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Re: SEC Regulation B Presents Challenges for Banks

The Gramm-Leach-Bliley Act of 1999 ("GLB") eliminated the longstanding blanket exemption from broker-dealer regulation for banks engaged in securities activities. The Securities and Exchange Commission ("SEC") is charged with implementing GLB and its amendments to the 1934 Securities Exchange Act. Regulation B was proposed by the SEC almost two years ago to interpret GLB's bank exceptions from broker regulations; however, Regulation B's provisions were so coldly received by the banking industry its effective date has been delayed until September 30, 2006.

While there is the possibility, if not the likelihood, that Regulation B will be further revised and its implementation further delayed, there is no doubt that the SEC will eventually finalize regulations that will significantly impact the trust, custody and wealth management businesses of banks.

Under GLB, banks will need to tailor their activities to comply with certain exceptions or else "push-out" those activities to registered broker-dealer entities. The banking industry generally holds the belief that GLB was intended to continue as exempt from broker regulation longstanding bank fiduciary and custody practices. Banking regulators and many influential members of Congress agree. However, as proposed by the SEC in Regulation B and in an earlier proposal (known as the interim final rules), the SEC views bank exceptions from broker regulation as being far narrower. Regulation B's significant exceptions are summarized as follows:

Networking Exception. GLB provides an exception from the definition of broker that permits banks to contract with broker-dealers to offer brokerage services, without the bank registering as a broker (the "Networking Exception"). Regulation B construes the Networking Exception narrowly and strictly limits compensation arrangements between the broker-dealer, the bank and any non-licensed bank employees participating in the networking arrangement. For example, non-licensed bank employees may only receive a nominal one-time cash amount for referring a customer to the broker-dealer. We understand this limitation as proposed may significantly affect many banks' bonus compensation programs.

Trust and Fiduciary Exception. GLB contains an exception from the definition of broker that permits a bank to effect transactions in a trustee or fiduciary capacity without registering as a broker. Regulation B imposes additional requirements for a bank to qualify for the exception, including (i) the bank must effect transactions in its trust department or other department subject to regular compliance examinations, (ii) the bank must be "chiefly compensated" for such transactions in a way that is consistent with fiduciary principles (for example a percentage of assets under management); and (iii) the bank must not publicly solicit brokerage business. Although the "chiefly compensated" test may be done on a line-of-business basis rather than an

account-by-account basis,¹ banks may need to devote substantial permanent resources to comply with this test.² The rules provide conditional safe harbors for both tests and certain existing personal trust accounts are grandfathered. Also, an exemption is provided for indenture trustees effecting transactions in no-load money market mutual funds (as defined by the SEC).

Custody Exception. GLB permits banks to perform securities-related services in connection with custody and safekeeping services. Significantly, however, Regulation B provides that a bank may not effect securities trades for custodial accounts, other than existing accounts or accounts of large qualified investors, unless the bank qualifies for the small bank exception (assets of \$500 million or less, among other requirements). Moreover, custodial individual retirement accounts are not exempt and must be “pushed out” to a registered broker-dealer, unless (as noted) the bank qualifies as a small bank, the account already exists or the IRA owner is a large qualified investor.³ This provision of Regulation B has the potential to create customer service concerns for banks in addition to compliance concerns.

Sweep Accounts. GLB provides an exception for banks that effect securities transactions in connection with the investment of deposit funds in any no-load, open-end money market mutual fund. Regulation B interprets this exception narrowly and clarifies that the sweep accounts exception requires regular, automatic sweeps. Separate from this exception, as noted below, the SEC issued a helpful special purpose exemption for transactions with certain investors (trust, escrow and agency accounts generally) in money market mutual funds (not limited to no-load funds).

General and Special Purpose Exemptions. Regulation B provides additional exemptions from broker-dealer registration, the most notable of which may be the Employee Benefit Plan Exemption. Subject to certain conditions, this exemption is available to banks for employee benefits trust and custody services. That is the good news. The bad news for banks is that the conditions provided by the SEC are complex, mismatched with existing Department of Labor rules and far too narrow in scope. Other exemptions are provided for mutual fund transactions, transactions with non-U.S. persons and transactions with certain investors in money market funds. Limited exemptions are provided for savings and loan associations and credit unions.

Regulation B contains significant additional provisions that will impose ongoing compliance issues for banks. Included are many definitions and subparts of rules that must be known to confirm compliance with Regulation B.

We believe there will be additional changes to Regulation B; however, the basic framework of GLB requirements are in place and compliance considerations should not be put off by banks with existing or contemplated trust, custody and wealth management businesses. We welcome your inquiries.

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¹ Under this test, the ratio of “sales compensation” to “relationship compensation” cannot exceed 1 to 9. This ratio has been opposed by the banking industry as being too low.

² 12b-1 fees are designated “sales compensation” under Regulation B. Many commenters have stressed to the SEC that these fees frequently may be considered “relationship compensation.”

³ Custodial health savings accounts are similarly affected.