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SEC and Federal Reserve Issue Final Rule on Bank Brokers
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Almost eight years after the passage of the Gramm-Leach-Bliley Act (GLBA), the Securities and Exchange Commission (SEC) and the Federal Reserve Board (Fed) have enacted new rules which finally implement the bank broker provisions of GLBA.

These rules, which are codified in Regulation R, 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. Compliance with Regulation R must occur on the first day of a bank's fiscal year commencing after September 30, 2008, in order to allow banking organizations to make any necessary changes in their systems and compliance programs.

The SEC and the Fed had previously issued proposed rules for comment in December 2006.
The final rules are substantively similar to the proposed rules, but contain several modifications to make them less burdensome, in response to comments received from the banking industry.

As a whole, the final rules represent an earnest regulatory effort to accommodate the current business practices of banking organizations without sacrificing investor protections. The broker exemptions provided by Regulation R also are available to savings associations, but not to credit unions. As required by GLBA, the federal banking agencies will develop recordkeeping requirements to enable banks to demonstrate compliance with Regulation R.

Networking Exception

The third-party networking exception continues to allow banks to enter into a contractual arrangement with a registered broker-dealer to offer brokerage services to bank customers. This exception does not address the type of compensation that a bank may receive under the arrangement, and prohibits the payment of incentive compensation to unlicensed employees for brokerage transactions. Unlicensed bank employees may, however, continue 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 1/1000 of the average of the minimum and maximum annual base salary, established by the bank for the current or prior year for the job family that includes the employee; (2) twice the employee's actual base hourly wage or 1/1000 of the employee's actual annual base salary; or (3) $25, as adjusted for inflation every five years.

Consistent with the statutory language, the proposal requires that all referral fees be paid

TEL 724.935.6789 CELL 412.760.6246 FAX 724.935.6790 DIRECT 724.935.2700
vdb@vmdlegal.com
4500 Brooktree Road, Suite 103 Wexford, Pennsylvania 15090
www.vmdlegal.com

in cash. In paying nominal referral fees, banks also may use cash-equivalent "points," paid at least quarterly. The cash amount that an employee will receive under a points system may not vary based on whether an employee makes a specified number or type of referral during the period. A supervisory employee may receive a separate, nominal one-time cash fee for a referral made by another individual supervised by the employee only if the supervisory employee personally participated in the referral.

The rule 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, but may not be contingent on whether the customer opens an account. In addition, the rule also excludes certain types of bonuses from the ban on paying "incentive compensation" to unlicensed employees.

Banks may pay bonuses under discretionary, multi-factor bonus programs which include multiple and significant factors or variables that are not related to the securities transactions at the broker-dealer and any referral made by the employee or any other person is not a factor or variable under the program. Alternatively, banks may pay bonuses under programs that are based on the overall profitability or revenues of the bank or any affiliate, or any department of a bank or affiliate. Profits or revenues from a broker-dealer affiliate may be included if the bonus plan meets the same criteria noted above with respect to discretionary, multi-factor bonus programs.

The rule permits a bank to pay a contingent referral fee of more than a nominal amount for referring an institutional customer or a high net worth customer to a broker-dealer pursuant to a written networking agreement. Specifically, the referral fee may be a dollar amount based on total assets or other criteria which is not transaction-based. In the case of a referral for investment banking services, the fee may be based on a fixed percentage of revenues. According to the SEC and Fed, the revenue thresholds used in defining an institutional customer are somewhat lower than the asset thresholds previously proposed.

In addition, any company controlled by an institutional customer will itself be considered an institutional customer. An "institutional customer" is defined as any corporate entity that has at least $10 million in investments, $20 million in revenues or $15 million in revenues in the case of a referral for investment banking services. A "high net worth customer" is defined to mean any 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 must have a reasonable basis to believe that the customer is an institutional customer or high net worth customer before the time specified in the rule (for example: by obtaining a signed acknowledgment from the customer). The bank also must provide the customer with certain disclosures about the employee's interest in the referral. These disclosures may be provided in writing at or prior to the time of referral or orally, if either the bank or the broker-dealer subsequently provide written disclosures. Further, the bank must provide the broker with certain

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qualifying information regarding the employee.

The broker must perform a suitability analysis when the referral fee is contingent and a suitability or sophistication analysis for other referrals (i.e., when the fee is higher than nominal but not contingent.) The required analyses generally correspond to the suitability requirements currently applicable under FINRA rules. The broker-dealer must notify the customer if the applicable suitability or sophistication standard is not met.

Although the alternative fee calculations provide greater flexibility in structuring compensation programs, most banks (and particularly most smaller banks) will likely opt for the simplicity of a standard amount. The institutional and high net worth eligibility requirements continue to be significantly more stringent than SEC investor eligibility criteria used for sales purposes, and will significantly limit the number of referrals eligible for the payment of a contingent, higher-than-nominal referral fee. Nevertheless, these improvements will be important to the wealth management and capital market activities of banking organizations.

Trust and Fiduciary Activities Exception

This exception permits a bank to complete securities transactions in a trustee or fiduciary capacity if it is "chiefly compensated" for such transactions on the basis of "relationship compensation." This compensation 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. Relationship compensation includes: 12b-1 fees, mutual fund service or account maintenance fees or other fees paid by an investment company or other service provider 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 complete 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 percent 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 percent of total compensation from such accounts.

The rule also permits a bank to exclude certain short-term accounts, accounts acquired as part of a business combination or asset acquisition, accounts held at certain foreign branches or (in alternative years) a de minimis number of accounts.

The final rule contains additional examples of administration fees, annual fees and assets under management fees that are considered relationship compensation, but continues to require a higher compensation threshold for the bank-wide test than for the account-by-account test. The SEC attempts to justify this discrepancy on the grounds that there is a "loss of particularity when the chiefly compensated test is implemented and

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monitored on a bank-wide basis, rather than on an account-by-account basis."

Sweep Accounts and Transactions in Money Market Funds

A bank also is exempt from broker registration to the extent that it invests customer deposits in a no-load money market mutual fund as part of its or another bank's 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 rule further clarifies the types of charges that are not deemed to be sales charges and related expenses.

A bank also may complete transactions in money market funds that would not be considered no-load as long as the bank delivers a prospectus to the customer no later than the time the customer authorizes the transaction.

Issue – This rule 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 rule exempts from registration certain bank custody and safekeeping activities. Specifically, the custody exemption allows 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 restrictions on advertising, compensation, and the provision of investment advice.
The rule also permits a bank to rely on these provisions when it acts as a directed trustee, and extends the exemption to sub-custodians and non-fiduciary administrators and record keepers for an employee benefit plan for which another bank acts as custodian.

Other Proposed Exemptions

Regulation R also:

- exempts banks from broker registration for agency transactions in Regulation S securities with non-U.S. persons or registered broker-dealers
- permits banks to engage in non-custodial securities lending transactions (and related services) 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 complete transactions in mutual funds, variable annuities and variable life insurance

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policies through the National Securities Clearing Corporation's Mutual Fund Services (Fund/SERV), directly with transfer agent or directly with an insurance company or separate account that is excluded from the definition of transfer agent
- permits banks to complete transactions in the securities of a company for the company's employee benefit plans and participants as long as certain conditions are met
- 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 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.