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Memo

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Date: April 27, 2005
To: ABASA Board
From: Sally Miller, ABA and ABASA
RE: Regulation B

Recently I had the opportunity to hear Linda Stamp Sundberg from the Securities and Exchange Commission speak on Regulation B at the American Bar Association's Spring Meeting. Before and after her remarks, Linda continued to stress that the industry and the SEC were actually a lot closer than many would believe. As a result of Linda's presentation, and her off-the-record statements, I came away from that presentation with the impression that the staff had moved somewhat in our direction on a number of fronts; on other issues, I detected no movement. I thought I would share my impressions with you.

Before I do so, however, I should point out that Linda gave the usual disclaimer that her remarks were her own and did not reflect the views of the Commission, the Commissioners or the SEC staff.

- **Trust.** The staff does not seem to moving away from requiring "chiefly compensated" to be calculated on an account-by-account basis. Their logic seems to be that compliance with, and enforcement of, the federal securities laws is required on an account basis, not on a department or line-of-business basis. We did not pick up any information as to whether the staff would increase the line-of-business percentage. Linda did indicate that the exemptions in Regulation B could be used together.
- **Employee Benefit Exemption.** The staff is inclined to allow banks to follow the DOL's Aetna letter and, thus, not be required to perform dollar-for-dollar offsets of fees received from mutual funds against fees charged by the bank to the plan. Linda gave no indication that the scope of the exemption would be expanded to include all employee benefit plans, not just those that are qualified, 403(b) or 457 plans.
- **Custody.** There seems to be some movement towards allowing banks to take orders from all customers and charge a securities movement fee, so long as there are some soliciting/advertising restrictions. You will

remember that this is the position the industry put before the staff in our one-pager. However, the staff also continues to believe that there needs to be limits on custody department employee compensation. We should hasten to add that these indications are more soft, than say, the revisions to the employee benefit and money market funds exemption, discussed above and below respectively. In this connection, Linda made clear that research generated by the trust department and provided to custody accountholders would be considered soliciting. It is unclear whether research generated by the bank's brokerage affiliate would be similarly prohibited. I believe staff at the FRB is drafting some suggested soliciting/advertising restrictions.

- **Money Market Funds.** The staff is giving serious consideration to expanding the money market fund exemption by eliminating the qualified investor restriction. Disclosures of the fees paid to the bank by the money market fund and monies earned by the accountholder would be required. If the Commission approves this revision, it would take care of the industry's concerns regarding no-load sweep programs. The issues of whether a sweep program must be "automatic" and whether a bank can outsource sweep services need to be clarified.
- **Bonus Plans.** The troublesome language regarding the permissibility of those bonus plans based on profitability of the bank or bank holding company would be eliminated. No other discussion would be substituted, leaving the industry somewhat at risk. SEC staff has said you can't do indirectly what is prohibited directly and the bonus issue highlights a compliance risk.
- **Referral Fees.** There was very little discussion about referral fees, other than to reiterate the SEC staff's view that the statutory exception covers both retail and institutional referrals.

Last week, I had the opportunity to hear Linda speak at another conference. She reiterated many of the points discussed above.

REGULATION B PRINCIPLES

Trust and Fiduciary

- “Chiefly compensated” test should be measured on a broadly defined line-of-business or department-wide basis rather than on an account-by-account basis
- Method of calculation must be revised so that banks will not be forced to build expensive new reporting systems. There should be only two categories of fees: Banks should either calculate the ratio of “relationship compensation” to “total compensation,” or conversely the ratio of “sales compensation” to “total compensation”
- Ceiling on “sales compensation” must be substantially greater than proposed level of 11%, and even higher to extent that Rule 12b-1 fees are treated -- inappropriately -- as “sales compensation,” and broad exemption is not provided for employee benefit plans

Safekeeping and Custody

- As provided under the statute, banks must be permitted to take orders for securities transactions from employee benefit and IRA custodial customers
- In addition, as is customary with current bank custodial activities, banks must be permitted to (a) take orders for securities transactions from all other custodial customers and (b) charge securities movement fees that do not differ based on whether the order was taken by the bank directly from the customer (including through his/her adviser), or from the customer’s broker
 - Reasonable limits on ability to solicit custodial order-taking are acceptable

Referral Fees

- Bank bonus plans must not be affected by prohibition on paying referral fees to unregistered bank employees unless bonus is clearly a conduit for paying impermissible referral fees
 - E.g., if bonus is contingent on number of factors, and only one factor relates to securities activities, bonus plan should not be deemed an impermissible conduit
- Rule must not affect payments made by broker-dealers to banks (as opposed to payments made to individual bank employees)
- “Nominal referral fees,” which are permissible, should not be further defined by regulation, given standards used by bank examiners and given that circumstances change over time
 - Banks should be allowed to pay higher referral fees to unregistered bank employees for the referral of certain corporate, institutional, governmental and not-for-profit customers

Sweep Accounts

- Definition of “no load” must not be so restrictive as to interfere with banks’ long-standing practices for sweeping deposits into money market funds

Dual Employees

- The problems with dual employee relationships (between banks and broker-dealers) caused by NASD Rule 3040 need to be resolved through coordination with the bank regulators