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## Resolving the Bank/Broker Impasse – Proposed Regulation R Represents Joint Effort by SEC and Federal Reserve Board

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On December 13, 2006, the Securities and Exchange Commission (SEC or Commission) voted to propose, together with the Board of Governors of the Federal Reserve System (FRB), new Regulation R<sup>[i]</sup> and certain independent companion rules.<sup>[ii]</sup> Proposed 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. Comments on proposed Regulation R are due March 26, 2007.

### 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 a broker-dealer with the SEC.

The scope of these exempted activities has proved difficult to define and has been the subject of several rounds of attempted rulemaking, including proposed Regulation R. In particular, while final rules defining "dealer" were adopted in 2003, the SEC has yet to adopt final rules defining the exempted brokerage activities. The SEC's initial effort in May 2001, known as the "Interim Final Rules," was met with a storm of criticism from both the banking industry and federal banking regulators.<sup>[iii]</sup> Three years later, the SEC published proposed Regulation B for comment in June 2004.<sup>[iv]</sup> 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, Congress passed the Financial Services Regulatory Relief Act of 2006, requiring the SEC to engage in joint rulemaking with the FRB, 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. Proposed Regulation R is the result of this joint effort, and is thus better positioned than its predecessors to gain the support of both the securities and banking industries.

## Summary of Proposed Regulation R

Below is a brief summary of the most significant provisions of proposed Regulation R. A chart analyzing the key differences between proposed Regulations B and R is attached.

### *Networking Arrangements*

The third-party brokerage or networking exemption to the definition of "broker" in Section 3(a)(4)(B)(i) of the Exchange Act permits unregistered banks to enter into networking arrangements with third-party broker-dealers under which the broker-dealers offer brokerage services to bank customers. The exemption specifies that banks 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."<sup>[v]</sup>

Proposed Regulation R provides additional definitions and, notably, permits unregistered bank employees to receive more than nominal referral fees for referring institutional or high net worth customers under certain circumstances. These fees may also be contingent upon whether the referral results in a transaction. Details on this provision—including the definitions of "institutional" and "high net worth customers"—are provided in the attached table.

In addition, while Regulation R prohibits bank employees from being paid "incentive compensation" for their referrals, it will permit compensation paid under a bonus or similar plan that is paid on a discretionary basis and based on multiple factors.

### *Trust and Fiduciary Activities*

Section 3(a)(4)(B)(ii) of the Exchange Act provides that, under certain circumstances, banks may effect securities transactions in a trustee or fiduciary capacity without registering as a broker. Proposed Regulation R provides additional guidance on this exemption. While it still requires that banks be "chiefly compensated" by certain enumerated forms of compensation (relationship compensation), Regulation R greatly reduces the administrative burdens suggested in Regulation B.

Significantly, Regulation R provides that banks can demonstrate that they are chiefly compensated by relationship compensation on an account-by-account or bank-wide basis. To show compliance on an account-by-account basis, banks must demonstrate that the "relationship-total compensation percentage" for each trust or fiduciary account is greater than 50 percent.<sup>[vi]</sup> To show compliance on a bank-wide basis, banks must demonstrate that the "aggregate relationship-total compensation percentage" for their trust and fiduciary business as a whole is at least 70 percent.<sup>[vii]</sup>

In addition to permitting banks to calculate relationship compensation on a bank-wide basis, Regulation R also expands the definition of relationship compensation. Notably, 12b-1 fees received from mutual funds are included in the definition of relationship compensation.<sup>[viii]</sup>

### *Sweep Accounts*

Section 3(a)(4)(B)(v) of the Exchange Act permits banks, without registering as brokers, to "effect transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund." Proposed Regulation R defines "no-load," and, more importantly, provides an exemption for sweep programs that invest customer funds into money market accounts that do not meet the "no-load" definition.

### *Safekeeping and Custody*

Proposed Regulation R provides an exemption that allows banks to accept orders for securities transactions from employee benefit plan accounts, individual retirement plan accounts and other similar accounts. In addition, subject to certain limitations, banks will be permitted to accept orders for securities transactions from other custodial accounts on an accommodation basis. Both of these exemptions are discussed in more detail in the attached table.

### *Additional Proposals*

#### — Proposed Exemption for Regulation S Transactions with Non-US Persons

Proposed Rule 771 under Regulation R exempts banks from the definition of "broker" where banks execute certain types of agency transactions for non-US persons involving securities issued under Regulation S. Without being deemed a "broker," a bank could, as agent: (1) sell securities in compliance with Regulation S to purchasers outside the United States; (2) resell eligible securities after their initial sale to purchasers outside the United States if the bank reasonably believed the shares had initially been sold under Regulation S; or (3) resell an eligible security after its initial sale outside the United States on behalf of a registered broker-dealer or purchaser outside of the US, provided that the sale complies with Rule 904 under Regulation S if the sale is made prior to the expiration of the compliance period specified in Regulation S.

#### — Proposed Securities Lending Exemption

Under proposed Rule 772, a bank would be exempt from the definition of the term "broker" to the extent that, as agent, "it engages in or effects securities lending transactions, and any securities lending services in connection with such transaction" <sup>[ix]</sup> with or for a person or plan the bank reasonably believes to be: (1) a qualified investor; or (2) an employee benefit plan that owns and invests on a discretionary basis not less than \$25,000,000.

As a related matter, the Commission also issued an order exempting banks from the definition of "broker" to allow banks to engage in securities lending transactions as agent when banks do not have custody of the securities, or, if they do have custody, do not retain the securities for the entire period of the stock loan. <sup>[x]</sup> This exemption will no longer apply after the SEC and FRB adopt a set of final rules as instructed by the Regulatory Relief Act.

#### — Proposed Exemption for Way in Which Banks Effect Transaction in Investment Company Securities

Under proposed Rule 775, a bank that meets all of the conditions for an exemption or exception to

the definition of the term "broker" except section 3(a)(4)(C)(i) (which requires banks to direct trades to registered brokers or dealers) would not lose the exemption or exception if it effects transactions in securities issued by an open-end company that is neither traded on a national securities exchange nor through a national securities association or interdealer quotation system, provided certain other enumerated conditions are met.

- Proposed Temporary and Permanent Exemption for Contracts Entered into by Banks from Being Considered Void or Voidable

Proposed Rule 780(a) and (b) provides two exemptions for banks to liability under section 29 of the Exchange Act. These exemptions are designed to prevent contracts from becoming void or voidable under section 29 of the Exchange Act as a result of inadvertent bank failures.

- Extension of Time and Transition Period

Proposed Rule 781 would exempt banks from the definition of the term "broker" until the first day of their respective first fiscal years commencing after June 30, 2008. Note that on December 18, 2006, the Commission issued an order granting banks an exemption from compliance with the definition of the term "broker" until July 2, 2007.<sup>[xi]</sup>

For more information on this or other securities matters, contact:

[Martin E. Lybecker](#)

+1 202 663 6240

[martin.lybecker@wilmerhale.com](mailto:martin.lybecker@wilmerhale.com)

Cristie L. March

+1 202 663 6267

[cristie.march@wilmerhale.com](mailto:cristie.march@wilmerhale.com)

[Brian M. Johnson](#)

+1 202 663 6013

[brian.johnson2@wilmerhale.com](mailto:brian.johnson2@wilmerhale.com)

### Significant Differences Between Previously Proposed Regulation B and New Proposed Regulation R

Subject	Proposed Regulation B	Proposed Regulation R
<b>Networking Arrangements</b>		
<i>Defining "nominal" compensation</i>	Provided a narrower definition of "nominal one-time cash fee of a fixed dollar amount" to mean a	Rule 700(c) defines "nominal one-time cash fee of a fixed dollar amount" as a payment that does not exceed:

	<p>payment that does not exceed the greater of: (1) the employee's hourly rate of pay; (2) a flat \$25; or (3) \$15 in calendar-year 1999 dollars.</p>	<ul style="list-style-type: none"> <li>- (i) twice the average of the minimum and maximum hourly wages established by the bank for the current or prior year for the job family that includes the employee; or (ii) 1/1000<sup>th</sup> of the average of the minimum and maximum annual base salaries established by the bank for the current or prior year for the job family that includes the employee;</li> <li>- twice the employee's actual base hourly wage; <b>or</b></li> <li>- \$25, as adjusted in accordance with Rule 700(f).</li> </ul>
<i>Scope of permissible bonuses</i>	<p>Limited the extent to which bank employees could receive year-end bonuses that took referrals into account.</p>	<p>Addresses the scope of permissible bonuses in the definition of "incentive compensation" found in Rule 700(b). A bank could compensate employees under a bonus or similar plan as long as the discretionary payments were based on a variety of factors that are unrelated to securities transactions at the broker-dealer.</p>
<i>Referral fees for institutional and high net worth customers</i>	<p>Did not provide exceptions or exemptions for referral fees generated from referrals of institutional or other sophisticated customers.</p>	<p>Rule 701 permits a bank to pay an employee a contingent referral fee of more than a nominal amount for referring institutional or high net worth customers under certain circumstances.</p> <ul style="list-style-type: none"> <li>- Rule 701(d)(1) defines a <b>high net worth customer</b> as a natural person who, either individually or jointly with his or her spouse, has at least \$5 million in net worth excluding the primary residence and associated liabilities.</li> <li>- Rule 701(d)(2) defines an <b>institutional customer</b> as an entity that has at least \$10 million in investments or \$40 million in assets, or one that has \$25 million in assets and the bank employee refers it to the broker-dealer for investment banking services.</li> </ul> <p>Bank employees must meet certain requirements, and the bank and broker-dealer</p>

		must have a written agreement that, among other things, requires the broker-dealer to review the referred transactions for suitability.
<b>Trust and Fiduciary Activities</b>		
<i>Defining the "chiefly compensated" requirement</i>	Rule 721(a) would have required banks to assess the ratio of relationship compensation to sales compensation either account-by-account or by line of business. In the latter case, banks would have been required to show that each line of business they wished to qualify for the trust/fiduciary exceptions met or exceeded a 9-to-1 ratio of relationship-to-sales compensation in the trust and fiduciary department.	<p>Rules 721(a)(2) and (3) more flexibly allow banks to calculate the percentages of relationship compensation on an account-by-account or bank-wide basis, based on a two-year rolling average to allow for short-term fluctuations.</p> <ul style="list-style-type: none"> <li>- <b>Account-by-account:</b> Relationship compensation must be greater than 50% for each trust or fiduciary account.</li> <li>- <b>Bank-wide:</b> Relationship compensation must account for 70% or more of compensation received by trust and fiduciary departments.</li> </ul> <p>The rules set out parameters for calculating the relevant percentages. Notably, the rules assess relationship compensation as a percentage of <b>total</b>, and not sales, compensation.</p>
<i>Defining Relationship Compensation</i>	Took a narrow view of "relationship compensation," and, among other things, did not include 12b-1 fees in the definition of relationship compensation.	Expands the definition of "relationship compensation." Notably, Rule 721(a)(4)(iii)(A) includes 12b-1 fees paid by investment companies as relationship compensation.
<b>Sweep Accounts</b>		
<i>Scope of permissible sweep accounts</i>	Rule 740 under Regulation B provided definitions and conditions relevant to permissible sweep account activities.	<p>The definition of "no-load" in Regulation R closely tracks the proposed definition in Regulation B, but Rule 741 permits banks to sweep customer funds into money market funds that <b>do not</b> meet the "no-load" definition. To qualify:</p> <ul style="list-style-type: none"> <li>- banks will have to provide another product or service that would not itself require broker registration, <b>and</b></li> </ul>

		<ul style="list-style-type: none"> <li>- the provided securities must be: <ul style="list-style-type: none"> <li>• no-load, <b>or</b></li> <li>• not no-load (typically where fees are above 25 basis points) <b>but</b> the bank must not characterize them as no-load and also must provide customers with prospectuses for the securities.</li> </ul> </li> </ul>
<b>Custody and Safe Keeping</b>		
<i>Accepting orders for securities transactions from employee benefit and similar plans</i>	Because accepting orders to purchase or sell securities is considered a "core broker-dealer function," banks could not accept orders from employee benefit plans and similar plans except under the limited circumstance spelled out under then-proposed Rule 770. Then-proposed Rule 760 permitted banks to take orders from certain grandfathered accounts and qualified investors, subject to additional extensive conditions.	Rule 760(a) permits banks to accept orders for securities transactions from employee benefit plans, individual retirement and similar accounts under certain conditions. Bank employees may not receive compensation from the bank or executing broker-dealer that is based on whether a securities transaction is executed, or on the quantity, price or identity of the securities purchased or sold. In addition to other specific requirements, banks are prohibited from advertising that they accept orders from these plans except as part of advertising the other custodial or safekeeping services the bank provides to these accounts.
<i>Accepting orders on an accommodation basis</i>		<p>Rule 760(b)(1) will allow banks to accept orders from other custodial accounts on an accommodation basis under certain circumstances. In addition to other enumerated requirements, banks will have to:</p> <ul style="list-style-type: none"> <li>- limit employee compensation;</li> <li>- limit bank fees;</li> <li>- comply with advertising restrictions; <b>and</b></li> <li>- refrain from providing investment advice, research and related services.</li> </ul>

[i]Exch. Act Rel. No. 54946 (Dec. 18, 2006), 71 Fed. Reg. 77522 (Dec. 26, 2006) ("Proposing Release")

[ii\]](#) In a companion release to the Proposing Release, the SEC also proposes to make certain conforming changes and other amendments to its bank/dealer regulation, including the following: "(i) adopt a 'reasonable belief' exemption for riskless principal transactions with non-US persons pursuant to Regulation S; (ii) amend an existing exemption for banks' securities lending activities as conduit lenders; and (iii) conform a limited exemption from U.S. broker-dealer registration for foreign broker-dealers to amended definitions of 'broker' and 'dealer.'" *See* Exch. Act Rel. No. 54947 (Dec. 18, 2006), 71 Fed. Reg. 77550 (Dec. 26, 2006).

[iii\]](#) Exch. Act Rel. No. 44291 (May 11, 2001), 66 Fed. Reg. 27760 (May 18, 2001).

[iv\]](#) Exch. Act Rel. No. 49879 (June 17, 2004), 69 Fed. Reg. 39682 (June 30, 2004).

[v\]](#) Proposing Release at 77524. *See also* Exch. Act Section 3(a)(4)(B)(i)(VI).

[vi\]](#) Proposing Release at 77528.

[vii\]](#) *Id.*

[viii\]](#) Proposing Release at 77529.

[ix\]](#) Proposing Release at 77534.

[x\]](#) *See* 17 CFR 240.15a-11.

[xi\]](#) Exch. Act Rel. No. 54948 (Dec. 18, 2006), 71 Fed. Reg. 77557 (Dec. 26, 2006).