commission has requested comment on them. Comments on the rules, which are summarized below, must be filed with the Commission no later than July 17, 2001. The Institute plans to comment on the rules only to the extent that they impact investment companies. Persons with comments relating to the rules' impact on investment companies should provide them to the undersigned by phone (202-326-5825), fax (202-326-5839) or e-mail (tamara@ici.org) no later than Tuesday, July 3rd. 1 See Release No. 34-44291 (May 11, 2001)(the "Release"), 66 FED. REG. 27,759 (May 18, 2001). Cites to the Release in this memo are to the version available on the SEC's web site at www.sec.gov. Effective May 12, 2001, Sections 201 and 202 of the GLB Act substantially amended the Exchange Act's definitions of "broker" and "dealer," respectively. Prior to these amendments, these terms did not include banks. Accordingly, banks that engaged in securities activities were not required to register under the Exchange Act as brokers or dealers. The interim rules were necessitated by amendments in the GLB Act to the Exchange Act that repealed the blanket exclusion for banks from the definitions of "broker" and "dealer" and replaced it with functional exceptions that were more narrowly tailored to ensure that investors purchasing securities through a bank receive the same protections as those who purchase through registered broker-dealers. In particular, the blanket exclusions were replaced with eleven exceptions for banks from the definition of "broker," four from the definition of "dealer," and three from both definitions. 2I. RULES THAT MAY BE OF PARTICULAR INTEREST TO INVESTMENT COMPANIES The vast majority of the rules included in this interim rule packet appear not to directly impact investment company activities. There are, however, a few that may be of interest to investment companies. In the following summary, the interim rules that may be of particular interest to investment companies will be summarized first, followed, in

numerical order, by each of the remaining interim rules. A. Rule 3b-17 Rule 3b-17 defines various terms used in the exceptions set forth in Section 3(a)(4) of the Exchange Act. These definitions, however, significantly affect the scope of the exceptions. The definitions that would appear to be of most interest to investment companies are those described below relating to the exceptions for trust and fiduciary activities and sweep accounts.2 1. Trust and Fiduciary Activities: Indenture Trustees; ERISA and IRA Trustees; Transfer Agents; Rule 3b-17(k) Section 3(a)(4)(B)(ii) of the Exchange Act provides an exception from the definition of "broker" for banks that act as trustees or fiduciaries provided that the bank effects transactions in a trustee or fiduciary capacity, does not publicly solicit brokerage business, and complies with conditions relating to where within the bank the transaction is effected and how the bank is "chiefly compensated" for these transactions.3 According to the Release, the law is unclear as to whether banks acting in the following three capacities should be covered by this exception in the Exchange Act: indenture trustees, ERISA trustees, and IRA trustees. The Commission has resolved this uncertainty through Rule 3b-17(k), which defines the term "trustee capacity" as used in the Exchange Act to include "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."4 As such, according to the Release, the trust and fiduciary exception in Act does include trust indenture trustees and trustees for certain tax- 2 As amended by the GLB Act: Section 3(a)(4)(B)(ii) provides an exception from the definition of "broker" for banks that act as trustees or fiduciaries, subject to certain conditions and Section 3(a)(4)(B)(v) excepts banks that effect certain sweep account activities. 3 According to the Exchange Act, the bank must be "chiefly compensated" on the basis of an administration or annual fee, 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. See Section 3(a)(4)(B)(ii) of the Exchange Act. In the Release's discussion of this provision, it notes 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. Soft dollar benefits are, on their face, more than the cost of executing a trade." See Release at p. 25. See, also, the discussion of "service fees" in connection with this issue on pp. 26-27 of the Release and in footnote 146. 4 Footnote 85 to the Release states as follows concerning this exception: "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 is unavailable to common trust funds holding IRA assets. . . . The [GLB Act codified] 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.'" 3deferred accounts (including ERISA and IRA accounts) provided that such activities are conducted in accordance with all of the other terms of the exception for trustee activities, summarized above.5 Accordingly, banks that engage in these activities subject to the conditions set forth in the Exchange Act will be able to continue to effect securities transactions without having to register as a broker. The Release expressly states, however, that the trust and fiduciaries activities exception "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." 6 2. Sweep Accounts: No-load Money Market Funds; Rules 3b-17(e) and (f) Section 3(a)(4)(B)(v) of the Exchange Act provides an exception for a bank that "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."

According to the Release, this exception in the Act is intended to permit banks to continue to sweep funds into no-load money market funds without having to register as broker-dealers.7 Because the terms “no-load” and “money market fund” are not defined in the GLB Act, to clarify the sweep accounts exception, the Commission has adopted definitions for these terms, in Rules 3b-17(f) and (e), respectively. “No-load” is defined in Rule 3b-17(f) to be consistent with the definition of this term in Rule 2830(d)(4) of the NASD’s rules. As such, an investment company registered under the Investment Company Act is considered no-load if: (1) purchases of the investment company’s securities are not subject either to a sales load or a deferred sales load as defined in the Investment Company Act or rules thereunder; and (2) its total charges against net assets that provide for sales or sales promotion expenses and for personal service or maintenance of shareholder accounts do not exceed 0.25% of 1% of average net assets annually and are disclosed in the fund’s prospectus. While the Release states that all charges against fund assets that fall within the definition in Rule 3b-17(f) count towards 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, a footnote to the Release notes 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.8 5 See Release at pp. 16-17. 6 The Commission reaches this conclusion by considering the trust and fiduciary activities exception together with the definition of “transfer agent” in Section 3(a)(25) of the Exchange Act. See Release at p. 18. 7 See Release at p. 33. 8 See Release at footnote 168. According to this footnote, the following charges do not count towards this limit: charges for transfer agent and subtransfer agent services for beneficial owners of 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. 4“Money market fund” is defined in Rule 3b-17(e) as an open-end management investment company registered under the Investment Company Act that is regulated as a money market fund under Rule 2a-7. The Release notes that these rules defining “no-load money market fund” would not prevent a bank from directly charging its customers for the bank’s sweep services because such charges would not impact the “no load” determination. Similarly, the rules 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 maintenance of shareholder accounts.9 B. Rule 3a4-3: Banks Effecting Transactions as an Indenture Trustee in a No-load Money Market Fund Unlike Rule 3b-17, which is a definitional rule, Rule 3a4-3 and the remaining rules discussed in this section provide exemptions from the registration requirements of the Exchange Act for certain banks. In particular, Rule 3a4-3 relates to the trust and fiduciary exception discussed above, and provides an exemption for the “narrow role” of indenture trustees investing in no-load money market funds. As such, a bank, acting in its capacity as a bond indenture trustee that complies with all of the conditions of the trust and fiduciary activities exception, other than the compensation condition, would be exempt from the definition of “broker” solely for effecting transactions as an indenture trustee in no-load money market funds. C. Rule 3a4-4: Exception for Small Banks Effecting Transactions in Investment Company Securities in Tax-Deferred Custody Accounts Rule 3a4-4 provides an exemption for a small bank, under certain conditions, solely for effecting transactions in securities of an investment company in a tax-deferred account for which the bank acts as custodian under the

safekeeping and custody activities exception (discussed below under Rule 3a4-5), or as trustee under the trust and fiduciary exception (discussed above). Conditions to this exemption include: that the bank have no affiliation or networking arrangement with a broker-dealer; the relevant bank employees not be associated persons of a broker-dealer or receive incentive compensation for such transactions; the bank complies with limits on its solicitation activities; if the bank sells investment company securities 9 See Release at pp. 34-35. Footnote 169 of the Release also cautions banks relying on the sweep accounts exception to "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." 5of an affiliate, it also must make available to the tax-deferred account the securities of similar investment companies that are not affiliates; and the bank's compensation relating to effecting transactions in securities pursuant to this exemption must be less than 3% of its annual revenue.10 D. Rule 3a4-6: Exemption to Permit Execution of Investment Company Securities Through NSCC and Fund/SERV Rule 3a4-6 provides an exemption to allow banks to continue to execute transactions in shares of open-end investment companies through NSCC's Mutual Fund Services, including Fund/SERV. According to the Release, "NSCC's Mutual Fund Services simplify and automate the process for purchasing and redeeming investment company securities without raising investor protection concerns."11 II. RULES OF PARTICULAR INTEREST TO BANKS The remaining Interim Rules included in the Commission's Release are briefly summarized below. • Rule 3a4-2: Exemption for Banks that are Compensated by Relationship Compensation -- This rule permits banks that are compensated entirely by relationship compensation to avoid making calculations on an account-by-account basis.12 In particular, it 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 the total fiduciary activities.13 • Rule 3a4-5: Exemption for Banks Effecting Transactions in Securities in a Custody Account -- This rule provides an exemption, subject to specified conditions, for banks that effect transactions in securities for custody accounts without, directly or indirectly, receiving compensation for providing this services. A bank relying on the exemption may pass on to the customer the broker-dealer's charge for executing the transaction. 10 Generally, "small bank" is defined in the rule as one that had less than $100 million in assets as of December 31st of both the prior two years. "Tax deferred account" is defined in the rule 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. 11 See Release at pp. 45-46. 12 As discussed above, to qualify for the trust and fiduciary activities exception, banks must meet certain compensation limits for transactions effected in a fiduciary capacity. In particular, they must be "chiefly compensated" on a specified basis. To assist banks in determining whether they are chiefly compensated, the rules require a bank to determine its "relationship compensation," "sales compensation," and "unrelated compensation." (See Rules 3b-17(i) and (j) for the definitions of the first two of these terms.) Such compensation must be determined annually on an account-by-account basis. For the bank to be "chiefly compensated," its relationship compensation must exceed its sales compensation. 13 "Sales compensation" includes payment for order flow and fees paid to the bank pursuant to a 12b-1 plan. See Rule 3b-17(j)(2) and (6). 6• Rule 3a5-1: Exemption for Banks Engaged in Riskless Principal Transactions -- This rule provides an exemption from the definition of "dealer" solely for banks engaging in riskless principal transactions if

the number of such 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 Act14 during that same year do not exceed 500 transactions. • Rule 3b-17: Definitions -- In addition to the definitions discussed above, Rule 3b-17 also defines the following terms, which are used in the Exchange Act and the Interim Rules interpreting that Act: “chiefly compensated;” “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;” “indenture trustee;” “investment adviser if the bank receives a fee for its investment advice,” which is relevant for banks relying on the trust and fiduciary activities exception; “nominal one-time cash fee of a fixed dollar amount,” which is relevant to banks that engage in networking arrangements; “referral;” “relationship compensation;” “sales compensation;” and “trustee capacity.” • Rule 3b-18: Definitions -- Rule 3b-18 defines various terms used in the exception in Section 3(a)(5)(c)(iii) of the Exchange Act, which allows banks to issue and sell certain asset-backed securities. • Rule 15a-7: Extensions of Time -- Rule 15a-7 consists of two subsections, each of which is intended to provide banks additional time to comply with the federal securities act as amended by the GLB Act. Subsection (a) exempts until October 1, 2001 banks that would otherwise be required to register as a broker or dealer because the bank no longer qualifies for an exception. Subsection (b) exempts until January 1, 2002 banks that would be a broker solely because their compensation arrangements make them ineligible to claim an exception or exemption. (This would include effecting transactions in a money market fund that does not qualify as no-load under the sweeps exception.) • Rule 15a-8: Exemption for Contracts Entered into by Banks Before 2003 from being Considered Void or Voidable -- This rule provides an exemption for contracts entered into by banks before January 1, 2003 from being considered void or voidable by reason of Section 29 of the Exchange Act because a bank that is a party to the contract violated the Act’s registration requirements based solely on the bank’s status as a broker or dealer when the contract was created. • Rule 15a-9: Exemption for Savings Associations and Savings Banks-- This rule provides an exemption from the definitions of “broker” and “dealer” for savings associations and savings banks on the same terms and conditions that banks are excepted or exempted from broker-dealer registration. • Rule 30-3: Delegation of Authority -- This rule delegates 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 association, and savings banks exemptions from the broker-dealer registration requirements. Such delegation is designed to conserve the Commission’s resources by permitting Division staff to grant or deny exemptions where appropriate and in a timely manner. 14 Section 3(a)(4)(B)(xi) of the Exchange Act provides an exception from the definition of “broker” for banks that effect no more than 500 securities transactions, other than transactions that qualify for one of the other statutory exceptions, in any calendar year provided such transactions are not effected by an employee of the bank who is also an employee of a broker-dealer. According to the Release, a transaction in which the bank is acting as an agent for a customer would count as one transaction toward the 500-limit. See Release at pp. 41-42. 7A copy of the Commission’s Release, which runs 109 pages, is available on the Institute’s member web site and on the Commission’s web site (www.sec.gov). Tamara K. Reed Associate Counsel