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Securities Law Developments

SEC Issues Interpretive Rules on the GLB "Push-Out" Requirements for Banks

On May 11, 2001, the Securities and Exchange Commission ("SEC" or "Commission") issued long-awaited interim final rules interpreting the provisions of the Gramm-Leach-Bliley Act ("GLB Act" or "Act") on the bank exceptions from broker-dealer regulation.[1] The GLB Act essentially eliminated the blanket exemption that banks have long enjoyed from the broker-dealer requirements of the Securities Exchange Act of 1934 ("Exchange Act"). Instead, the Act effectively requires U.S. banks and U.S. branches and agencies of foreign banks to "push out" most of their securities brokerage and dealing activities to broker-dealers that are registered with the SEC under the securities laws.

Despite this general statutory requirement to push out securities activities, the GLB Act specifically identified several broker-dealer activities that banks may continue to conduct directly. These "excepted" activities are designed to permit banks to continue to provide those core securities services that they have traditionally offered. In response to questions received regarding the new statutory provisions, the SEC's rules provide guidance as to the meaning of several of the exceptions.[2]

The Interpretive Release was sure to be divisive, and the new rules have immediately sparked controversy. The Commission has already received letters from banking trade groups expressing "the intense opposition [of] the banking industry," contending that the Commission has misinterpreted the GLB Act and urging that the rules be withdrawn and rewritten.[3] Moreover, senior officials at both the Federal Reserve Board and the Office of the Comptroller of the Currency ("OCC"), speaking at a

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[1] *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 Rel. No. 44291), 66 Fed. Reg. 27,760 (May 18, 2001) (to be codified at 17 C.F.R. pts. 200, 240) (the "Interpretative Release").

[2] The new rules also delegate authority to the staff of the Division of Market Regulation to consider, on a case-by-case basis, individual requests for exemptive relief by banks, savings associations, and savings banks. The Interpretive Release cautions, however, that the Commission expects the staff to submit novel and complex requests for exemption to it.

[3] Letter, dated June 4, 2001, from The American Bankers Association ("ABA") and the ABA Securities Association ("ABASA") to Annette L. Nazareth, Director of the SEC's Division of Market Regulation ("the ABASA letter").

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conference on June 5, 2001, offered strong criticism of various aspects of the rules. An influential Senate staffer went so far as to accuse the SEC of writing rules principally intended to protect regulated broker-dealers from bank competition, to the ultimate detriment of small investors. A spokesman for Senator Phil Gramm's office voiced strong opposition to the new rules, stating that "Sen. Gramm is encouraging banks to let the SEC know they're not happy with this" and that the Senator's office had reviewed the rule and "determined it is not in keeping with what Congress intended."[4]

Deadlines. Although they became effective on May 11, 2001, the interim final rules continue to exempt completely banks engaging in securities activities from broker-dealer registration until October 1, 2001. 66 Fed. Reg. 27,760, 27,763. The rules also exempt until January 1, 2002 banks that would be required to register as broker-dealers based on their compensation arrangements. *Id*. In addition, the rules exempt banks from potential Section 29 rescission liability (for failure to register as a broker-dealer) on contracts entered into prior to January 1, 2003. *Id*. The SEC has expressed its willingness to amend the rules based on comments, which are solicited through July 17, 2001.[5] 66 Fed. Reg. 27,760, 27,760.

Overview. The GLB Act created eleven statutory exceptions from the definition of "broker" under the Exchange Act and four exceptions from the definition of "dealer" (three of which are essentially similar to three of the "broker" exceptions). Most attention has been focused on the exception for banks' trust and fiduciary activities. The Act provides additional exceptions for networking arrangements, certain stock purchase accounts, sweep accounts, affiliate transactions, private placements, custodial activities, municipal securities transactions, de minimis activities, dealing in certain asset-backed securities, and transactions in certain permissible securities and identified banking products.

The SEC's release contains eight new rules to flesh out certain ambiguities regarding these statutory exceptions. The new rules focus primarily on the exceptions for trustee and fiduciary services, networking arrangements, and custodial and safekeeping services. The Commission also issued rules containing a series of definitions of terms contained in several of the statutory exceptions. The rules and the accompanying commentary are discussed in detail below.

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[4] *See* Vanessa Blum, *Banks Attack SEC Over New Rules,* Legal Times (June 13, 2001).

Somewhat surprisingly, the new rules also provide that any *savings association or savings bank* with federally-insured deposits (and that is not operated for the purpose of evading the provisions of the Exchange Act) is exempt from the Exchange Act definitions of "broker" and "dealer" on the same terms as banks. (The rules also provide, however, that if the savings association or bank acts as a municipal securities dealer, it shall be considered a bank municipal securities dealer under the Exchange Act and the rules thereunder.) "We are quite thrilled and very pleasantly surprised," said Charlotte Bahin, director of regulatory affairs for America's Community Bankers. This allows [thrifts] to go about doing business in the same way that their competitors are doing business." Rob Blackwell, *SEC Rule Would Help Thrifts Sell Stocks,* American Banker (May 15, 2001), *available at* http://www.AmericanBanker.com.

[5] Each appropriate federal banking regulatory agency is also specifically directed by section 204 of the GLB Act to issue (after consultation with the SEC) recordkeeping rules for banks that wish to rely on the push-out exceptions. The banking regulators have been delaying issuance of any such rules pending the SEC's clarifying guidance. The SEC solicited comment on whether it should also adopt recordkeeping rules and whether it was necessary for the regulators of savings associations and savings banks to also adopt recordkeeping rules.

1. Trust and Fiduciary Activities

The amended Exchange Act permits banks to continue to effect securities transactions in (1) a trustee capacity, or (2) "a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards." 15 U.S.C. § 78c(a)(4)(B)(ii).

Under the GLB Act, as interpreted by the Commission, a bank may rely on this trust and fiduciary exception only if the bank:

- effects transactions in a trustee or fiduciary capacity;
- effects such transactions in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards;
- does not publicly solicit brokerage business (the bank may, however, advertise that it effects transactions in securities for its trustee and fiduciary customers);
- generally executes trades involving publicly traded U.S. securities through a registered broker-dealer (including an affiliated broker-dealer);
- is "chiefly compensated" for such transactions through the following fee arrangements: (a) an administrative or annual fee payable on a monthly, quarterly or other basis; (b) a percentage of assets under management; or (c) a flat or capped per order processing fee that does not exceed the cost of executing securities transactions for trustee or fiduciary customers.

The Interpretive Release notes that this exception is intended to permit banks to continue to conduct their traditional securities-related trust activities, but not to authorize banks to conduct securities activities outside those traditional lines. The new rules provide guidance on a number of aspects of this exception.

"Limited" Trustees. The Interpretive Release notes that the SEC has received questions about whether the trustee-fiduciary exception is available for banks acting in capacities that, although labeled "trustees," involve situations where the law may not arguably impose upon the bank a comprehensive set of fiduciary duties. The three examples cited by the SEC are indenture trustees, Employee Retirement and Income Security Act ("ERISA") trustees, and Individual Retirement Account ("IRA") trustees. The Exchange Act Rule 3b-17(k) is intended to cover these situations (and thereby alleviate any legal uncertainty with regard to these arguably "limited" fiduciary obligation trustees) by defining "trustee capacity" to include "a trust indenture trustee or a trustee for a tax-deferred account described in [the relevant sections] of the Internal Revenue Code." The ABASA letter notes in this regard, however, the conspicuous absence of any discussion of personal trusts, charitable foundation trusts, insurance and viatical trusts, and "rabbi" and secular trusts.

Fiduciary Capacities. The term "fiduciary capacity" is defined by the Exchange Act to mean acting (1) as a trustee, executor, administrator, registrar, transfer agent, guardian, assignee, or receiver; (2) as "an investment adviser," provided that the bank receives a fee for its investment advice; (3) in

"any capacity in which the bank possesses investment discretion on behalf of another"; and (4) "in any other similar capacity." 15 U.S.C. § 78c(a)(4)(D). This definition is virtually identical to the definition of "fiduciary capacity" contained the regulations of the OCC at 12 C.F.R. § 9.2(e).

The Release clarifies that banks who act as *transfer agents* generally only qualify for this exception to the extent that the bank engages in transfer agent activities for shareholders on behalf of an issuer of securities of the type that are specified in the Exchange Act's definition of transfer agent (such as countersigning securities upon issuance, monitoring securities' issuance to prevent unauthorized issuance, registering the transfer of securities, and transferring record ownership of securities by book-keeping entry.) *See* 15 U.S.C. § 78c(a)(25). The exception is not available to the extent a bank transfer agent conducts securities activities that resemble those of a broker-dealer, such as effecting securities transactions for investors.

One of the definitions contained in the new rules also defines the term *investment adviser if the bank receives a fee for its investment advice* only to cover those relationships where the bank provides "continuous and regular" investment advice to a customer's account based on the individual needs of the customer and where by law or contract the bank is subject to a duty of loyalty, including an affirmative duty to make full and fair disclosure to the customer of all material facts relating to conflicts. The Commission explained that the requirement for "continuous and regular" advice was intended to ensure that a bank employing this exception was actually conducting a traditional bank fiduciary function, not conducting principally a brokerage service with only ancillary or incidental investment advice.[6]

Other Similar Capacities. The Interpretive Release identifies several other similar capacities in which a bank may act, which although not expressly included in any of the new rule definitions, the Commission believes qualify for the trust-fiduciary exception, so long as the other requirements for the exception are met. In particular, the Commission identified several capacities under a variety of uniform state laws, including acting as a "personal representative" under the Uniform Probate Code, as a "conservator" or "custodial trustee" under the Uniform Custodial Trust Act, and as a "conservator" or "custodian" under the Uniform Transfers to Minors Act.

"In" the Trust or Similar Department. The Release notes that the GLB Act permits banks to conduct their fiduciary activities in another department other than the trust department so long as it is regularly examined by bank examiners for compliance with fiduciary standards and principles. The Commission intends to rely principally on bank examiners to make this determination. The Release further asserts that for banks' securities activities to qualify for the trust-fiduciary exception, *all* aspects of the bank's role in the transactions must occur in the trust or other regularly examined department. The Commission asserted in this regard that such securities activities include identifying potential investors and screening them for creditworthiness, soliciting securities transactions, facilitating trade executions, and preparing and sending confirms.

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[6] The Commission borrowed the "continuous and regular" standard from section 203A(a)(2) of the Investment Advisers Act, where it is used to determine which assets are under management by an investment adviser for purposes of computing whether the Adviser has over $25 million such assets and is thus regulated by the SEC. 15 U.S.C. § 80b-3a(a)(2).

"Chiefly Compensated." Perhaps the most controversial aspect of the new interim rules may be the SEC's approach to the requirement that a bank performing trust and fiduciary securities activities must be "chiefly compensated" by forms of so-called "relationship compensation": an administrative or annual fee payable on a monthly, quarterly or other basis; a percentage of assets under management; or a flat or capped per order processing fee that does not exceed the cost of executing securities transactions for trustee or fiduciary customers. In the absence of any guidance from the terms of the GLB Act as to the meaning of "chiefly" compensated, the SEC's rules provide a detailed interpretation of the term.

First, the rules provide that a bank conducting trust and fiduciary activities must divide all the compensation it receives in connection with those activities into three buckets: "relationship," "sales," and "unrelated" compensation. "Relationship compensation" includes the statutorily-listed forms described above. For these purposes, the new rules define a "flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions" as equal to no more than the cost the broker-dealer charged the bank for executing the trade, plus the cost of bank resources "solely dedicated to transaction execution, comparison, and settlement for trust and fiduciary customers." 66 Fed. Reg. at 27774. The Release makes clear the SEC intends to read this "solely dedicated" requirement quite strictly, although the Commission also solicited comment on whether a more balanced approach would permit banks to pass on proportional allocations of shared costs. Finally, relationship compensation only includes compensation received directly from a customer, a beneficiary, or the assets of the trust account, not compensation received from other persons, such as investment companies.

"Sales compensation" includes transaction fees other than the flat, capped fees described above, payment for order flow, fees received in connection with a securities transaction or account (other than the networking referral fee discussed above), fees paid for an offering of securities received from a third person, 12b-1 fees, and "service" fees paid by an investment company for personal service or account maintenance. The Release notes that annual or asset-based fees that also include a specified number or unlimited occasional securities trades should be scrutinized closely to see whether they qualify more as "relationship" compensation or compensation that gives rise to sales incentives.

In order to meet the "chiefly compensated" requirement, a bank's relationship compensation must exceed its sales compensation. ("Unrelated compensation", which is everything else that does not fit within the other two categories, is simply excluded from this calculation.) The SEC specifically requests comment on whether the percentage of required relationship compensation effectively created by this standard -- 50% -- is a proper interpretation of the word "chiefly," or if a higher percentage, such as 75% or 90%, is more appropriate.

The most controversial aspect of rules definition will likely be the process provisions on the chiefly-compensated calculation. The new rules require banks to make this calculation yearly and on an *account-by-account basis*. The Release notes that permitting a bank to make such a calculation at the department or business-line level could potentially allow a bank to engage primarily in a brokerage relationship (without the protection of broker-dealer regulation) with a large number of customers, if the relationship compensation across the department or business line exceeded the sales compensation. We expect the banking industry to raise significant protest to this requirement. The ABASA letter, for example, asserts that this rule would require yearly analyses of fees charged to over 19 million accounts valued at over $22 trillion.

The SEC also adopted a rule, however, which provides an exemption to permit banks to compute this compensation on the basis of their *total* fiduciary activities if sales compensation is less than 10% of relationship compensation for such total activities. The Commission explained that it chose the 10% number on the understanding that "many" banks would fall within this threshold. 66 Fed. Reg. at 27773 n.132. Even for this exemption, however, the bank must adopt procedures reasonably designed to ensure account-level compliance with the "chiefly-compensated" requirement at certain key times in the life of an account, including when it is opened and when its compensation arrangement is changed. In response, the ABASA asserted that these conditions make this exemption of little value.

Exemption for Certain Indenture Trustees. One of the new rules provides that a bank acting as an indenture trustee may still qualify for the trust-fiduciary exemption even if it does not meet the "chiefly compensated" condition, where the bank effects transactions in no-load money market funds. The Release observes that banks acting as such indenture trustees may not meet the chiefly-compensated condition because of fee structures individually negotiated with issuers. The Commission observed that providing bank indenture trustees with an exemption to directly place idle cash in a no-load money market fund (a vehicle with a constant net asset value per share and without a sales load) does not create any serious risk of abuse.

2. Networking Arrangements

Following a long line of letters from Commission staff, the GLB Act provided an exception for the definition of "broker" for banks that enter into third-party brokerage, or "networking," arrangements. Under this exception, a bank is not considered to be a broker if it "enters into a contractual or other written arrangement" with a registered broker-dealer through which the broker-dealer offers brokerage services. 15 U.S.C. § 78c(a)(4)(B)(i). The Act imposes a number of conditions for banks to meet this exception that are similar to the requirements of the *Interagency Statement on Retail Sales of Nondeposit Investment Products* (February 15, 1994).

Referral Fees. The SEC's new rules provide guidance on one particular statutory condition to this exception which prohibits *bank* employees (who are not also associated with a broker-dealer and qualified under self-regulatory organization rules) from receiving "incentive compensation" for any brokerage transactions. The Commission explained that the ban on incentive compensation was designed to ensure that bank employees (who are not subject to the sales practices rules and other broker-dealer regulation) do not have an improper "salesman's stake" in soliciting customers to engage in securities transactions. The GLB Act provides an exception from this condition, however, for a "referral" fee that is "a nominal one-time cash fee of a fixed-dollar amount … not contingent on whether the referral results in a transaction." 15 U.S.C. § 78c(a)(4)(B)(i)(VI). The Commission believes that such a limited referral fee does not create an inappropriate salesman's stake.

The SEC's new rules flesh out the parameters of such permissible fees in several ways. First, the rules make clear that a "referral" is defined only to cover the bank employee "arranging a first securities-related contact" with the registered broker-dealer and that it does not otherwise include "any activity . . . related to effecting transactions in securities." 66 Fed. Reg. at 27779. Second, the rules provide that in order to avoid giving bank employees incentives to solicit customers to engage in securities transactions, the fees may not be based on the customer's financial status or his securities transactions, assets gathered, or account size.

Third, the rules specify two alternative definitions of the term "nominal one-time cash fee of a fixed dollar amount " -- either (i) a payment that is no greater than the gross cash wages of the bank employee, or (ii) a payment in the form of "points" in a program covering a range of banking (non-securities) products and services, so long as the points awarded for securities referrals are not greater than the points awarded for non-securities banking products. Fourth, the Release goes out of its way to observe that serious questions would be raised if such fees in the aggregate constitute a substantial portion of any bank employee's compensation and to explicitly reject *bonuses* based on brokerage referrals as an acceptable fee. (The ABASA letter warns that this view raises questions concerning the continued legality of many year-end bank bonus programs that consider securities transactions in connection with awarding bonuses to employees.) Finally, the Interpretive Release clarifies that such referral fees can only be paid to natural persons and that incentive compensation paid by a broker-dealer to the bank (rather than its employees) is permissible. *See, e.g.*, *Chubb Securities Corp.*, SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,829 (Nov. 24, 1993) (Chubb Letter"). The Chubb Letter superseded prior staff positions regarding these arrangements. *See also* NASD Rule 2350 (Broker-Dealer Conduct on the Premises of Financial Institutions).[7]

3. Safekeeping and Custodial Activities

The GLB Act also permits banks to provide safekeeping and custody services without having to register as brokers. The Act makes clear that banks may hold customer funds and securities in this regard if, except with respect to government securities, they do not act as a carrying broker.

This statutory exception explicitly permits banks that hold securities for their customers to exercise warrants and other rights on behalf of customers; facilitate the transfer of funds or securities in clearance and settlement of customer transactions; effect securities lending or borrowing transactions when the securities are in the custody of the bank; invest pledged collateral for customers; and facilitate the pledging or transfer of securities that involve the sale of those securities.

The SEC, however, rejected arguments that this exception permits a bank to accept orders for the purchase or sale of securities in situations other than those explicitly provided for in the Act. The Commission noted that the point at which orders are accepted from customers (and routed for execution) is a critical juncture that should be covered by the protections that flow from broker-dealer regulation. The Commission did, however, adopt rules creating two new exemptions (i) to permit small banks to effect transactions in investment company securities in customers' tax-deferred accounts and (ii) to permit banks to accept orders for securities for safekeeping and custody accounts where the bank is not compensated for such transactions.

4. Other Exceptions

Sweep Accounts. The GLB Act provides that banks may sweep customer deposit funds into no-load, open-end money market mutual funds without becoming a broker. For these purposes, the Commission adopted in its rules a definition of "no load" borrowed from NASD Rule 2830(d)(4).

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[7] The Release advises that the Chubb Letter will remain in effect for required service corporations of savings associations and savings banks; however, the Chubb Letter is available only to service corporations so long as a savings association or savings bank is required to use one. A savings association or savings bank that complies with the terms of the networking exception will automatically comply with the terms of the Chubb Letter.

Affiliates. The SEC clarified that the exception for "transactions for the account of any affiliate" does not cover a bank effecting trades with non-affiliated *customers*, even where the customer transaction also is effected as part of a trade involving an affiliate.

De Minimis. The SEC adopted a new rule to clarify whether the statutory *de minimis* exception (for banks effecting no more than 500 securities transactions a year) can be relied on for banks engaging in "riskless principal" transactions. The rule exempts banks from the definition of "dealer" so long as the number of riskless principal *and* agency transactions does not exceed more than 500 transactions per year.

Asset-Backed Securities. The GLB Act provides that banks may issue and sell certain asset-backed securities through a separate entity subject to certain conditions. The securities must be backed by obligations or pools of obligations that are "predominantly originated by" the dealing bank, an affiliate of the bank that is not a broker-dealer, or a syndicate of banks of which the dealing bank is a member. If issued by a syndicate of banks, the assets must consist of mortgages or consumer-related receivables.

The SEC adopted a new rule to flesh out several aspects of this exception, including defining "predominantly" to mean at least 85%, and "originated" to mean initially making and funding an obligation. The rule also defines "affiliate," "consumer-related receivables," and "pool."

NSCC's Mutual Fund Services. Finally, the SEC adopted a rule permitting banks to continue to execute transactions in shares of open-end investment companies through NSCC's Mutual Fund Services (including Fund/SERV) on the theory that these services simplify and automate the process for buying and redeeming investment company securities without raising investor protection concerns. The exemption is available only to banks that process orders through a service of a registered clearing agency subject to the SEC's supervision and regulation.

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If you would like a copy of the new rules or require further assistance, please contact Brandon Becker, (202) 663-6979 (bbecker@wilmer.com), Soo J. Yim, (202) 663-6958 (syim@wilmer.com), Satish M. Kini, (202) 663-6482 (skini@wilmer.com), David A. Luigs, (202) 663-6451 (dluigs@wilmer.com), or Jerome Roche (202) 663-6870 (jroche@wilmer.com).

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