DechertOnPoint

December 2006 / Issue 17

A legal update from Dechert's Financial Services Group

# SEC Proposes Regulation R to Implement Bank Broker Provisions of Gramm-Leach-Bliley Act

On December 13, 2006, the Securities and Exchange Commission (the "SEC" or the "Commission") voted to publish for public comment new proposed rules, under the Securities Exchange Act of 1934 ("Exchange Act"), to define the relationship between banks and brokers. At the direction of Congress, the SEC and the Board of Governors of the Federal Reserve System (the "Board") worked together to develop proposed Regulation R to implement the Gramm-Leach-Bliley Act ("GLB") bank exceptions to the definition of "broker." The Board will consider this proposal at its December 18, 2006 meeting. In addition, the Commission voted to publish for public comment a companion proposal, concerning certain bank dealer activities and other related matters. Finally, the Commission extended the temporary exemption of banks from the definition of "broker" until July 2, 2007.

## Response to Congressional Action

On October 13, 2006, President Bush signed into law the Financial Services Regulatory Relief Act of 2006 (the "Act").[1] Among other things, the Act requires the SEC and the Board to adopt a joint set of rules to implement Section 3(a)(4)(B) of the Exchange Act. Section 3(a)(4)(B) states that a bank will not be considered a "broker" under Section 3(a)(4) if it limits its activities to those described in the statute. The Act requires the SEC and the Fed to issue these rules within 180 days of the date of enactment[2] and states that such rules will supersede any other proposed or final rules issued by the SEC on or after the enactment of GLB.[3] Congress enacted GLB in 1999,[4] but, despite multiple efforts, the SEC had not adopted rules implementing Section 3(a)(4)(B). On September 29, 2006, SEC Chairman Cox announced that the Commission, along with the Board, intended to issue these joint proposed rules by the end of 2006.

## History of the Treatment of Certain Banking Activities and Brokerage

As originally enacted, the Exchange Act exempted banks from the regulatory scheme created for brokers and dealers. The Banking Act of 1933 (popularly referred to as the "Glass-Steagall Act") created barriers between commercial banking and investment banking, and each was generally subject to a separate regulatory regime. Over time, the barriers between these industries began to erode, and GLB had the effect of largely eliminating these barriers. However, GLB also sought to subject banks to a new system of "functional regulation," in which their securities activities would be subject to the existing system of broker-dealer regulation and SEC oversight. To that end, GLB amended Section 3(a)(4) of the Exchange Act. In place of the blanket exemption from the definition of "broker" previously provided to banks, new Section 3(a)(4)(B) lists a number of traditional securities-related banking activities in which banks can continue to engage without being

1 Pub. L. No. 109-351, 120 Stat. 1966 (2006).

2 Section 101(a)(2).

3 Section 101(a)(3).

4 Pub. L. No. 106-102, 113 Stat. 1338 (1999).

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subject to regulation as a broker.[5] If a bank engages in brokerage activities not covered by the enumerated exceptions, it must either confine such activities to an existing affiliated broker-dealer or else register itself or an affiliate as a broker and be subject to regulation as such. New Section 3(a)(5)(C) does much the same with respect to the definition of "dealer," creating four exceptions for certain traditional securities-related banking activities.[6]

## The SEC's Rulemaking Post-GLB

In 2001, the SEC adopted interim final rules (the "Interim Final Rules"), which became effective on May 11, 2001.[7] However, the SEC also adopted new Rule 15a-7 under the Exchange Act, which exempted until October 1, 2001 banks that would otherwise be required to register as brokers or dealers because their securities activities do not fall within the exceptions created by GLB and the SEC under its rulemaking authority.[8] Since the publication of this release, the SEC has delayed the effective date of these and subsequent related rules (discussed below) through a series of orders that extended the temporary exemption for banks from the definitions of "broker," with the most recent extension (prior to that announced on December 13, 2006) continuing until January 15, 2007.[9]

Following the release of the Interim Final Rules, the SEC first proposed new rules relating to the bank activity exceptions to the definition of "dealer" under Section 3(a)(5)(C)[10] and then adopted the dealer rules substantially as proposed.[11] The SEC's dealer rules have proved to be less controversial than its broker rules, and the Act does not disturb them, *i.e.* the joint rulemaking authority of the SEC and Board extends only to rulemaking regarding the bank activity exceptions to the "broker" definition.

In 2004 the SEC proposed Regulation B, which substantially altered the Interim Final Rules relating to the bank activity exceptions to the "broker" definition.[12] While generally regarded by the banking industry and banking regulators as an improvement over the Interim Rules,[13] many remained unhappy with proposed Regulation B. Critics charged that the Commission had misinterpreted GLB, failed to understand certain traditional banking functions, and created a regulatory system that was overly complex and unworkable.[14] Indeed, several members of the U.S.

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5 These activities include, as defined by statute, third party brokerage arrangements; trust activities; permissible securities transactions (*i.e.*, transactions in commercial paper, bankers acceptances, commercial bills, exempted securities qualified Canadian government obligations, and certain credit enhanced debt securities issued by foreign governments); transactions as part of transfer agency activities; sweep account transactions; affiliate transactions; private securities offerings; safekeeping and custody activities; transactions in "identified banking products;" and municipal securities transactions. There is also a *de minimis* exception for banks engaging in no more than 500 transactions annually.

6 These activities include, as defined by statute, permissible securities transactions (i.e., transactions in commercial paper, bankers acceptances, commercial bills, exempted securities qualified Canadian government obligations, and certain credit enhanced debt securities issued by foreign governments); investment, trustee, and fiduciary transactions; certain asset-backed transactions; and transactions in "identified banking products."

7 Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 44261 (May 11, 2001).

8 *Id.*

9 Order Extending Temporary Exemption of Banks, Savings Associations, and Savings Banks from the Definition of "Broker" under Section 3(a)(4) of the Securities Exchange Act of 1934, Exchange Act Release No. 54544 (Sept. 29, 2006).

10 Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 46745 (Nov. 5, 2002).

11 Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 47364 (Feb. 13, 2003).

12 Regulation B, Exchange Act Release No. 49879 (June 17, 2004).

13 *See, e.g.,* letter dated September 24, 2004 from Sarah A. Miller, Director, Center for Securities, Trust and Investment, American Bankers Association and General Counsel, ABA Securities Association (the "ABA/ABASA Letter") and letter dated October 8, 2004 from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System; Donald E. Powell, Chairman, Federal Deposit Insurance Corporation; and John D. Hawke, Jr., Comptroller of the Currency, Federal Reserve Board (the "Banking Agency Letter").

14 *Id.*

Senate submitted a comment letter to the SEC stating that Regulation B as proposed was "fundamentally inconsistent with Congressional intent" and that it would "impose burdensome and wholly unjustifiable compliance costs on the whole banking industry."[15] Similarly, certain members of the U.S. House of Representatives noted in their comment letter to the SEC that they "did not believe that the SEC ha[d] taken into consideration the unnecessarily negative impact that Regulation B will have on the ability of banks and savings associations to continue to provide traditional banking services... ."[16] Parts of Regulation B were non-controversial, and many welcomed the changes, but the banking industry remained vigorously opposed to a number of its provisions.

On December 13, 2006, the Commission voted to: (i) approve the publication of the proposed Regulation R; (ii) approve the publication of the SEC's companion proposal, which complements Regulation R; and (iii) extend the temporary exemption of banks from the definition of "broker" until July 2, 2007. Some of the more controversial provisions of Regulation B (which will be officially withdrawn and superseded by Regulation R once adopted) and proposed Regulation R's modifications to those provisions are briefly summarized below.

## The Networking Exception

The Exchange Act creates an exception to the definition of "broker" for banks that enter into contractual arrangements with outside broker-dealers under which the broker-dealers offer brokerage services to bank customers, provided that the arrangement satisfies a number of criteria.[17] Among other restrictions, the exception generally prohibits bank employees that are not registered representatives of the broker-dealer from receiving incentive compensation for brokerage transactions. However, such employees are permitted to receive referral compensation from the broker-dealer only if it is a "nominal one-time cash fee of a fixed dollar amount" and payment is "not contingent on whether the referral results in a transaction."[18] Under Regulation B, the SEC defines "nominal" to mean that the fee cannot exceed the greater of: the employee's base hourly rate of pay; $25; or $15 in 1999 dollars, indexed for inflation. The Banking Agency Letter criticizes these restrictions as "unnecessary, unworkable and ill advised" and argues that the determination of whether a referral fee is "nominal" should be left to the supervision and examination process.

Subject to certain conditions, proposed Regulation R provides broker-dealers with more flexibility in paying incentive compensation to bank employees for referrals. Proposed Regulation R would allow broker-dealers to pay bank personnel amounts that would be more than "nominal" for referrals of certain institutional and high-net-worth customers. Moreover, we understand that Regulation R would permit broker-dealers to pay compensation that is contingent on the referral resulting in a transaction if the referred parties are institutional and high-net-worth customers as defined.

## The Trust Activities Exception

The Exchange Act creates an exception to the definition of "broker" for banks effecting transactions in a trustee or fiduciary capacity, provided that the bank: (i) is "chiefly compensated" for such transactions 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 bank's cost incurred for executing the transaction; and (ii) does not publicly solicit brokerage business.[19] The SEC in Regulation B attempts to define "chiefly compensated" and does so by creating compensation tests that banks must pass. Generally speaking, banks must make this "chiefly compensated" determination on an account-by-account basis, and this calculation requires banks to classify their compensation as "relationship compensation," "sales compensation" (which includes 12b-1 fees; a preponderance of sales compensation in an account would require a bank to either transfer the account to an

[15] Letter dated March 4, 2005 from Jim Bunning, Michael Enzi, Tim Johnson, Debbie Stabenow, Thomas Carper, Michael Crapo, Robert Bennett, Wayne Allard, Rick Santorum, Chuck Hagel, Elizabeth Dole, Charles Schumer, John Sununu, and Mel Martinez, Members of Congress.

[16] Letter dated October 14, 2004 from Michael G. Oxley, et al., House Committee on Financial Services, U.S. House of Representatives.

[17] Section 3(a)(4)(B)(i), which is commonly referred to as the "networking exception."

[18] Exchange Act Section 3(a)(4)(B)(i)(VI).

[19] Section 3(a)(4)(B)(ii).

affiliated broker-dealer or register as a broker), and "other compensation." While Regulation B created certain exemptions to this general framework, critics said it was overly complicated and would require new systems to measure and monitor the different types of compensation earned by banks. Many commentators suggest that the "chiefly compensated" determination should be made on a line-of-business basis only.[20]

Proposed Regulation R generally requires that the "chiefly compensated" determination be made on an account-by-account basis using a two-year rolling average comparison, and the test is satisfied if the percentage of "relationship compensation" exceeds 50% of total compensation. Alternatively, banks may test on a bank-wide basis if the percentage of "relationship compensation" is 70% or greater of total compensation. In addition, 12b-1 fees are now treated as "relationship income." These two changes, taken together, should allow a greater number of banks to avoid account-by-account testing and rely instead on bank-wide compensation testing.

## Safekeeping and Custody Activities

The Exchange Act creates an exception to the definition of "broker" for banks engaging in safekeeping and custody activities.[21] In the release adopting the Interim Final Rules and proposed Regulation B, the SEC has taken the position that "custody" or "related administrative services" does not include accepting orders from clients to purchase or sell securities. Regulation B mitigated this general rule by creating certain exceptions. One allows banks to be compensated for effecting securities transactions for existing accounts (*i.e.*, "grandfathered accounts"), and another allows banks to be compensated for effecting securities transactions in accounts of "qualified investors."[22] Many commentators have argued that, while the new exemptions are appreciated, order-taking is a customary custodial activity that is protected by the statutory exception.[23]

Proposed Regulation R revisits the definition of "customary banking activity." Banks are permitted to accept orders for certain types of accounts (*e.g.*, certain employee benefit plan accounts, IRAs, and similar accounts for which the banks act as custodian). In addition, banks may accept orders on an accommodation basis for other kinds of custody accounts. Additional conditions would apply when a bank accepts securities orders for a custodial account on an accommodation basis. In particular, the bank can not advertise securities order-taking, provide investment advice, or research or make recommendations concerning securities to the account or otherwise solicit securities transactions from the account.

## Employee Benefit Plan Exception

The Exchange Act does not specifically exclude from broker-dealer registration banks that administer employer-sponsored retirement programs, so the SEC attempted to do so under Regulation B, subject to certain conditions. This exemption would allow banks to purchase and sell mutual fund shares for employee benefit plans qualified under Section 401(a) of the Internal Revenue Code (the "Code") or described in Sections 403(b) or 457 of the Code. Moreover, banks would be required to offset or credit accounts with any compensation that the banks receive from fund complexes (*e.g.*, 12b-1 fees). The Banking Agency Letter argues that: a) this exception should be available for all types of qualified and non-qualified employee benefit plans for which banks serve as trustee, fiduciary, administrator, or custodian; b) banks should be permitted to purchase and sell all types of securities in these capacities; and c) the requirement that banks must credit accounts for compensation received from fund complexes is overly broad and inconsistent with ERISA as interpreted by the Department of Labor, which requires fee offsets only where the bank exercises discretionary authority or control over plan investments. It is currently unclear whether (and if so, how) proposed Regulation R will affect this provision, although it is possible that the recharacterization of 12b-1 fees as "relationship compensation" under the trust activities exception will allow banks to use that exception instead and carry out some of this activity in the bank's trust department.

## The Sweep Accounts Exception

The Exchange Act creates an exception to the definition of "broker" for banks effecting transactions in

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[20] *See, e.g.*, the ABA/ABASA Letter.

[21] Section 3(a)(4)(B)(viii).

[22] This term is defined in Exchange Act Section 3(a)(54). To meet this definition, corporations, companies, partnerships, and individuals must own and invest on a discretionary basis not less than $25 million in investments.

[23] *See, e.g.*, the ABA/ABASA Letter.

which they sweep customer deposits into no-load money market funds.[24] In Regulation B, the SEC has chosen to define "no-load" in a manner consistent with NASD Rule 2830(d)(4), which states that a fund cannot be described as "no-load" if it has a front-end or deferred sales charge or sales-related expenses and/or service fees that exceed 25 basis points per annum. The banking industry wished to limit the definition of "no-load" to those funds that have front-end or deferred sales charges only, pointing out some banks currently use money market funds with service fees in excess of 25 basis points. If banks have to curtail the use of these funds as sweep vehicles, they argue that it will be disruptive and that the explicit fees charged by banks for providing this service will increase.

Proposed Regulation R provides banks with a conditional exemption for transactions in money market funds that are not no-load as well as for transactions that are not sweeps. A bank relying on this exemption for transactions involving funds that are not no-load (*e.g.*, funds that have 12b-1 fees in excess of 25 basis points) would have to provide the customer with a prospectus showing the fund's fees, and could not characterize the fund shares as no-load.

## Miscellaneous Items

In addition to the foregoing, proposed Regulation R:

- includes an exemption that would permit banks to effect mutual fund transactions through the National Securities Clearing Corporation's Mutual Fund Services (Fund/SERV) or directly with a transfer agent;
- reproposes an exemption for banks from the definition of broker for noncustodial securities lending activities;
- includes an exemption for banks from the definition of broker for agency transactions in Regulation S securities with non-U.S. persons;
- provides banks with a transitional 18-month exemption to prevent their contracts from being void or voidable under Exchange Act Section 29(b); and
- provides banks with a transitional 18-month exemption until the first day of their first fiscal year commencing after June 30, 2008, designed to give banks time to make any necessary changes in their compliance programs.

The SEC's proposed companion release:

- reproposes an exemption from the definition of "dealer" for banks' conduit securities lending activities;
- provides a conditional exemption from the definition of "dealer" for banks' riskless principal Regulation S transactions; and
- provides a clarifying amendment to Exchange Act Rule 15a-6 to align that rule with the Exchange Act bank broker and dealer provisions and related rules.

The Commission is requesting public comment on these proposals within 90 days of their publication in the Federal Register.

## Conclusion

As outlined above, the SEC and the banking industry and regulators had been far apart conceptually on several points. Because the Board collaborated with the SEC in issuing new joint rules that will supersede Regulation B, proposed Regulation R represents a considerable shift toward what the banking industry and bank regulators had originally sought after passage of GLB.

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[24] Section 3(a)(4)(B)(v).

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