

## SEC, Fed Propose Regulation R to Implement Bank Broker Provisions of Gramm-Leach-Bliley Act

As we previously reported,<sup>1</sup> on December 13, 2006, the Securities and Exchange Commission ("SEC" or the "Commission") voted to publish for public comment new proposed rules under the Exchange Act to define the relationship between banks and brokers. On December 18, 2006, the Board of Governors of the Federal Reserve System (the "Fed") joined the SEC in a rule proposal retitled Regulation R, and the release of the joint rule proposal occurred the same day.<sup>2</sup> We briefly summarize some of Regulation R's more notable departures from the SEC's previous rulemaking below.

### The Networking Exception

In comparison to Regulation B,<sup>3</sup> proposed Regulation R provides broker-dealers with more flexibility in paying incentive compensation to non-registered bank employees for referrals. Generally speaking, Regulation R provides three alternatives for the payment of referral fees.

Bank employees can receive a fee that does not exceed:

- Either twice the average of the minimum and maximum average hourly wage established by the bank for the "job family" that includes the relevant employee, or 1/100th of the average of the minimum and maximum annual base salary established by the bank for the "job family" that includes the relevant employee
- Twice the employees' base hourly salary
- \$25, as indexed periodically for inflation<sup>4</sup>

In addition and subject to certain conditions, proposed Regulation R would allow broker-dealers to pay unregistered bank personnel contingent referral fees of more than a "nominal" amount for referrals of certain institutional and high net worth customers.<sup>5</sup>

### The Trust Activities Exception

Proposed Regulation R requires banks to measure their "relationship compensation" in order to make the "chiefly compensated" determination required to rely on the trust activities

<sup>1</sup> Please see Dechert's previous *OnPoint* on this subject (*SEC Proposes Regulation R to Implement Bank Broker Provisions of Gramm-Leach-Bliley*, December 2006/Issue 17) for a more complete discussion of the history of the regulation of banks' brokerage activities, the Financial Services Regulatory Relief Act of 2006 (the "Regulatory Relief Act"), the changes that the Gramm-Leach-Bliley Act ("GLB") made to Section 3(a)(4) and (5) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the SEC's post-Gramm-Leach-Bliley rulemaking in this area.

<sup>2</sup> Definition of Terms and Exemptions Relating to the "Broker" Exemption for Banks, Exchange Act Release No. 54946.

<sup>3</sup> Regulation B, Exchange Act Release No. 49879 (June 17, 2004).

<sup>4</sup> Proposed Exchange Act Rule 700(c).

<sup>5</sup> Proposed Exchange Act Rule 701. An "institutional customer" is one that has at least \$10 million in investments or \$40 million in assets; a "high net worth customer" is a natural person who has at least \$5 million in net worth, excluding primary residence and its associated liabilities.

exception.<sup>6</sup> Banks must generally make this determination on an account-by-account basis using a two-year rolling average comparison, and the test is satisfied if the “relationship-total compensation percentage” exceeds 50%.<sup>7</sup> Alternatively, a bank may test on a *bank-wide* basis if the “aggregate relationship-total compensation percentage” for the bank’s trust and fiduciary business is at least 70%.<sup>8</sup> Significantly, Rule 12b-1 fees and shareholder servicing fees paid by investment companies are now treated as “relationship compensation.”<sup>9</sup> These changes, taken together, should allow a greater number of banks to avoid account-by-account testing and rely instead on bank wide compensation testing.

### The Safekeeping and Custody Exception

In the release adopting the Interim Final Rules<sup>10</sup> and Regulation B, the SEC had taken the position that “custody” or “related administrative services” does not include accepting orders from clients to purchase or sell securities. Proposed Regulation R revises this former SEC approach. Banks are permitted to accept orders from employee benefit plan accounts, IRAs, and similar accounts for which the banks act as custodian.<sup>11</sup> In addition, banks may accept orders for securities transactions on an accommodation basis from other kinds of custody accounts, subject to a number of conditions and limitations.<sup>12</sup>

<sup>6</sup> Exchange Act Section 3(a)(4)(B)(ii) creates an exception for banks’ trust and fiduciary activities, but it requires, among other things, that banks be “chiefly compensated” 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 banks’ cost for executing the transaction.

<sup>7</sup> Proposed Exchange Act Rule 721(a).

<sup>8</sup> Proposed Exchange Act Rule 722(a)(2).

<sup>9</sup> Proposed Exchange Act Rule 721(a)(4).

<sup>10</sup> 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) (the “Interim Final Rules”).

<sup>11</sup> Proposed Exchange Act Rule 760(a).

<sup>12</sup> Proposed Exchange Act Rule 760(b). E.g., the bank must comply with certain employee compensation, bank fee, and sales literature restrictions, and cannot advertise securities order-taking, provide investment advice or

### The Sweep Accounts Exception

For the purpose of the sweep accounts exception, both Regulation B and Regulation R 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.<sup>13</sup> However, Regulation R provides banks with a conditional exemption for transactions in money market funds that are not no-load. 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 another traditional banking (i.e., non-brokerage) product or service; avoid characterizing the fund as no-load; and provide the customer with a fund prospectus.<sup>14</sup>

### Miscellaneous Regulation R Items

In addition to the foregoing, proposed Regulation R:

- Would permit banks that otherwise meet the requirements for the trust activities, stock purchase plan, or safekeeping and custody exemptions, to effect transactions in open-end investment companies through the National Securities Clearing Corporation’s Mutual Fund Services (Fund/SERV) or directly with a transfer agent acting for the investment company<sup>15</sup>
- Reproposes an exemption for banks from the definition of broker for noncustodial securities lending activities on behalf of persons reasonably believed to be qualified investors or employee benefit plans with not less than \$25 million in investments<sup>16</sup>

---

research, or make recommendations concerning securities to the account or otherwise solicit securities transactions from the account.

<sup>13</sup> Proposed Exchange Act Rule 741(c).

<sup>14</sup> Proposed Exchange Act Rule 741(a).

<sup>15</sup> Proposed Exchange Act Rule 775.

<sup>16</sup> Proposed Exchange Act Rule 772.

- Includes an exemption for banks from the definition of broker for agency transactions in Regulation S securities with non-U.S. persons<sup>17</sup>
- Provides banks with a transitional 18-month exemption to prevent their contracts from being void or voidable under Exchange Act Section 29(b)<sup>18</sup>
- Extends the time that banks have to come into compliance with the Exchange Act's provisions relating to the "broker" definition until the first day of their first fiscal year commencing after June 30, 2008<sup>19</sup>

## The SEC's Companion Release

In addition to jointly issuing Regulation R, on December 18, 2006, the SEC issued a proposed companion release.<sup>20</sup> The Companion Release is intended to complement Regulation R, and among other things it:

- Provides a conditional exemption from the definition of "dealer" for banks' riskless principal transactions with non-U.S. persons pursuant to Regulation S<sup>21</sup>
- Provides a clarifying amendment to Exchange Act Rule 15a-6. This rule, which provides a conditional exemption from U.S. broker-dealer registration for certain foreign broker-dealers, would thus be better aligned with the Exchange Act bank broker and dealer provisions and related rules. Thus, in transactions between a U.S. bank and its foreign broker-dealer affiliate, the former could rely on Exchange Act Section

<sup>17</sup> Proposed Exchange Act Rule 771.

<sup>18</sup> Proposed Exchange Act Rule 780.

<sup>19</sup> Proposed Exchange Act Rule 781.

<sup>20</sup> Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules, Exchange Act Release No. 54947 (the "Companion Release").

<sup>21</sup> Proposed Exchange Act Rule 3a5-2. Regulation R's proposed Rule 771 creates a similar exemption for banks' agency transactions in this area.

3(a)(4)(b)(vi) and the latter could rely on revised Rule 15a-6(a)(4)(i)

- Reproposes an exemption from the definition of "dealer" for banks' conduit securities lending activities on behalf of persons reasonably believed to be qualified investors or employee benefit plans with not less than \$25 million in investments<sup>22</sup>
- Withdraws Exchange Act Rules 3b-9,<sup>23</sup> 15a-8,<sup>24</sup> and 15a-9<sup>25</sup>

## Conclusion

Regulation R and the Companion Release both request comments within 90 days of their publication in the Federal Register. This, along with the rulemaking concessions that the SEC has made, suggests that the implementation of the "broker" provisions of GLB is much closer to becoming a reality.



This update was authored by David J. Harris (+1 202 261 3385; david.harris@dechert.com), Stuart J. Kaswell (+1 202 261 3314; stuart.kaswell@dechert.com), Robert A. Robertson (+1 949 442 6037; robert.robertson@dechert.com), Alan Rosenblat (+1 202 261 3332; alan.rosenblat@dechert.com), and John M. Thornton (+1 202 261 3377; john.thornton@dechert.com).

<sup>22</sup> Proposed Exchange Act Rule 3a5-3. Regulation R's proposed Rule 772 creates a similar exemption for banks' agency transactions in this area.

<sup>23</sup> This Rule, which defines the term "bank" for purposes of Exchange Act Section 3(a)(4) and (5), was invalidated by the U.S. Court of Appeals for the District of Columbia Circuit in *American Bankers Association v. SEC*, 804 F.2d 739 (1986).

<sup>24</sup> This Rule provides a temporary exemption from Exchange Act Section 29(b) liability for banks' securities activities but has since expired.

<sup>25</sup> This Rule creates similar "broker" and "dealer" exemptions for savings associations and savings banks, but the Regulatory Relief Act treats these institutions as "banks," rendering this Rule superfluous.

## Practice group contacts

For more information, please contact the authors, one of the attorneys listed, or any Dechert attorney with whom you are in regular contact. Visit us at [www.dechert.com/financialservices](http://www.dechert.com/financialservices).

**Margaret A. Bancroft**

New York  
+1 212 698 3590  
margaret.bancroft@dechert.com

**Allison R. Beakley**

Boston  
+1 617 728 7124  
allison.beakley@dechert.com

**Sander M. Bieber**

Washington, D.C.  
+1 202 261 3308  
sander.bieber@dechert.com

**Stephen H. Bier**

New York  
+1 212 698 3889  
stephen.bier@dechert.com

**Christopher Christian**

Washington, D.C.  
+1 202 261 3321  
christopher.christian@dechert.com

**Timothy M. Clark**

New York  
+1 212 698 3652  
timothy.clark@dechert.com

**Elliott R. Curzon**

Washington, D.C.  
+1 202 261 3341  
elliott.curzon@dechert.com

**Douglas P. Dick**

Newport Beach  
+1 949 442 6060  
douglas.dick@dechert.com

**Jennifer O. Epstein**

Washington, D.C.  
+1 202 261 3446  
jennifer.epstein@dechert.com

**Ruth S. Epstein**

Washington, D.C.  
+1 202 261 3322  
ruth.epstein@dechert.com

**Susan C. Ervin**

Washington, D.C.  
+1 202 261 3325  
susan.ervin@dechert.com

**Joseph R. Fleming**

Boston  
+1 617 728 7161  
joseph.fleming@dechert.com

**Brendan C. Fox**

Washington, D.C.  
+1 202 261 3381  
brendan.fox@dechert.com

**David M. Geffen**

Boston  
+1 617 728 7112  
david.geffen@dechert.com

**Terrie J. Hanna**

Boston  
+1 617 728 7174  
terrie.hanna@dechert.com

**David J. Harris**

Washington, D.C.  
+1 202 261 3385  
david.harris@dechert.com

**Robert W. Helm**

Washington, D.C.  
+1 202 261 3356  
robert.helm@dechert.com

**Jane A. Kanter**

Washington, D.C.  
+1 202 261 3302  
jane.kanter@dechert.com

**Stuart J. Kaswell**

Washington, D.C.  
+1 202 261 3314  
stuart.kaswell@dechert.com

**George J. Mazin**

New York  
+1 212 698 3570  
george.mazin@dechert.com

**Jack W. Murphy**

Washington, D.C.  
+1 202 261 3303  
jack.murphy@dechert.com

**John V. O'Hanlon**

Boston  
+1 617 728 7111  
john.ohanlon@dechert.com

**Fran Pollack-Matz**

Washington, D.C.  
+1 202 261 3442  
fran.pollack-matz@dechert.com

**Jeffrey S. Poretz**

Washington, D.C.  
+1 202 261 3358  
jeffrey.poretz@dechert.com

**Jon S. Rand**

New York  
+1 212 698 3634  
jon.rand@dechert.com

**Kimberly D. Rasevic**

Washington, D.C.  
+1 202 261 3447  
kimberly.rasevic@dechert.com

**Robert A. Robertson**

Newport Beach  
+1 949 442 6037  
robert.robertson@dechert.com

**Keith T. Robinson**

Washington, D.C.  
+1 202 261 3386  
keith.robinson@dechert.com

**Alan Rosenblat**

Washington, D.C.  
+1 202 261 3332  
alan.rosenblat@dechert.com

**Frederick H. Sherley**

Charlotte  
+1 704 339 3100  
frederick.sherley@dechert.com

**Patrick W. D. Turley**

Washington, D.C.  
+1 202 261 3364  
patrick.turley@dechert.com

**Brian S. Vargo**

Philadelphia  
+1 215 994 2880  
brian.vargo@dechert.com

**David A. Vaughan**

Washington, D.C.  
+1 202 261 3355  
david.vaughan@dechert.com

**Anthony H. Zacharski**

Hartford  
+1 860 524 3937  
anthony.zacharski@dechert.com

---

Dechert  
LLP

www.dechert.com

**U.S.**

Austin  
Boston  
Charlotte  
Harrisburg  
Hartford  
New York  
Newport Beach  
Palo Alto  
Philadelphia  
Princeton  
San Francisco  
Washington, D.C.

**U.K./Europe**

Brussels  
London  
Luxembourg  
Munich  
Paris

---

© 2007 Dechert LLP. All rights reserved. Materials have been abridged from laws, court decisions, and administrative rulings and should not be considered as legal opinions on specific facts or as a substitute for legal counsel.