INVESTMENT COMPANY INSTITUTE

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SEC and Federal Reserve Propose Joint Rules Implementing the Bank Exceptions From the 1934 Act's Definition of Broker-Dealer

 [20709] December 20, 2006 TO: BANK, TRUST AND RECORDKEEPER ADVISORY COMMITTEE No. 37-06 BANK INVESTMENT MANAGEMENT MEMBERS No. 1-06 RE: SEC AND FEDERAL RESERVE PROPOSE JOINT RULES IMPLEMENTING THE BANK EXCEPTIONS FROM THE 1934 ACT'S DEFINITION OF BROKER-DEALER Before the Gramm-Leach-Bliley Act was enacted in 1999, banks were completely excluded from broker-dealer registration requirements under the Securities Exchange Act of 1934. The GLB Act replaced this exclusion with a functional regulation approach to bank securities activities. It did so by amending Section 3(a)(4) of the Securities Exchange Act to limit the activities banks could engage in without registering as broker-dealers. To date, no permanent rules have been adopted by the SEC to implement this amendment.1 The Financial Services Regulatory Relief Act, signed into law in October 2006, requires the SEC and the Board of Governors of the Federal Reserve System to jointly adopt a single set of rules under the Exchange Act to implement the bank exceptions in the GLB Act. Pursuant to this mandate, the SEC and the Federal Reserve have jointly proposed such rules.2 The provisions in this proposal that may impact investment companies are briefly summarized below. Comments on the joint proposal will be due within 90 days after their publication in the Federal Register. The Institute plans to comment on the rules only to the extent they raise issues for investment companies. Persons with comments relating to any such issues should provide them to the undersigned by phone (202-326-5825), fax (202-326-5839), or email (tamara@ici.org) no later than Friday, February 2nd. 1 In 2001, the SEC adopted interim rules to implement the GLB Act's provisions. See Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Section 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, SEC Release No. 34-44291 (May 11, 2001) ("Interim Rules"). In 2004, the SEC proposed to revise and restructure the Interim Rules and codify them as Regulation B. See Regulation B, SEC Release No. 34-50056 (June 17, 2004). 2 See Definition of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, SEC Release No. 34-54946 (Dec. 18, 2006). A copy of the Release is available at: http://www.sec.gov/rules/proposed/2006/34-54946.pdf. By operation of the Regulatory Relief Act, the joint adoption of new final rules by the SEC and the Federal Reserve will supersede the Interim Rules and proposed Regulation B. 2 I. OVERVIEW The Exchange Act provides an exception from the definition of "broker" for banks that limit their securities

activities as set forth in Section 3(a)(4). Those banks that do not so limit their activities must register and be regulated as brokers under the Act. The proposed joint rules are designed to implement and facilitate compliance with the provisions of Section 3(a)(4). They include provisions relating to the following bank activities: networking arrangements with broker-dealers; trust and fiduciary activities; sweep accounts; transactions in money market funds and other investment company securities; safekeeping and custody activities; transactions with non-U.S. persons; and securities lending activities. II. PROPOSED RULES THAT MAY BE OF PARTICULAR INTEREST TO INVESTMENT COMPANIES The majority of the rules included in the joint rule proposal appear not to directly impact investment companies. There are a few provisions or rules in the joint proposal, however, that may be of interest to investment companies. These are as follows: A. Trust and Fiduciary Activities Exception 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 the Act is the basis for which the bank is “chiefly compensated” for such transactions. Proposed Rule 721 would define the term “chiefly compensated” as used in Section 3(a)(4)(B)(ii) by reference to a bank’s “relationship compensation.” As proposed to be defined, a bank’s “relationship compensation” would include 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 3 tabulating, and transmitting proxies executed by beneficial owners of investment company shares. B. 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.” Proposed Rule 740 would define the term “no-load” for purposes of this provision. As defined, “no load” would mean that the class or series of securities in which the bank effects transactions is neither 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 would be excluded when computing this amount.3 Proposed Rule 740 would also define 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. C. Exemption for Banks Effecting Transactions in Money Market Funds Proposed Rule 741 would create a new exemption for banks permitting them to effect, under certain conditions, transactions on behalf of a customer in securities issued by a money market fund. 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 proposed joint Rule 740, discussed above. To qualify for this new exemption, the bank would be required to provide the customer, directly or indirectly, any other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under the Exchange Act. If the series or class of money market fund offered by the bank is not a no-load fund, the bank could not characterize or refer to it as no-load. Also, the bank would have to provide the customer a prospectus for the money market fund no later than at the time the customer authorizes the bank to effect the transaction. 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. 4 D. Banks’ Use of NSCC’s Fund/SERV Proposed joint Rule 775 would permit 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. To qualify for this exemption, the transaction would have to involve shares in a mutual fund that is neither traded on a national securities exchange nor through a national securities association or an interdealer quotation system. Also, the securities would either have to be distributed through a registered broker-dealer or, in the alternative, the sales charge for the transaction would have to be no more than the amount a registered broker-dealer could charge pursuant to the rules of a registered securities association adopted pursuant to Section 22(b)(1) of the Investment Company Act. III. ORDER EXTENDING BANKS’ EXEMPTION UNDER SECTION 3(A)(4) OF THE EXCHANGE ACT In a related release, the SEC has issued an order granting banks an exemption from compliance with the definition of “broker” under the Exchange Act until July 2, 2007.4 This extension is intended to provide the SEC and the Federal Reserve time to receive comments on their joint rule proposal, evaluate such comments, and take final action on such rules. Accordingly, pursuant to the SEC’s order, banks shall be exempt from the definition of broker under the Exchange Act until July 2, 2007. Tamara K. Salmon Senior Associate Counsel 4 See Order Extending Temporary Exemption of Banks from the Definition of “Broker” under Section 3(a)(4) of the Securities Exchange Act of 1934, SEC Release No. 34-54948 (Dec. 18, 2007). A copy of this Release is available at: http://www.sec.gov/rules/other/2006/34-54948.pdf.
