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A legal update from Dechert's Financial Services Group

The SEC and the Fed Adopt Regulation R to Implement the Bank Broker Provisions of the Gramm-Leach-Bliley Act

As we previously reported, 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 (the "Exchange Act") to define the relationship between banks and brokers.[1] On December 18, 2006, the Board of Governors of the Federal Reserve System (the "Board," and together with the Commission, the "Agencies") did the same, and the release of the joint rule proposal, designated Regulation R, occurred that same day.[2] On September 19, 2007, the Commission voted to adopt Regulation R with some modifications (the "final Rules"), and the Board voted to do the same on September 24, 2007. The Agencies jointly released Regulation R that same day.[3]

After summarizing the history leading up to its adoption, we briefly discuss the more notable provisions of Regulation R and highlight where the final Rules, as adopted, diverge from their proposed counterparts to implement the following exceptions and exemptions relating to the regulation of bank broker activities:

- the networking exception;
- the trust activities exception;
- the safekeeping and custody exception;
- the sweep accounts exception; and
- other Regulation R exceptions.

Background

As originally enacted, the Exchange Act exempted banks from the regulatory scheme created for brokers and dealers. The Banking Act of 1933 (commonly referred to as the "Glass-Steagall Act") created barriers between commercial banking and investment banking, and each was generally subject to separate regulation and oversight. Over time, these barriers began to erode and were largely eliminated by the Gramm- Leach-Bliley Act ("GLB"). That Act amended the definition of "broker" in the Exchange Act so that banks engaging in securities activities would no longer be completely excluded from the broker-dealer registration requirements and SEC oversight, while at the same time creating specific exceptions from

1 *See* Dechert's previous Legal Updates 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"), and the SEC's post-GLB rulemaking in this area; "SEC, Fed Propose Regulation R to Implement Bank Broker Provisions of Gramm-Leach-Bliley," January 2007/Issue 1 for a more complete discussion of proposed Regulation R.

2 *Definition of Terms and Exemptions Relating to the "Broker" Exemption for Banks*, Exchange Act Rel. No. 54946.

3 *Definitions of Terms and Exemptions Relating to the "Broker" Exceptions For Banks*, Exchange Act Rel. No. 56501 (the "Release").

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the“ broker” definition for a number of traditional securities-related banking activities.[4]

These changes were designed to stimulate greater competition in the financial services industry and give investors a wider array of services at lower prices.

From 2001 through 2006, the SEC’s rulemaking efforts in this area stalled repeatedly. The SEC first adopted interim final rules to implement Section 3(a)(4)(B) of the Exchange Act in 2001,[5] but the SEC repeatedly delayed the effective date of these rules. In 2004, the SEC proposed Regulation B, which substantially altered the 2001 interim final rules.[6] Regulation B, like the interim final rules, met significant resistance in the banking industry and was never adopted. In 2006, President Bush signed into law the Regulatory Relief Act, which required the Commission and the Board to issue jointly proposed rules implementing Section 3(a)(4)(B) of the Exchange Act. This joint rulemaking culminated in the adoption of Regulation R to implement, among other policies, broker exceptions and exemptions for banks relating to their third-party networking arrangements, trust and fiduciary activities, sweep activities, and custody and safekeeping activities. Rule 781 of Regulation R (which exempts banks from the Exchange Act definition of “broker” until the first day of their first fiscal year commencing after September 30, 2008) became effective on September 28, 2007. All other rules comprising Regulation R are effective on December 3, 2007.

The Networking Exception

The networking exception authorizes bank employees to receive payment for referring bank customers to broker-dealers, provided that it is “nominal.”[7] Regulation R provides five alternatives for the payment of “nominal” referral fees. Under Rule 700, bank employees can receive compensation that does not exceed:

- twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee;
- 1/1000th of the average minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee;
- twice the employee’s actual hourly wage;
- 1/1000th of the employee’s actual annual base salary (this is a new addition to the Rule); or
- $25, as indexed periodically for inflation.[8]

In addition, broker-dealers may pay unregistered bank personnel contingent referral fees of more than a “nominal” amount for referrals of certain institutional and high net worth customers.[9] Rule 701, as adopted, modifies the definition of both “institutional customer” and “high net worth customer.” An “institutional customer” is an entity that has, or is controlled by an entity that has at a minimum:

- $10 million in investments;
- $20 million in revenues; or
- $15 million in revenues if the bank employee refers the client for investment banking services to the broker-dealer.[10]

Rule 701 defines a “high net worth customer” as a natural person who, either individually or in conjunction with his or her spouse, has $5 million or more in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse.[11] This definition, as revised, also includes any revocable, inter vivos or living trust the settlor of

4 Exchange Act Section 3(a)(4)(B).

5 *Definition of Terms 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 Rel. No. 44261 (May 11, 2001).

6 Regulation B, Exchange Act Rel. No. 49879 (June 14, 2004).

7 Exchange Act Section 3(a)(4)(B)(i).

8 Exchange Act Rule 700(c).

9 Exchange Act Rule 701.

10 Exchange Act Rule 701(d)(2).

11 Exchange Act Rule 701(d)(1)(i)(A).

which is a natural person who, either individually or together with his or her spouse, meets the $5 million in net worth test.[12]

The Agencies modified the definition of "incentive compensation" in the final Rule to better accommodate typical bank bonus programs and provide clarity on what kinds of bonus plans banks can use in conjunction with the exception.[13] Additionally, the final Rule allows multiple bank employees to receive payment for a single referral, provided the payments are limited to only those individuals personally involved in the referral.[14]

The Trust Activities Exception

Recognizing the role that banks traditionally play for their trust and fiduciary clients, the trust activities exception allows a bank to perform securities transactions as a trustee or fiduciary if the bank is "chiefly compensated" for those transactions, consistent with fiduciary standards and principles, based on specific types of fees.[15] Rules 721 and 722 require banks to calculate their "relationship compensation" in order to make the "chiefly compensated" determination necessary to rely on the trust activities exception. The Rules that implement this exception define "relationship compensation" as compensation specifically identified in the statutory exception.[16] The Agencies retained the two alternative approaches to measure the relationship compensation in substantially the same form as proposed. Banks can make the determination:

- on an account-by-account basis;[17] or
- on a bank-wide basis.[18]

Both approaches require banks to use a two-year rolling average comparison and make the calculation within 60 days of the end of the year. Banks satisfy the account-by-account approach if the "relationship-total compensation percentage" for each trust or fiduciary account exceeds 50%.[19] Alternatively, Banks meet the bank-wide approach if the "aggregate relationship-total compensation percentage" for the bank's trust and fiduciary business is at least 70%.[20] Notably, Rule 721 defines Rule 12b-1 fees as "relationship compensation."[21] In addition, proposed Rule 723 (which identifies types of accounts that need not be included in the calculations described above) has been expanded to include trust or fiduciary accounts held in a foreign branch or bank.[22]

The Safekeeping and Custody Exception

Rule 760, adopted substantially as proposed, relates to the safekeeping and custody exception.[23] Under this exception, banks may accept orders from employee benefit plan accounts, IRAs, and similar accounts for which the banks act as custodian.[24] Banks may also accept orders for securities transactions on an "accommodation" basis from other kinds of custody ac-

12 Exchange Act Rule 701(d)(1)(i)(B).

13 Exchange Act Rule 700(b).

14 Exchange Act Rule 700(c).

15 Exchange Act Section 3(a)(4)(B)(ii).

16 Exchange Act Section 3(a)(4)(B)(ii)(I).

17 Exchange Act Rule 721.

18 Exchange Act Rule 722.

19 Exchange Act Rule 721(a)(1). Under Exchange Act Rule 721(a)(2) and (3), the "relationship-total compensation percentage" for a trust or fiduciary account is calculated by (1) dividing the relationship compensation attributable to the account during the preceding two years by a total compensation attributable to the account in the relevant year; (2) translating into a percentage the quotient for the preceding two years; and (3) averaging the percentages for each of the two preceding years.

20 Exchange Act Rule 722(a)(2).

21 Exchange Act Rule 721(a)(4) defines "relationship compensation" to includes any compensation that a bank receives because of the trust or fiduciary account and that consists of an administration fee, an annual fee, a fee based on a percentage of assets under management, a flat or capped per order processing fee equal to or less than the bank's cost for effecting the transaction, or any combination of such fees. As adopted, this definition now provides additional examples of these types of fees.

22 Exchange Act Rule 723(c).

23 Exchange Act Section 3(a)(4)(B)(viii).

24 Exchange Act Rule 760(a).

counts, subject to a number of conditions and limitations.[25] The Agencies declined to define the term "accommodation" in the Rules or the Release. The Agencies modified Rule 760 as proposed to provide that a bank that acts as a directed trustee (defined as a trustee that does not exercise investment discretion) for an account may rely on the custody exception to accept orders for, and effect transactions in, securities for the account.[26]

In addition, Rule 760:

- extends the Rule's exemptions to subcustodians;[27]
- stipulates that recordkeepers, administrators, and subcustodians can cross or net orders between the accounts of a specific custodian bank, but not among the accounts of multiple banks;[28]
- does not define "carrying broker" (although the release discusses circumstances under which a bank may be considered an impermissible "carrying broker"); and
- continues to provide that, in order to thwart evasions of the custody exception, the Agencies will consider the form and the substance of the relevant account(s), transaction(s), and activities.[29]

The Sweep Accounts Exception

The sweep accounts exception allows banks to sweep deposits into no-load money market funds.[30] Rule 740 defines "no-load" in a manner consistent with NASD[31] 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.[32] A bank seeking to use this exemption for deposits involving funds that have 12b-1 fees in excess of 25 basis points (*i.e.*, load funds) must:

- provide the customer another traditional banking (*i.e.*, non-brokerage) product or service (this condition also applies to banks' use of no-load funds as sweep vehicles);
- avoid characterizing the fund as "no-load"; and
- provide the customer with a fund prospectus no later than at the time the customer authorizes the securities transaction.[33]

In addition, the Agencies have modified Rule 741 as proposed to allow banks to utilize this exemption to effect transactions on or on behalf of other banks as part of a program for the investment or reinvestment of deposit funds of, or collected by, the other banks.[34]

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25 Exchange Act Rule 760(b). For example, the bank must comply with certain employee compensation and sales literature restrictions and cannot 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. In addition, the bank's charges for effecting a securities transaction for the account cannot vary based on whether the bank accepted the order for the transaction, or based on the quantity or price of the securities to be bought or sold.

26 Exchange Act Rule 760(d)(1). Alternatively, the bank may continue to make transactions for the account under the trust activities exception and related Rules.

27 Exchange Act Rule 760(f).

28 Exchange Act Rule 760(e).

29 Exchange Act Rule 760(g).

30 Exchange Act Section 3(a)(4)(B)(v).

31 On July 30, 2007, NASD changed its name from National Association of Securities Dealers, Inc. to Financial Regulatory Authority "(FINRA"), and similarly changed its internet domain from www.nasd.com to www.finra.org. However, FINRA's rules, which consist of both NASD rules and certain NYSE rules that FINRA incorporated, will continue to be called NASD and NYSE rules, respectively, for the foreseeable future.

32 Exchange Act Rule 740(e).

33 Exchange Act Rule 741(a).

34 Exchange Act Rule 741(a)(1)(B).

Other Regulation R Items

In addition to the foregoing, Regulation R:

- includes an exemption for banks from the definition of "broker" for agency transactions with non-U.S. persons in Regulation S securities;[35]
- provides an exemption for banks from the definition of "broker" for noncustodial securities lending activities for persons reasonably believed to be qualified investors[36] or employee benefit plans that own and invest on a discretionary basis, not less than $25 million in investments;[37]
- permits banks that in all other ways satisfy the requirements for the trust activities, stock purchase plan, or safekeeping and custody exemptions, to effect transactions in open-end investment companies, as well as variable insurance contracts funded by any registered separate account, through the National Securities Clearing Corporation or directly with a transfer agent or with an insurance company or separate account;[38]
- allows banks to effect transactions in the securities of a company directly with that company's transfer agent, subject to certain conditions;[39]
- provides banks with a temporary 18-month exemption to prevent their contracts from being void or voidable under Exchange Act Section 29(b) and also provides a permanent exemption from Section 29(b) where a bank (i) has acted in good faith and had in place reasonable policies and procedures to comply with bank broker rules and regulations, and (ii) where the consequence of the failure to comply with the registration requirements did not result in a significant harm, financial loss, or cost to the person attempting to void the contract;[40] and
- extends the time that banks have to comply with the Exchange Act's provisions relating to the "broker" definition until the first day of their first fiscal year commencing after September 30, 2008.[41]

The SEC's Companion Release

In addition to jointly adopting Regulation R, the Commission voted to adopt a companion release intended to complement Regulation R, substantially as proposed, which it released on September 24, 2007.[42] Among other things, the companion release:

- provides a conditional exemption from the definition of "dealer" for banks' riskless principal transactions with non-U.S. persons pursuant to Regulation S;[43]
- provides a clarifying amendment to Exchange Act Rule 15a-6. This is unchanged from the proposing release. This Rule, which provides a conditional exemption from U.S. broker-dealer

35 Exchange Act Rule 771. See note 42, *infra*.

36 "Qualified investor" is defined in Exchange Act Section 3(a)(54)(A).

37 Exchange Act Rule 772. This Rule was adopted as proposed.

38 Exchange Act Rule 775. The Rule as adopted was expanded to include variable insurance contracts.

39 Exchange Act Rule 776. The conditions are as follows: (1) no commission is charged for the transaction; (2) the transaction is effected solely for the benefit of an employee benefit plan account; (3) the security is received directly from the company or the company's employee benefit plan; and (4) the security is transferred only to the company or its employee benefit plan.

40 Exchange Act Rule 780. This Rule was adopted as proposed.

41 Exchange Act Rule 781.

42 *Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules*, Exchange Act Rel. No. 56502.

43 Exchange Act Rule 3a5-2. The rule has been modified from its proposed form to provide that after a security's original sale, when the bank purchases an eligible security from a broker-dealer for resale to a non-U.S. person, the bank can rely on a reasonable belief that the eligible security was originally sold outside the U.S., consistent with Rule 903 under Regulation S. Exchange Act Rule 771 makes similar modifications for banks' agency transactions in this area.

registration for certain foreign broker-dealers, better aligns 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 3(a)(4)(b)(vi) and the latter could rely on revised Rule 15a-6(a)(4)(i);

- adopts, as proposed, 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;[44] and
- withdraws Exchange Act Rules 3b-9,[45] 15a-8,[46] and 15a-9.[47]

44 Exchange Act Rule 3a5-3. This Rule incorporates the dealer provisions of Exchange Act Rule 15a-11, which has been withdrawn. Exchange Act Rule 772 creates a similar exemption for banks' agency transactions in this area.

45 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 (D.C. Cir., 1986).

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

Conclusion

The adoption of Regulation R represents the culmination of eight years of work to implement the bank broker provisions of the Gramm-Leach-Bliley Act of 1999. Now that Regulation R has been adopted, banks wishing to take advantage of the Exchange Act's exceptions to the definition of "broker" can, with much greater certainty and clarity, begin the work of reviewing, and where necessary, restructuring their operations to comply with the Exchange Act and Regulation R.

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47 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.

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