VMD LAW GROUP

Regulation R: The Bank Broker Rules
January 02, 2007

Approximately seven years after the passage of the Gramm-Leach-Bliley Act ("GLBA"), the Securities and Exchange Commission and the Federal Reserve Board have issued proposed rules to implement the bank broker provisions of the Securities Exchange Act of 1934. These rules permit banks to continue to perform certain securities activities without having to either register as a broker with the SEC or to "push-out" such activities to a registered broker. The proposed rules, formally codified in Regulation R, will be subject to a 90-day comment period upon publication in the Federal Register. To provide sufficient time to consider such comments, the SEC has extended the temporary exemption from broker registration for banks and thrifts through July 2, 2007.

Previously, the SEC had sole authority to implement the GLBA push-out provisions, and had attempted to do so on two separate occasions. These rulemaking efforts were unduly burdensome, administratively complex and would have required banks to push-out many securities activities to a broker-dealer. These rules were viewed as a thinly disguised effort by the SEC to regain some jurisdictional turf that was lost during the GLBA debate, and were strongly opposed by the banking industry. Congress sought to break this regulatory impasse in the recently enacted Regulatory Relief Act by requiring both the SEC and the Fed to jointly adopt a single set of rules to implement the bank broker exceptions.

The proposed rules represent a significant departure from the SEC's earlier rulemaking efforts, and would allow banks to continue to perform many traditional securities-related activities within the bank. Subject to the concerns noted below, the proposed rules generally strike a reasonable compromise between GLBA functional regulation and the continuation of traditional bank securities activities.

This article will briefly summarize the various bank broker exceptions set forth in Regulation R.

Networking Exception

The third-party networking exception would continue to allow unlicensed bank employees to earn a "nominal one-time cash fee of a fixed dollar amount" for referring retail clients to a registered broker-dealer if the payment of the referral fee is not "contingent on whether the referral results in a transaction."

A "nominal" referral fee is defined as a fee that does not exceed any of the following standards: (1) twice the average of the minimum and maximum hourly wage, or 1/1000th of the average of the minimum and maximum annual base salary, established by the bank for the current or prior year for the employee's job category or department; (2) twice the employee's actual base hourly wage; or (3) twenty-five dollars ($25), as adjusted for inflation every five years. Consistent with the statutory language, the proposal requires that all referral fees be paid in cash.

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The proposal expressly recognizes that a referral fee may be contingent upon whether a customer contacts or keeps an appointment with a broker; or meets any objective, customer qualification criteria. More importantly, the proposal would permit a bank to pay a contingent referral fee of more than a nominal amount for referring an institutional customer or high net worth customer to a broker. Specifically, the referral fee may be a dollar amount based on total assets or (in the case of a referral for investment banking services) a fixed percentage of revenues. An "institutional customer" is defined as any corporate entity that has at least $10 million in investments or $40 million in assets. A lower threshold is prescribed or institutional customers referred for investment banking services. A "high net worth customer" is defined to mean any natural person who, either individually or jointly with his or her spouse, has at least $5 million in net worth, excluding the primary residence.

A bank would be required to confirm the status of an institutional customer or high net worth customer (by, for example, obtaining a signed acknowledgment from the customer). The bank must also provide the customer with certain written disclosures about the employee's interest in the referral. Further, the bank must provide the broker with certain qualifying information regarding the employee.

In addition, the proposal requires the broker to perform a suitability or sophistication analysis of the securities transaction or the customer. The required analyses generally correspond to the suitability requirements currently applicable under NASD rules.

The networking provisions appear to be somewhat more burdensome than necessary. Although the alternative fee calculations do in fact provide greater flexibility in structuring compensation programs, most banks may opt for the simplicity of a standard amount. Further, the institutional and high net worth eligibility requirements are significantly more stringent than other SEC criteria used to determine investor suitability, and will significantly limit the number of referrals eligible for the payment of a contingent referral fee. Nevertheless, the flexible calculation methodology, together with the ability to pay contingent referral fees in a greater than nominal amount, will be important to the wealth management and capital market activities of banking organizations.

Trust and Fiduciary Activities Exception

A bank may, under certain conditions, continue to effect transactions in a trustee or fiduciary capacity without registering as a broker. To qualify for this exception, the bank must be "chiefly compensated" for such transactions on the basis of "relationship compensation," which includes an administration or annual fee; a fee based on the percentage of assets under management; a flat or capped per order processing fee that does not exceed execution cost, or any combination of such fees. Significantly, relationship compensation includes: 12b-1 fees, mutual fund service or account maintenance fees or other fees paid by an investment company based on a percentage of assets under management. Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities in

conjunction with advertising their other trust activities. Finally, the bank must direct the trade to a registered broker-dealer for execution.

A bank would meet the "chiefly compensated" test if the relationship compensation is more than 50% of total compensation for each trust or fiduciary account, as calculated over a rolling two-year period. Alternatively, the bank may satisfy this test if the average relationship compensation received from all trust and fiduciary accounts on a bank-wide basis over a rolling two-year period is greater than 70% of total compensation from such accounts.

he proposed rules also would permit a bank to exclude certain short-term accounts, accounts acquired as part of a business combination or asset acquisition or (in alternative years) a de minimis number of accounts.

It's not clear why, for purposes of the "chiefly compensated" standard, the threshold for the bank-wide compensation test is different than the account-by-account test. Likewise, banks should be permitted to utilize the de minimis standard in consecutive years (in lieu of every other year). Banks who fail to meet the bank-wide compensation test face significantly more onerous consequences than banks who fail the account-by-account test.

Sweep Accounts and Transactions in Money Market Funds

A bank is also exempt from broker registration to the extent that it invests customer deposits in any no-load money market mutual fund as part of a sweep account program. Consistent with NASD rules, the proposed rules prohibit a fund from describing itself as "no-load" if its annual sales charges and related expenses exceed 25 basis points. The proposal further clarifies the types of charges that are not deemed to be sales charges and related expenses.
A bank may also effect transactions in money market funds that would not be considered no-load as long as some other banking relationship exists and the bank delivers a prospectus to the customer no later than the time the customer authorizes the transaction.

This proposal accommodates those banks which offer money market funds which are not no-load (whether pursuant to a sweep arrangement or otherwise).

Safekeeping and Custody Exception

The proposal would exempt from registration certain bank custody and safekeeping activities. Specifically, the proposed custody exemption would allow banks to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as a custodian as long as the bank does not act in a trustee or fiduciary capacity; directs such trades to a registered broker-dealer for execution and does not act as a carrying broker for any broker-dealer. A bank relying on the exemption may not advertise that it accepts orders for securities transactions for such accounts, except as part of advertising the other custodial or safekeeping services provided by the bank.

In addition, the exemption allows banks to accept orders for securities transactions on an accommodation basis from other types of custodial accounts, subject to more stringent

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restrictions on advertising, compensation and the provision of investment advice.

This exemption is a significant improvement over previous proposals, but the additional limitations and restrictions pertaining solely to accommodation trades may significantly impact this activity.

Other Proposed Exemptions

Proposed Regulation R also:

- exempts banks from broker registration for agency transactions in Regulation S securities with non-U.S. persons;
- permits banks to engage in non-custodial securities lending transactions as agent for any person the bank reasonably believes is a qualified investor (as defined in the Exchange Act) or any employee benefit plan that owns and invests on a discretionary basis at least $25 million in investments;
- permits banks to directly effect mutual fund transactions with the National Securities Clearing Corporation's Mutual Fund Services (Fund/SERV) or the fund transfer agent;
- exempts banks from rescission liability for an 18-months period after the effective date of the final rule, if the bank has acted in good faith, adopted reasonable policies and procedures, and any violation of broker registration requirements did not result in significant harm or financial loss to the person seeking to void the contract; and
- continues the general bank exemption from the definition of "broker" under the Exchange Act until the first day of a bank's first fiscal year commencing after June 30, 2008, in order to allow for the changes to bank compliance programs necessitated by the rules.

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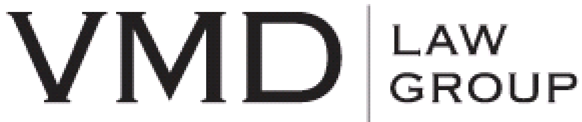

Regulatory Relief Act of 2006 Eases Compliance Burden
November 17, 2006

The Financial Services Regulatory Relief Act of 2006 (Relief Act) was enacted into law on October 13, 2006. The Relief Act is the first such measure passed in a decade and provides long sought relief from various regulatory constraints and compliance burdens imposed on the banking industry. Although the final bill is not as comprehensive as some earlier versions, it does provide some meaningful relief to commercial banks, savings associations and credit unions, large and small. The more important provisions of the Relief Act are noted below.

Federal Reserve Act Amendments

Section 201 of the Relief Act authorizes the payment of interest on funds held at a Federal Reserve Bank. The Federal Reserve Board (FRB) is permitted to choose the interest rate it pays on reserve balances, although the maximum rate can not surpass short-term interest rates.

Section 202 allows the FRB to determine the reserve ratio that depository institutions are required to maintain against their transaction accounts, including a zero percent ratio when appropriate.

Section 203 delays the implementation of these changes to October 1, 2011 due to budgetary concerns.

Thrift Parity under Securities Laws

Thrifts will now have parity with commercial banks under the Investment Advisers Act of 1940 (Advisers Act) and under the Securities Exchange Act of 1934 (Exchange Act). Section 401 of the Relief Act exempts federal savings associations from investment adviser and broker-dealer registration requirements to the same extent as banks. Like banks, thrifts will still have to register when advising registered mutual funds under the Advisers Act. They will also have the same exemptions as banks under the broker-dealer registration provisions of the Exchange Act (as more fully discussed below).

Miscellaneous Thrift Provisions

Section 402 eliminates the current cap on the valuation of purchased mortgage servicing rights held by thrifts. Savings associations may now, under certain circumstances, value purchased mortgage servicing rights up to 100 percent of fair market value.

For clarification purposes, Section 403 expressly states that when determining federal court diversity jurisdiction, thrifts are now only citizens of the State in which their home office is located.

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