Final Broker Push-Out Rules for Banks — At Long Last

2007-09-24

On September 19, 2007, the United States Securities and Exchange Commission (SEC or Commission) unanimously voted to adopt, jointly with the Board of Governors of the Federal Reserve System (Board), Regulation R and certain independent companion rules. Regulation R addresses the definition of "broker" under the Securities Exchange Act of 1934 (Exchange Act) and the range of permissible securities activities that banks may perform without registering as broker-dealers with the SEC. Regulation R was published for comment on December 18, 2006.[i]

While the final version of Regulation R has not yet been published, several of the comments by the Commission and its senior staff at the open meeting on September 19, 2007, in addition to the Commission's recent press release, shed some light on the scope of the final rules.[ii]The analysis that follows is based on these limited statements; a more detailed treatment of these issues will follow when the Commission and the Board publish the final rules.

I. Background

In 1999, the Gramm-Leach-Bliley Act (GLBA) eliminated the blanket exception that banks had enjoyed from the definition of "broker" and "dealer" under the Exchange Act. The GLBA generally required banks to "push out" most of their securities-brokerage and securities-dealing activities to registered broker-dealers, except that banks were permitted to continue to perform certain traditional banking activities without registering as broker-dealers with the Commission.

The scope of these exempted activities has proved difficult to define and has been the subject of several rounds of attempted rulemaking, including Regulation R. In particular, while final rules defining "dealer" were adopted in 2003, the Commission has only recently approved final rules interpreting the definition of "broker" -- eight years after the GLBA was enacted. The Commission's initial effort in May 2001, known as the "Interim Final Rules," was met with criticism from both the banking industry and federal banking regulators. Three years later, the Commission published proposed Regulation B for comment in June 2004. Regulation B was also viewed by most critics as imposing unduly burdensome and unworkable regulatory requirements on banks.

In an effort to break this regulatory impasse and to accomplish other objectives, Congress passed the Financial Services Regulatory Relief Act of 2006, requiring the Commission to engage in joint rulemaking with the Board, and to consult and seek the concurrence of the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. Regulation R is the result of this joint effort. In order to provide consistent treatment across financial services organizations, the Financial Services Regulatory Relief Act also expanded the definition of "bank" in the Exchange Act to include savings associations and federal savings associations.

II. Key Provisions of the Final Rules

Summarized below are the significant statements made by the Commission and its senior staff at the open meeting on September 19, 2007, and in the related press release.

A. <u>The Networking Exception</u>

Section 3(a)(4)(B)(i) of the Exchange Act provides an exception from the definition of "broker" that generally permits banks to establish referral relationships with broker-dealers, and allows banks to pay their unregistered employees limited forms of compensation for referring bank customers to associated broker-dealers. Specifically, banks generally may not pay their unregistered employees "incentive compensation" for referring a customer to the broker-dealer, although bank employees may receive a "nominal one-time cash fee of a fixed dollar amount" for referrals so long as the fees are not "contingent on whether the referral results in a transaction."

The final rules will define certain terms used in the exception, including "nominal" and "incentive compensation." In particular, the final rules will allow banks to award bonuses based on their overall profitability or revenues, or that of their operating affiliates or operating units, so long as the relevant entity does not, over time, predominantly engage in making referrals to broker-dealers. The final rules will also allow banks to allocate a referral payment for a single securities transaction to more than one bank employee, so long as the payment is allocated only to employees involved in the referral.

As in the proposed rules, the final rules will allow banks to pay their unregistered employees more than nominal referral fees for referring certain institutional or high net worth customers to affiliated broker-dealers. The final rules, however, broaden the definition of "institutional customer." Specifically, the final rules will define an "institutional customer" to mean an entity that has (or is controlled by an entity that has) at least (1) $10 million in investments; or (2) $20 million in revenues; or (3) $15 million in revenues if the bank employee refers the customer to the broker-dealer for investment banking services. A "high net worth customer" will be defined as a natural person who, individually or together with his or her spouse, has a net worth of at least $5 million, excluding the primary residence and any associated liabilities. The definition will also now include any revocable, inter vivos, or living trust, where the settlor is a natural person who, individually or together with his or her spouse, has a net worth of $5 million.

Finally, banks will be able to rely on this exception if they have a "reasonable basis to believe" that a customer qualifies as an institutional or high net worth customer. By contrast, the proposed rules would have required banks to follow more detailed procedures to certify that customers meet these requirements. The suitability or sophistication analyses required under the proposed rules will still apply.

Signaling future developments, at the open meeting discussing the final rules, Commissioner Atkins questioned why the definition of a high net worth customer used in this exception is tied to a $5 million asset test, rather than an existing threshold. He described the current law on institutional qualifications as a "crazy quilt," and stated that he anticipates an ongoing dialogue on this issue, and hopes the Commission can "rationalize" its approach.

Commissioner Atkins also noted that Regulation R, and the networking exception in particular, is still quite detailed, and may be unnecessarily prescriptive. He stated that such detailed regulations may be a "shock" to banks. He also observed that such detailed regulations are not responsive to recent suggestions that the Commission adopt "principal-based" regulations.

B. Trust and Fiduciary Activities

Section 3(a)(4)(B)(ii) of the Exchange Act provides that, under certain circumstances, a bank may effect securities transactions in a trustee or fiduciary capacity without registering as a broker with the Commission. Among other things, banks must be "chiefly compensated" by enumerated fees, collectively referred to as "relationship compensation," to take advantage of this exception.

Comments at the open meeting clarified four aspects of the trust and fiduciaries activities exception. First, certain fees that qualify as relationship compensation may be paid either by an investment company, as specified in the proposed rules, or by an investment company's service provider. Second, when determining whether it is chiefly compensated by relationship compensation, a bank may exclude income received for executing securities transactions exempted or excepted by other provisions of the final rules. Third, banks may exclude the revenues of certain foreign branches from the chiefly compensated computation under certain circumstances. Specifically, a bank may exclude these foreign branches if the bank reasonably believes that less than 10% of the branch's accounts are held by US persons. Finally, a bank that lacks trust powers may still rely on this exception if its appropriate federal regulator examines its fiduciary accounts for compliance with trust and fiduciary principles.

C. Sweep Accounts

Section 3(a)(4)(B)(v) of the Exchange Act permits banks, without registering as brokers, to sweep customer funds into no-load money market funds. Under certain circumstances, the final rules will allow banks to (1) sweep customer funds into money market funds that are not no-load; and (2) effect transactions that are not sweeps. To sweep customers' funds into money market funds that charge a sales load, a bank must provide the customer with a prospectus disclosing the fund's fee. Of course, the bank must not mischaracterize the fund as no-load. Finally, the final rules will also permit a bank to effect transactions under this exemption on behalf of another bank under certain circumstances.

D. Safekeeping and Custody

Section 3(a)(4)(B)(viii) of the Exchange Act provides an exception from the definition of "broker" for banks that engage in certain custody and safekeeping activities. Under the final rules, a bank may take orders for securities transactions from employee benefit plan accounts, individual retirement plan accounts, and similar accounts for which the bank acts as a custodian, recordkeeper, or administrator. Banks will also be able to accept orders on an accommodation basis from other safekeeping and custody accounts.

To accept orders from a custody account, a bank must ensure that no bank employee receives compensation that is based on whether a securities transaction was executed for the account or on other factors that might create a salesman's stake in the transaction. If the order is for a custody account as an accommodation, the bank must comply with additional limitations. Specifically, the bank's fee for effecting the transaction may not vary based on whether the bank accepted the order for the account, or on the quantity or price of the securities. In addition, the bank may not (1) advertise that it accepts orders for securities transactions; (2) provide investment advice or research; (3) make recommendations regarding securities transactions; or (4) otherwise solicit securities transactions from the account. A bank will also be able to rely on these exemptions when it acts as a directed trustee without investment discretion.

The final rules will also allow administrators, recordkeepers, and sub-custodians to engage in cross-trades to the same extent as the custodian bank -- i.e., between accounts within the same bank, but not between accounts in different banks.

Finally, both the final rules and the adopting release will address carrying broker activities. Specifically, the adopting release will provide guidance on when a bank might be considered an impermissible carrying broker. The final rules will also address the extent to which systems may be shared between a bank's broker-dealer and custody departments. The extent to which these systems may be shared is unclear, but the staff noted at the open meeting that it would be problematic for broker-dealers to push clients into custody accounts in order to avoid back-office requirements.

E. Exemption for Banks to Effect Transactions in Investment Company Securities

The final rules will allow banks to execute transactions in mutual funds and certain variable insurance products through a clearing agency system, transfer agent, or with an insurance company or separate account, rather than through a broker-dealer. However, banks may only rely on this exemption where the securities at issue are not traded on a national securities exchange, through the facilities of a national securities association, or on an inter-dealer quotation system.

F. Exemption Allowing Banks to Effect Transactions in Company Securities

The final rules will permit banks to effect transactions in the securities of a company directly with a transfer agent acting for the company if the bank satisfies the following four conditions. First, no commission is charged for the transaction. Second, the transaction is conducted solely for the benefit of an employee benefit plan. Third, the relevant securities are obtained directly from the company or its employee benefit plan. Finally, the security is transferred only to the company or its employee benefit plan.

Securities Lending Exemption

This exemption re-proposes the Commission's current rule exempting banks from the definition of "broker" when they effect certain securities lending transactions. The Commission is re-proposing this rule because otherwise it would be invalidated by the Financial Services Regulatory Relief Act of 2006. Under this exemption, banks will be permitted to engage in certain securities lending transactions as agent when they either do not have custody of the securities, or have custody for less than the entire period of the transaction. The Commission will also seek comment on repurchase agreements.

H. Regulation S Transactions

The final rules will provide an exemption to allow banks to effect certain agency transactions in Regulation S securities. Among other requirements, a bank relying on this exemption will have to reasonably believe that the securities were initially sold in compliance with Regulation S. The purpose of this exemption is to allow the branches of United States banks to compete on an equal footing with foreign banks not subject to regulation by the Commission.

I. Section 29 Exemptions

The final rules will provide banks with limited relief from possible third-party rescission actions under Section 29(b) of the Exchange Act. That section voids certain contracts (or renders them voidable) that are made in violation of the Exchange Act or rules thereunder. Specifically, the final rules will provide banks a transitional 18-month exemption from Section 29(b), and a permanent exemption where the bank acted in good faith, had reasonable policies and procedures governing its bank-broker activities, and the violation did not cause any significant harm, financial loss, or cost to the aggrieved customer.

J. SEC-Only Rules

The SEC-Only rules (1) provide a conditional exemption from the definition of "dealer" for certain Regulation S transactions; (2) renumber the current exemption from the definition of "dealer" for certain bank securities lending activities; (3) eliminate outdated rules; and (4) make conforming amendments to Rule 15a-6 under the Exchange Act.

III. Implementation

Banks will have until the first day of their first fiscal year commencing after September 30, 2008, to comply with the final rules. As Mr. Sirri pointed out at the open meeting, the networking exception will thus be phased in as soon as October 2008, while the trust and fiduciary exception will not be phased in for some time after September 2008, because that exception uses a two-year rolling average to measure compliance. The SEC-only rules will become effective 30 days after they are published in the Federal Register.

Assuming the Board approves Regulation R on September 24, 2007, it will then need to develop recordkeeping rules, in consultation with the staff of the Commission. The staff also anticipates helping the Board draft additional guidance for banks. Finally, in the longer term, the staff will work with the self-regulatory organizations to make any necessary changes to their rules.

[i] *See* Exch. Act Rel. No. 54946 (Dec. 18, 2006), 71 Fed. Reg. 77522 (Dec. 26, 2006) (Regulation R proposing release). *See also* Exch. Act Rel. No. 54947 (Dec. 18, 2006), 71 Fed. Reg. 77550 (Dec. 26, 2006) (companion rules proposing release).

[ii] See SEC Votes for Final Rules Defining How Banks Can Be Securities Brokers, Sept. 19, 2007, http://www.sec.gov/news/press/2007/2007-190.htm.

Authors

Franca Harris Gutierrez

PARTNER

Chair, Financial Institutions Practice

Co-Chair, Securities and Financial Regulation Practice

franca.gutierrez@wilmerhale.com

+1 202 663 6557

Andre E. Owens

PARTNER

Chair, Broker-Dealer Compliance and Regulation Practice

Co-Chair, Securities and Financial Regulation Practice

andre.owens@wilmerhale.com

+1 202 663 6350