INDEPENDENT COMMUNITY
BANKERS of AMERICA

September 1, 2004

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Regulation B: File No. S7-26-04

Dear Mr. Katz:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the proposed new series of rules known as Regulation B that will implement the exceptions that banks have from the definition of the term "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 (Exchange Act) as amended by the Gramm-Leach-Bliley Act ("GLBA").

Background

Prior to the passage of GLBA in 1999 ("GLBA"), banks were specifically excluded from the definition of "broker" contained in the Exchange Act and could engage in securities sales activities without registering as a broker with the SEC. With the enactment of GLBA, banks are excluded from the definition of 'broker" only to the extent that their securities sales activities fall into one or more of the eleven statutory functional exceptions. Each of these exceptions permits a bank to act as an agent with respect to specified securities products or in transactions that meet specific statutory conditions. In particular, the Exchange Act provides conditional exceptions for banks that engage in networking arrangements; trust and fiduciary activities; permissible securities transactions; certain stock purchase plans; sweep accounts; affiliate transactions; private securities offerings; safekeeping and custody activities; municipal securities; and de minimis transactions.

[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to protecting the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

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In 2001, the Commission adopted interim final rules (the "Interim Rules") to implement these exceptions.[2] The Interim Rules were suspended after the trade associations and members of the banking industry expressed serious concerns about the compliance burdens of the new rules, including their impact on traditional bank activities. Congressional hearings were also held after the Interim Rules were issued. During those hearings, Chairman Oxley of the House Committee on Financial Services questioned whether the SEC has upheld the spirit of GLBA and emphasized that the legislation "was never meant to make banks disrupt their customer relationships and force traditional banking activities into broker-dealer affiliates."[3]

During the past year, the SEC staff, the banking regulators, and representatives from the industry, including ICBA, have met several times in an effort to amend the Interim Rules and arrive at a new series of regulations that simultaneously would allow the banking industry to retain certain types of business as permitted and intended by GLBA and address SEC concerns that investors be sufficiently protected.

ICBA's Position

Regulation B is an improvement over the Interim Rules and the SEC staff deserves credit for the time they have taken to meet with the trade associations and industry representatives in an attempt draft a workable rule. ICBA appreciates the fact that the SEC has tried to accommodate the special needs of community banks by providing specific exemptions for small banks.

However, even though Regulation B is an improvement over the Interim Rules, it is still unnecessarily complex and reflects a narrow reading of the statutory provisions of GLBA. Title II of GLBA was designed to ensure that traditional banking activities involving securities transactions, such as fiduciary activities and custodial functions, not be disturbed and that banks be able to continue to provide services to customers as they have for many years. In its current state, proposed Regulation B is extremely burdensome, unnecessarily complicated and restrictive, and will prove so costly for banks to implement that it essentially nullifies some of the statutory exceptions, defeating the Congressional intent that banks be allowed to continue to function as they have. Without further revision, Regulation B will force many banks—especially community banks—to discontinue existing services to the detriment of their customers. It is ironic that when the banking agencies are attempting under EGRPRA[4] to find ways to relieve the regulatory burden of banks that the SEC has issued a proposal that will substantially increase that burden.

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[2] Bank Broker-Dealer Interim Final Rules, Release No. 34-44291, 66 Fed. Reg. 27760 (May 18, 2001).
[3] Pushing Back the Push-Outs: Hearing on the SEC's Broker-Dealer Rules Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services (August 2, 2001).
[4] EGRPRA stands for the Economic Growth and Regulatory Paperwork Reduction Act of 1996. EGRPRA requires the federal financial regulatory agencies to identify outdated, unnecessary, or unduly burdensome statutory or regulatory requirements. Currently, the federal financial regulatory agencies are in the middle of a three-year review all the banking regulations and have been soliciting input from the industry as to what requirements are outdated, unnecessary or unduly burdensome.

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The statutory exceptions in Title II of GLBA are very important for community banks and their customers. Registering as a broker is simply not an option for most community banks. The capital required and the compliance and reporting systems that small banks would have to implement to register as broker-dealers are not commensurate with the potential income streams for these banks. Furthermore, many community banks operate in rural areas where attracting qualified personnel to staff such an operation is not feasible. Therefore, practical and useful applications of the statutory exception are critical to continue to provide these services and to make them available to investors.

In its approach to some of the exemptions in Regulation B, the SEC appears to have a strong concern that banks may attempt to operate a full-scale broker-dealer operation in their trust and custody departments in disregard of the law and without detection by the banking regulators. This concern is unfounded and ignores the fact that banks are so closely supervised. Banks are examined every 12 to 18 months and all aspects of the bank are examined, including trust and fiduciary activities, to ensure that laws and regulations are complied with. Banks are subject to a full range of enforcement actions if their regulator discovers any issues in the way the institution is operated. Furthermore, banking regulators are quite capable of determining whether a bank is operating a broker-dealer operation in violation of GLBA.

Following are ICBA's comments on the specifics of Regulation B and our recommendations for revising it. We urge the SEC to revise the rule to make it less burdensome to community banks and more compatible with Congressional intent and the plain terms of GLBA.

Third Party Brokerage Arrangements

One of the most important exceptions from the definition of broker under GLBA for ICBA members is the third party brokerage exception or networking exception. This exception allows banks to partner with broker-dealers in offering their customers securities brokerage services. If the bank's networking activities meet the conditions of the statutory exception, it may, without itself being registered as a broker-dealer, receive compensation related to brokerage transactions the broker-dealer effects as a result of the networking arrangement. The exception also allows unregistered bank employees[5] to engage in securities-related activities and to receive incentive compensation in the form of a "nominal one-time cash fee of a fixed dollar amount" for referring bank customers to the broker-dealer. This exception for referral payments to unregistered bank employees is critical to the success of community banks that wish to employ a third party brokerage network.

Definition of "Nominal."

Proposed Regulation B defines a "nominal one-time cash fee of a fixed dollar amount" to mean that a referral payment must have a value that does not exceed the

[5] "Unregistered" bank employees are bank employees who are not also employed as registered representatives of a registered broker-dealer that supervises their securities activities.

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greater of three alternative measures: (1) the employee's base hourly rate of pay, (2) a dollar amount equal to $15 in 1999 plus an adjustment for inflation, or (3) $25.

ICBA commends the SEC for providing an alternative—a specific dollar amount of $25--to an hourly compensation standard based on an employee's base hourly rate of pay. Under the Interim Rules, there was no practical alternative to the hourly compensation standard. The definition of "nominal" used in the Interim Rules required that banks use one of two approaches to determine when a "nominal" amount was being paid. One approach could only be used if the bank allowed referral fees as part of a points system. The other approach required banks to compute the gross cash wages of the employee making the referral. We objected to the hourly compensation standard because of the impracticalities and burdens of using an hourly wage level as a cap for a referral fee. A specific amount cap is much clearer and much easier for community banks to administer.

However, ICBA believes that the $25 cap is too low. Although it appears that the referral fees of a majority of our members are below $25, some ICBA banks pay their employees $30 for security referrals. Therefore, we would suggest that the cap be raised to at least $30. We would further recommend that the inflation adjustment be based on the cap amount in effect at the time the regulation becomes effective rather than $15 as of 1999. $15 dollars in 1999 dollars after adjustment for inflation equals approximately $17 in 2004 dollars. In this low inflation environment, it may take 20 years for the inflation adjustment to ever catch up with a $25 or $30 cap.

ICBA believes that the hourly compensation standard is also too low. Since most referring employees at community banks are lower paid tellers and customer service representatives, we would recommend that it be defined as at least twice the employee's hourly compensation, if the employee is paid on a hourly, nonsalaried basis. For those being paid on a salaried basis, the hourly compensation cap should work. However, even if the SEC were to adopt a hourly compensation standard, we think that most community banks will be relying on the specific dollar cap since (1) it is much clearer, (2) an hourly compensation standard would produce different referral fees for different employees, a result not conducive to the teamwork among employees, and (3) it is often difficult to compute and monitor on a regular basis the hourly compensation of employees.

In our view, the SEC has defined the term "nominal" too narrowly. The SEC notes that the dictionary definitions of "nominal" leads to the conclusion that the payment should be inconsequential or trifling. However, we question the relevance these dictionary meanings have to networking arrangements. "Nominal" should not be defined so narrowly as to have little value to an employee making a referral, as that defeats the purpose of allowing the bank to incent employees to refer customers to the registered representatives. Instead, the standard should be based on whether the referral fee gives an unregistered bank employee an incentive not to just make referrals, but also to sell securities brokerage services to bank customers in violation of the law.

The SEC is also soliciting comment on the merits of providing another alternative standard for determining whether a referral fee is nominal that would be based on the incentive a bank would pay its employee for the sale or renewal of a certificate of deposit. Based on our limited survey, we found few community banks paying a fee for

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the renewal of a CD. Therefore, such an alternative standard would not be of much benefit to community banks.

Definition of "One-Time."

ICBA objects to the SEC's narrow definition of the term "one-time." This definition should be flexible enough so that, for instance, banks may pay their unregistered employees two referral fees, one at the time of the referral and a second one later if the employee achieves the goal of a particular number of referrals in a period of time covering the referral for which the employee was paid. In the alternative, a bank should be able to pay a referral fee for the same customer once every year. In other words, "one-time" should not be interpreted to mean that a bank can never pay two or more referral fees for the referral of the same customer.

Banks need this type of flexibility to provide the necessary incentive compensation programs for their employees. Bank employees should be allowed to receive incentive compensation that is based, directly or indirectly, on a referral for which the employee has already received a referral fee, particularly when the new referral occurs in the year following the original referral. Furthermore, the SEC should refrain from regulating bank compensation programs. GLBA never gave the SEC authority to regulate or limit bonus programs paid to bank employees. This is another area where the SEC has chosen to unnecessarily complicate Regulation B in the name of investor protection.

Definition of "Cash Fee"

The SEC is also proposing an amended definition of "nominal one-time cash fee of a fixed dollar amount" that would allow the payment of referral fees or portions of referral fees other than in cash to the extent that: (1) such payments are in units of value with a readily ascertainable cash equivalent; (2) the total value of the referral fee meets the nominal value conditions of the proposed amended definition; and (3) the payment is made under an incentive program that covers a broad range of products and that is designed primarily to reward activities unrelated to securities. This interpretation of the networking exceptions "cash fee" requirement would permit banks to continue using certain types of point-based incentive programs under which points are accumulated toward a cash bonus or other incentive. However, referral fees paid in part or entirely in points must still meet the definition of "nominal."

Subject to making further changes to the definitions of "nominal" and to "one-time" as noted above, ICBA generally supports the SEC's proposed definition of "cash fee". The proposed definition is more flexible than the one required under the Interim Rules, which prohibited any sort of point system if the points awarded for securities referrals exceeded the points awarded for other products. As we noted in our comment letter on the Interim Rules, that kind of prohibition discourages securities referrals, since all other banking products other than securities products must be given equal or higher priority in order to ensure compliance with the rule.

However, we do have concerns about the requirement that the points or other-than-cash property must be "paid in units of value with a readily ascertainable cash

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equivalent." Under many bonus programs, the value of the points or other-than-cash property does not have readily ascertainable cash equivalent value until sometime after they are awarded. We would suggest a more flexible definition that would allow the cash equivalency value of other-than-cash bonuses to be determined at a later date. Otherwise, the rule will improperly intrude into bank compensation programs.

Proposed Definition of "Contingent on Whether the Referral Results in a Transaction"

ICBA commends the SEC for proposing a more flexible definition of the statutory requirement that the payment of referral fees cannot be "contingent on whether the referral results in a transaction." The proposed definition would permit referral fees to be contingent on two factors. First, the term would permit referral fees to be contingent on whether a customer contacts or keeps an appointment with a broker-dealer as a result of the referral. Second, referral fees may be contingent on whether a bank customer has assets meeting any minimum requirement that the registered broker-dealer, or the bank, may have established generally for referrals for securities brokerage accounts. As the SEC notes, both of these factors give broker-dealers the flexibility to avoid paying fees for worthless referrals without inappropriately aligning the financial interests of the bank's employee with those of the broker-dealer. This condition is important to ensuring that unregistered bank employees aren't motivated to sell securities brokerage services directly to customers. Because of this condition, the other requirements under the networking exception do not have to be so restrictive.

It is important to note that banks have operated under regulatory guidelines similar to the networking statutory exception for years without abuse or any negative impact on investors. Therefore, there is no reason why Regulation B needs to be more restrictive than the statute.

Trust and Fiduciary Exemption

Banks have offered customers trust and fiduciary activities that involve securities transactions for many years. These traditional activities have served as a mainstay for the business of banking, have been delivered to customers successfully without any serious problems, and are subject to state laws on fiduciary activities and supervision by banking agencies.

Recognizing this longstanding tradition, Congress included an exception in GLBA that allows banks to continue to provide securities transactions for their trust and fiduciary customers as they have for many years. To prevent banks from conducting a full-scale brokerage operation in the guise of trust department activities, GLBA placed some qualifications on this exception: the statute requires a bank to be "chiefly compensated" for trust and fiduciary services on the basis of non-brokerage related fees and prevents the bank from advertising its securities services, except in connection with general trust services. However, Congress clearly intended that existing trust and fiduciary activities—including securities services—be allowed to continue. In fact, in the

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Conference Report on GLBA, Congress warned the SEC not "to disturb traditional bank trust activities" in such a manner as to impose huge regulatory burdens on the industry.[6]

Although the "chiefly compensated" test in proposed Regulation B is more flexible than the test under the Interim Rules, the rules are still unnecessarily complex and restrictive. The proposed "chiefly compensated test will increase costs and impose a significant regulatory burden on banks, forcing many of them to discontinue certain trust activities, contrary to the intent of GLBA.

Review of the Statute. The Exchange Act, as amended by the GLBA, permits a bank to effect transactions in a trustee or fiduciary capacity without registering as a broker. Under this exception, a bank must effect such transactions in its trust department, or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. The bank also must be "chiefly compensated" for such transactions, consistent with fiduciary principles and standards, on the basis of: (1) an administration or annual fee, (2) a percentage of assets under management, (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions, or, (4) any combination of such fees.

The term "chiefly compensated" is not defined in the GLBA. Proposed Regulation B states that a bank will satisfy the "chief compensated" condition if it meets one of two tests: an account-by-account test or a line of business test. Banks would have to perform these tests annually.

Account-by-Account Test

Under proposed Rule 722, a bank is exempt from the "chiefly compensated" condition with respect to a particular account during any year if it meets four conditions. First, the bank is required to meet the other conditions of the trust and fiduciary activities exception. Second, the bank must meet the "chiefly compensated" condition with respect to that particular account during the preceding year (e.g., that is, during the preceding year, the bank must have received more relationship compensation than sales compensation from that account). Third, a bank is required to maintain procedures reasonably designed to ensure that, before opening or establishing an account, the bank reviews the account to ensure that the bank is likely to receive more "relationship compensation" than "sales compensation" with respect to that account. Fourth, a bank is required to maintain procedures reasonably designed to ensure that, after opening or establishing an account, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of "sales compensation" as compared to "relationship compensation," the bank reviews the account to ensure that the bank is likely to receive more "relationship compensation" than "sales compensation" with respect to that account.

The account-by-account test is extraordinarily burdensome and unworkable for most community banks. Requiring a bank to make an assessment each year of every account to determine whether the account meets the "chiefly compensated" test is very burdensome and costly. Most community banks will not have the resources to make

[6] Conf. Rep. 106-434, 106th Cong. 1st Sess. at 164 (1999).

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an annual account-by-account analysis particularly when sales compensation has to be allocated to each account. Even with the proposed new "safe harbor" exemption that would allow certain accounts to fail so long as they did not represent more than ten percent of the total number of fiduciary accounts, the account-by-account method will still be extremely burdensome for community banks and will force them to use the alternative "line of business" test.

Line of Business Test

The "line of business" test under proposed Regulation B requires a bank to calculate its "sales compensation" and its "relationship compensation" for one or more lines of business (e.g., personal trust accounts, institutional accounts, etc.). A bank passes the test if it can demonstrate that during the preceding year, its ratio of sales compensation to relationship compensation was no more than one to nine for all of its lines of business. (Another way to look at the test is that sales compensation cannot exceed 11% of relationship compensation.) A bank may include all of its fiduciary accounts as one line of business.

In addition, the bank must (a) maintain procedures reasonably designed to ensure that, before opening or establishing a fiduciary account, the bank reviews the account to ensure that the bank is likely to receive more "relationship compensation" than "sales compensation" with respect to that account (a determination that will be difficult for most banks to make), and (b) maintain procedures reasonably designed to ensure that, after opening a fiduciary account, at such time as the bank individually negotiates with the accountholder or beneficiary of that account to increase the proportion of sales compensation as compared to relationship compensation, the bank reviews the account to ensure that the bank is likely to receive more relationship compensation than sales compensation with respect to that account.

<u>Definition of "sales compensation"</u> The SEC defines "sales compensation" to include (1) a fee for effecting a securities transaction that exceeds the cost incurred by the bank, (2) a finders' fee received in connection with a securities transaction, (3) a fee paid for an offering of securities that the bank does not receive directly from a customer or beneficiary, or directly from the assets of the fiduciary account, (4) 12b-1 fees from investment companies, and (5) fees paid by an investment company for personal service or the maintenance of shareholder accounts other than transfer agent service fees, fees for account statements, fees for processing dividends or forwarding communications from the investment company.

<u>Definition of "relationship compensation."</u> The SEC defines "relationship compensation" as administration or annual fees, fees based on a percentage of assets under management, 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 fiduciary customers, or a combination of such fees.[7]

[7] Although proposed Regulation B doesn't define it, bank trust departments also generate "unrelated compensation" which is neither relationship compensation nor sales compensation. Unrelated compensation would include fees charged for preparing fiduciary tax returns, taking deposits, margin lending, or providing other services that are not related to managing securities accounts. Most likely, banks

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We commend the SEC for providing an alternative test to the account-by-account test for community banks. However, as described under proposed Rule 721, the line of business test is unnecessarily complicated and restrictive. First, it will require banks to separate all their trust accounts into different categories based on the various exemptions provided in Regulation B. For instance, banks will have to separate fiduciary accounts from custodial, employee benefit plan, and trust indenture accounts and determine which accounts fit into which exemptions. Second, banks will have to decide the various lines of business for the accounts and determine which personal and charitable accounts can be grandfathered[8] and which do not comply as grandfathered accounts. Third, banks will then have to compute "sales compensation" and "relationship compensation" for each line of business, two figures that will require extra computer programming time and expense to calculate on an annual basis. Banks will have to invest heavily in technology and systems to comply with the test and to track the compensation. If the proportion of sales compensation to relationship compensation changes with respect to a particular account or accounts, then an individual account analysis will still have to be done.

We recommend that the line of business test be simplified so that the ratio compares either "sales compensation" or "relationship compensation" to total trust department compensation. Instead of requiring banks to compute "sales compensation" and "relationship compensation", we would suggest that they only compute one of those figures and compare that to total trust department compensation, a figure that should be available to them and that will need to computed for completing the required Schedule RC-T (Fiduciary and Related Services) of their Call Report. Since it will be easier for most banks to compute total "relationship compensation" than "sales compensation", we would recommend that the test be a comparison of total "relationship compensation" to total trust department compensation.

Furthermore, the 1:9 ratio should be raised to a 1:4 ratio so that sales compensation could be as high as 25% of total trust department compensation. Alternatively, the SEC should consider raising the ratio to 1:2 and simplify the "chiefly compensated test by eliminating some of the other exemptions such as the exemption for employee benefit plans. The 1:9 ratio or 11% test is much too low. If the purpose of the test is to "push-out" possible brokerage activities, a higher ratio would still achieve that goal. Furthermore, there is nothing in GLBA that speaks to a requirement that sales compensation has to be an amount other than something below 50% of total trust compensation for the bank to be considered "chiefly compensated".

When computing "sales compensation" for purposes of the trust and fiduciary exemption or the custodial exemption, 12b-1 fees should be excluded. We do not agree that 12b-1 fees create conflicts between banks and investors or create special incentives to distribute investment company securities. Banks receive 12b-1 fees from mutual funds to compensate them for the work involved in providing fund information to

will have to compute their unrelated compensation as part of their calculation of "relationship compensation."

[8] Proposed Rule 726 conditionally exempts from the chiefly compensated test personal and charitable trust accounts opened before July 30, 2004. These grandfathered accounts have to meet certain requirements.

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the customer and selling customer the fund. Furthermore, since a 12b-1 fee is a fee based on a percentage of assets, it should be considered “relationship compensation.”

Morever, allocating 12b-1 fees among individual trust accounts will be difficult and time-consuming for banks even under the more simplified approaches describe under proposed Rule 724. Banks will still have to determine the number of each class of a mutual fund’s shares held in each account on the last business day of the preceeding year and will have to multiply that by the net asset value per share on that day and the annual Rule 12b-1 fee rate applicable to that class of securities. The sale of shares by one significant account right before the end of the year, for instance, could cause problems with accurately allocating the fees to other accounts.

We commend the SEC for exempting transactions for living, testamentary or charitable trust accounts opened or established before July 30, 2004 from the chiefly compensated test. The fees received in connection with these accounts were negotiated in the past and would be difficult to change to meet the test. Banks often administer trusts that were created by grantors who have died or who may have become incompetent and state law may make it impracticable to change the compensation structure of existing trusts.

ICBA still has concerns with the definition of “Investment Adviser if the Bank Receives a Fee for its Investment Advice.” The Exchange Act defines the term “fiduciary capacity” to include acting as an “investment adviser if the bank receives a fee for its investment advice.” However, where the statue offers no qualifications to this provision, proposed rule 724(d) provides further conditions that restrict the ability of a bank to qualify for the trust and fiduciary exception. **ICBA believes that these qualifications are unnecessary and should be eliminated.** If a bank is offering investment advice for a fee, by the very terms of the statute the bank is acting in a fiduciary capacity and therefore qualifies for the exception. If for some reason the SEC believes that the bank is abusing the exception, it has the ability to refer the problem to the appropriate banking supervisor for further investigation.

While we applaud the fact that the phrase “continuous and regular” that was in the Interim Rules has been omitted from the definition in proposed rule 724(d), we still object to the fact that the proposed rule requires a bank acting as an investment adviser for a fee to have a duty of loyalty to the customer and must make full and fair disclosure of all conflicts. ICBA believes that these requirements are unnecessary and redundant, given existing standards that govern bank fiduciary duties in their customer relationships.

Sweep Accounts

The sweep accounts exception set out in the Exchange Act and GLBA permits a bank to participate in mixed product arrangements in which the bank offers a mutual fund “sweep’ service linked to deposit accounts under certain conditions. Specifically, this section exempts a bank from the definition of “broker” to the extent 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.”

Exchange Act Rule 3b-17(f)[9] provides that an investment company is "no-load" for purpose of the sweep accounts exception if: (1) it does not have a sales load or a deferred sales load; and (2) its total charges against net assets to provide for sales-related expenses and service fees (including 12b-1 fees) do not exceed 25 basis points of average net assets annually and are disclosed in the mutual fund's prospectus. This definition is consistent with the NASD's definition of "no-load". Under the NASD rule, a mutual fund may not be advertised as "no-load" if it imposes asset-based sales and other charges in excess of 25 basis points. Notably, the preamble of the proposed Regulation B explains that banks are not prohibited by Exchange Act's "no-load" condition from directly charging their customers for sweep services, because those direct charges are not charges against fund assets.

ICBA continues to believe that the restrictions on what constitutes a no-load fund will cause community banks to discontinue current sweep arrangements and services they offer customers. Administrative costs of implementation and servicing of sweep accounts is significant, especially for community banks that have lower aggregate account balances and fewer customers involved in the sweep function. A 25 basis point cap is not an exemption for community banks—it is an economic prohibition. **At a minimum, the 25 basis point cap should be raised to 50 basis points to allow community banks more of an opportunity to recover some of their administrative costs for these programs. Furthermore, the SEC should consider a small bank exemption for sweep accounts that would allow those banks to recover their administrative costs without restriction.**

The no-load restrictions will also put banks at a disadvantage with other financial service competitors, particularly brokerage firms. We question why it is appropriate for brokerage firms to receive over 25 basis points for their cash management accounts but it is inappropriate for banks to receive over 25 basis points for their sweep accounts. To customers, the two products look virtually the same but because of inconsistent regulatory standards, the bank product will not be able to compete effectively with the brokerage product. Banks should be free to offer a sweep account that allows them to receive as much as brokerage firms do from 12b-1 fees.

Custodial Exemption

The Exchange Act, as amended by the GLBA, provides an exception from broker-dealer registration with respect to certain securities-related safekeeping and custody services that banks may perform for their customers. The exception explicitly allows a bank that holds funds and securities for its customers as part of "customary banking" activities to perform specified securities-related functions with respect to those securities without registering as a broker.

In particular, a bank may, among other things without registering as a broker, exercise warrants or other rights, facilitate the transfer of funds or securities in connection with clearing and settling customers' securities transactions, effect securities lending or

[9] 17 CFR 240.3b-17(f)

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borrowing transactions and invest cash collateral pledged in connection with such transactions, and hold securities pledged by a customer or facilitate the pledging or transfer of securities that involve the sale of those securities.

In addition, the exception expressly permits a bank to "serve as a custodian or provider of other related administrative services" to IRAs, pension, retirement, profit sharing, bonus, thrift, savings, incentive, or other similar benefit plans without being considered a broker. **But according to the SEC, the exception for custodial activities does not permit a bank to accept orders to purchase or sell securities.** The SEC believes that accepting orders to purchase or sell securities is a core broker-dealer function and is not permitted under the safekeeping and custody exemption of GLBA.

ICBA continues to believe that the SEC is misinterpreting the statutory exemption for safekeeping and custody activities. Accepting orders for the purchase or sale of securities has always been a core custody activity for banks. If a bank cannot accept orders from a customer on the disposition of securities the bank holds as custodian, including orders to purchase and sell, then there is little reason for a bank to serve as a custodian. The SEC interpretation makes the bank custodial role little more than one of corporate safety deposit box.

The Exchange Act gives banks the ability to "facilitate the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities." Congress qualified this exception from the definition of broker by requiring that banks execute such transactions through a registered broker-dealer. The SEC interpretation fails to give full effect to the logical statutory interpretation that banks be allowed to accept orders for securities sales and purchase from customers as part of their custodial function. The bank is merely facilitating the investment decision made by the customer and as long as the transaction is executed by a registered broker-dealer, that should be sufficient.

Proposed Regulation B does allow banks to accept orders to purchase and sell securities for their custodial accounts pursuant to two separate exemptions, the General Exemption and the Small Bank Exemption. However, ICBA believes that these exemptions would be unnecessary under a proper interpretation of the safekeeping and custody exception that gives full effect to Congressional intent and allows banks to accept orders to purchase and sell securities as an accommodation for their safekeeping and custody customers.

General Custodial Exemption. Under the General Custodial Exemption, a bank can accept orders to purchase or sell securities in a custodial account for: (1) a person with an account that was opened before July 30, 2004 (a "grandfathered account") or (2) for a "qualified investor"[10] if: (a) the bank can demonstrate that it does receive any compensation for effecting such transactions that directly or indirectly varies based on whether the bank accepts an order to purchase or sell a security, other than a fee paid under Rule 12b-1 or a fee paid by a registered investment company other than pursuant to

[10] The Exchange Act defines a "qualified investor" as an investment company, a bank, any government or political subdivision, and any corporation or natural person who owns and invests on a discretionary basis, not less than $25,000,000 in investments.

Rule 12b-1, for personal service or the maintenance of shareholder accounts; (b) any bank employee effecting such transactions does not receive compensation from the bank, the executing broker or dealer, or any other person related to the size, value or completion of any securities transaction effected under this exemption; and (c) the bank does not directly or indirectly solicit such securities transactions except through responding to inquiries of a potential purchaser in a communication initiated by the potential purchaser of the security, provided that the content of such responses is limited to certain information.

The proposed General Custodial Exemption is a modest improvement over the exemption provided in the Interim Rules. It does allow banks to be compensated for accepting securities orders through 12b-1 or shareholder servicing fees for accounts that were opened before July 1 or for "qualified investors."

However, most large community banks that don't qualify for the small bank exemption will find the proposed General Custody Exemption to be too restrictive. Since most of these banks will have few, if any, custody clients who would qualify as "qualified investors", the exemption will only provide some value with respect to securities transactions involving grandfathered accounts. These larger community banks will still be prohibited from purchasing and selling securities for newly-established custodial relationships, crippling their ability to grow that business and ultimately forcing them to discontinue it, contrary to Congressional intent.

Small Bank Exemption. Under the Small Bank Exemption, small banks (with less than $500 million in assets that are not affiliated with a bank holding company with consolidated assets of more than $1 billion) can accept orders to purchase or sell securities in an account for which the bank acts as a custodian if (1) the bank is not affiliated with a broker or dealer; (2) the bank does not publicly solicit such securities transactions (except by soliciting brokerage business as permitted for trust accounts); (3) the bank does not pay its employees any incentive compensation related to any brokerage transaction except pursuant to the networking exception; and (4) the annual "sales compensation" the bank receives for effecting transactions in securities pursuant to this exemption does not exceed $100,000 in 2004 dollars adjusted for inflation.

ICBA commends the SEC for raising the bank asset size limit to $500 million for the Small Bank Exemption. The $100 million limit in the Interim Rule was too low and would have been of limited usefulness to most community banks. The new limit greatly expands the availability of this exemption, increasing the number of potentially eligible banks and thrifts from about 48% to 88% of all FDIC-insured institutions.

ICBA recommends that the size limit be increased to $1 billion without reference to holding company size. Recently, both the FDIC and the Office of Thrift Supervision proposed raising the asset size of a "small bank" for purposes of the Community Reinvestment Act to $1 billion. Most banks under $1 billion in assets have only a limited number of custodial relationships. As noted above, banks with assets sizes of between $500 million to $1 billion will find the General Bank Exemption to be of limited usefulness, since most of their custodial customers will not be "qualified investors." For them, raising the asset size limit for the Small Bank Exemption would

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significantly minimize their potential compliance costs, and give greater effect to Congressional intent.

ICBA also recommends that the annual sales compensation limit for the Small Bank Exemption be raised from $100,000 to $300,000. Under the Interim Rules, the limit under the Small Bank Exemption was 3% of a bank's annual revenue. As of December 1, 2003, 3% of the annual revenue of an average bank with $500 million in assets was $183,570. Therefore, the $100,000 compensation limit is actually less than the limit under the Interim Rules. Raising the limit to $300,000 (which would be less than 5% of the annual revenue of an average bank with $500 million in assets) should provide community banks that occasionally effect transactions in securities as an accommodation in their custody relationships with sufficient flexibility to continue to serve the needs of their customers without requiring the banks to register as brokers.

ICBA commends the SEC for eliminating the requirement that excluded banks that had a networking relationship with a broker from using the Small Bank Exemption. Permitting banks to have networking arrangements with registered broker-dealers will greatly increase the utility of this exemption to community banks.

However, ICBA is concerned about the complexity of the Small Bank and General Bank Exemptions and how banks can use these exemptions in conjunction with the other exemptions. For instance, the proposed rules indicate that the General Custody Exemption cannot be used with the Small Bank and Employee Benefit Plan exemptions. Furthermore, the General Bank Exemption must be used only with custody accounts in which the bank does not act in a trustee or fiduciary capacity. The rules also say that small banks that use the Small Bank Custody Exemption cannot use any other of the trust and fiduciary exemptions in the rules. This confusing array of exemptions and restrictions will only add to the regulatory burden of community banks. Banks should be free to use one or more of the exemptions in conjunction with each other.

General Exemption

Proposed Rule 776 provides for a general exemption, not tied to any of the GLBA exemptions, that would permit banks to buy and sell money market securities for bank customers who are "qualified investors," a person who directs the purchase of securities from any cash flows that relate to an asset-backed security that has a minimum original asset amount of $25,000,000, and for other customers for whom banks act in a trustee or fiduciary capacity, or in an escrow agent, collateral agent, depository agent, or paying agent capacity.

We applaud the SEC for including the general exemption. Proposed Rule 776 will permit banks to make available money market funds for cash management purposes to customers that have particular cash management needs and that prefer to compensate banks for these other services through 12b-1 fees. For example, banks will be able to continue to provide cash management services when the bank is acting as an indenture trustee for a municipality that needs to invest bond proceeds on a short-term basis or as escrow agent for corporations that need to invest funds pending the consummation of a corporate transaction.

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However, we recommend that the exemption be broadened to include other investors other than just "qualified investors." As we stated under the sweep exemption, community banks have very few customers that fit the definition of "qualified investors." If community banks are expected to continue buying and selling money market securities as part of their cash management services, then the exemption needs to be broaden to include customers whose available assets to invest are as low as $1,000,000.

Furthermore, it is not clear under the rules whether a small bank could use the general exemption concurrently with the Small Bank Custodian Exemption. Community banks should be able to use both exemptions concurrently so that 12b-1 sales compensation from activities under the General Exemption are not included as part of sales compensation for purposes of computing the sales compensation limit under the Small Bank Custody Exemption. Otherwise, if the general exemption is not independently available, it will be of minimal value to community banks. Broadening the availability of proposed Rule 776 should help towards leveling the playing field between community banks and larger institutions that compete for the same cash management business.

Employee Benefit Plan Exemption

Neither the Exchange Act nor GLBA specifically exclude from broker-dealer registration banks that administer employer-sponsored retirement plans. Since banks are often compensated through 12b-1 fees and other fees that meet the "sales compensation" definition, many banks cannot meet the requirement in the trust and fiduciary activities exception to be "chiefly compensated" through relationship fees. For that reason, the SEC is proposing a specific exemption for banks that administer employee benefit plans.

Under proposed Rule 770, bank trustees and non-fiduciary administrators that effect transactions in securities of open-end companies for participants in employee benefit plans would be exempt from the definition of a "broker." However, a bank relying on this proposed exemption would be required to offset or credit any compensation it received from a fund complex related to securities in which plan assets are invested against fees and expenses that the plan owes to the bank. According to the SEC, a dollar-for-dollar offset or credit would address the conflict of interest that banks would other have when choosing particular funds to offer to plan sponsors.

In addition, the exemption in proposed Rule 770 would require the bank to disclose clearly and conspicuously to the plan sponsor or its designated fiduciary, if any, all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex. These disclosure requirements are intended to ensure that banks relying on the exemption provide their customers with information on their compensation and offsets that makes the disclosure of fees charged more transparent and easier to compare for plan sponsors.

Conspicuously missing from the definition of an "employee plan" under proposed Rule 770 are individual retirement accounts (IRAs) and simplified employee plans (SEPs). Presumably, banks would need to find other exemptions in Regulation B to cover securities transactions involving IRAs and SEPs. **ICBA believes that including**

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IRAs (both trust and custodial IRAs) and SEPs as part of the employee benefit plan exemption would simplify Regulation B and reduce the compliance burden for banks. Otherwise, banks will need to divide their IRA and SEP accounts between those that are custodial and those that they fit the SEC's definition of serving as a fiduciary to determine whether they are covered by one of the custodial exemptions or the trust and fiduciary exemption. The simpler and more logical solution would be to include them as part of the employee benefit plan exemption particularly since they more closely resemble employee benefit plans than custodial or fiduciary accounts. **Securities transactions involving IRAs and in particular, self-directed IRAs, should be exempted from Regulation B as a traditional bank activity.**

Exemptions for Savings Associations and Savings Banks

The SEC proposes to extend to savings associations and savings banks some of the proposed exemptions under Regulation B but not all of them. As proposed, thrifts could not use the general custody exemption or the employee benefit plan exemption. **ICBA believes that thrifts should have complete parity with banks under proposed Regulation B. Thrift should not be only partially exempt from Regulation B as the SEC has proposed with regard to the Investment Advisers Act of 1940.** [11]

Thrift institutions have fiduciary powers that are indistinguishable from banks and are subject to similar regulation. For instance, most state savings associations are subject to the same state fiduciary law and regulation as are commercial banks. Federal savings associations are also subject to fiduciary regulation that is similar to national banks.[12] Thrifts engage in custodial services and act as trustees and fiduciaries for employee benefit plans in which they receive "sales compensation." They need the full array of exemptions provided under Regulation B to avoid having to register as a broker-dealer. **We urge the SEC to fully exempt thrifts under proposed Regulation B.**

Transition Period

ICBA commends the SEC for proposing a one-year transition period to comply with Regulation B. Banks will need at least a one-year transition period to develop compliance systems to adapt to the complex and limited bank exemptions under Regulation B. If Regulation B goes into effect January 1, 2005, then banks should have at least until January 1, 2006 before they have to comply with the new requirements.

Conclusion

ICBA appreciates the efforts that the SEC has made to improve the Interim Rules and to reduce their regulatory burden. During the past year, the staff has been very generous with its time, meeting with bank representatives and trade associations in an attempt to draft a workable rule. We are particularly pleased that the SEC has tried to

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[11] See the SEC's proposed rule under the Investment Advisers Act of 1940 at 69 Fed. Reg. 25778 (May 7, 2004)

[12] For instance, when the Office of the Comptroller of the Currency revised its fiduciary rules in 1996 (12 CFR Part 9) governing the fiduciary powers of national banks, the Office of Thrift Supervision similarly revised their rules.

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accommodate the special needs of community banks by providing specific exemptions for small banks.

Although Regulation B is an improvement over the Interim Rules, it remains unnecessarily complex and restrictive and does not reflect Congressional intent as embodied in GLBA. Title II of GLBA was designed to ensure that traditional banking activities involving securities transactions, such as fiduciary activities and custodial functions, not be disturbed and that banks be able to continue to provide services to customers as they have for many years. Proposed Regulation B, with its confusing array of exemptions and restrictions, is so burdensome and complicated and will prove so costly for banks to implement that it will force many banks—especially community banks—to discontinue many of their existing services to the detriment of their customers, and contrary to Congressional intent.

We would urge the SEC to simplify Regulation B as we have recommended to make it less burdensome for community banks. We remain available to work with the Commission in formulating a regulation that is less burdensome but that provides sufficient protection to investors. If you have questions or need any additional information, please do not hesitate to contact me at 202-659-8111 or at Chris.Cole@icba.org.

Sincerely,

Christopher Cole

Christopher Cole
Regulatory Counsel