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ClientAdvisory

# SEC Proposes Regulation R to Implement Bank Broker Provisions of Gramm-Leach-Bliley Act

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## I. Introduction

The Securities and Exchange Commission ("SEC") has issued proposed rules[1] in conjunction with the Board of Governors of the Federal Reserve System ("Board") that would implement and clarify certain exceptions for banks from the definition of "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act"). As a matter of background, the bank broker exceptions, created by the Gramm-Leach-Bliley Act of 1999 ("GLBA"), replaced the blanket exclusion to the definition of "broker" that banks previously enjoyed. Among other things, GLBA amended several federal statutes regulating the activities of banks, changed the way in which supervisory responsibilities over the banking and securities industries are allocated, and eliminated many of the barriers between the banking and securities industries created by the Banking Act of 1933, more commonly known as the Glass-Steagall Act.

Proposed Regulation R seeks to change the 2001 SEC interim final rules and 2004 proposed Regulation B, both of which were criticized by the banking industry and members of Congress as inadequately implementing the provisions of GLBA. If Regulation R is adopted, Regulation B will be officially withdrawn, and *banks will, subject to the rule, be able to compete for business with the securities industry without having to register as a broker or dealer.*

Section 3(a)(4)(B) of the Exchange Act provides eleven conditional exceptions to the definition of "broker" for banks engaging in certain securities activities. The proposed rules, as detailed below, affect securities activities in connection with four of the eleven exceptions: (1) third-party networking arrangements, (2) trust and fiduciary activities, (3) sweep activities, and (4) safekeeping and custody.

## II. Third-Party Networking Arrangements

The third-party networking exception in Exchange Act Section 3(a)(4)(B)(i) allows a bank to avoid "broker" status where it enters into a written agreement with a registered broker-dealer under which the broker-dealer offers its services to bank customers (the "Networking Exception"). Under the Networking Exception, a bank employee cannot receive "incentive compensation" unless such employee is an associated person of the broker-dealer. However, unregistered bank employees may receive referral compensation if such compensation is "a nominal one-time cash fee of a fixed dollar amount," and (2) payment of the fee is not "contingent on whether the referral results in a transaction." The proposed rules, some of the details of which follow, seek to (1) clarify ambiguity by defining certain of the cited terms, and (2) permit referral fees of more than a "nominal" amount where a bank employee refers an institutional or high net worth customer.

### *A. Proposed Definition of "Nominal One-Time Cash Fee of a Fixed Dollar Amount"*

The proposed rules define the term "*nominal* one-time cash fee of a fixed dollar amount" as a cash payment for a referral in an amount that meets any one of three alternative standards for referral fees that are small in relation to the employee's

[1] Securities Exchange Act Release No. 54946 (Dec. 13, 2006).

overall compensation, and therefore do not provide incentive for an employee to sell securities to bank customers. Under these alternatives, the referral fee would be considered "nominal" if:

- it does not exceed twice the average of the minimum and maximum hourly wage, or in the case of a salaried employee, 1/1000 of annual base salary, established by the bank for the current or prior year for the "job family" (as defined in the proposal) that includes the relevant employee;
- it does not exceed twice the employee's actual base hourly wage; or
- the payment does not exceed $25.

### *B. Proposed Definition of "Contingent on Whether the Referral Results in a Transaction"*

The proposed rules would not permit a referral fee to be paid when "contingent on whether the referral results in a transaction." Such a contingency is generally deemed to exist when payment of the fee depends on whether the referral results in a purchase or sale of a security or on whether an account is opened with a broker or dealer. However, the proposed rules permit referral fees contingent on whether a customer (1) contacts or keeps an appointment with a broker or dealer as a result of the referral, or (2) meets any objective qualification criteria established by the bank, such as minimum assets, income, or net worth.

### *C. Proposed Definition of "Incentive Compensation"*

The proposed rules also would clarify that "incentive compensation" does not include compensation paid by a bank under a bonus plan that is discretionary and based on multiple factors, and would allow banks to consider as one of the factors the profitability of the broker-dealer.

### *D. Proposed Exemption for Payment of More than a Nominal Fee for Referring Institutional or High Net Worth Customers*

The proposed rules would permit a bank to pay an unregistered employee a contingent fee of more than a nominal amount for referrals of institutional or high net worth customers. Among other requirements, a bank must:

- Determine that a non-natural person meets the definition of an "institutional customer," which means any corporation, partnership, or other non-natural person with at least $10 million in investments or $40 million in assets, or with $25 million in assets if the referral is for "investment banking services," as defined in the proposal;
- Determine that a natural person is a "high net worth customer," defined as any natural person who, either individually or jointly with spouse, has at least $5 million in net worth (excluding primary residence and associated liabilities);
- Disclose to institutional and high net worth customers, in writing, and prior to, or at the time of referral, certain information regarding the employee's interest in the referral; and
- Provide certain disclosures in the written agreement between the bank and broker-dealer, including, among other requirements, that the broker-dealer perform suitability and/or sophistication analysis of customers.

Importantly, a bank that has reasonable policies and procedures in place to comply with these requirements, acts in good faith, and acts promptly to remedy any deficiency, would not lose its exception to the definition of "broker" under Section 3(a)(4) solely because it fails in a particular instance, to provide the required disclosures or to determine that a customer is an institutional or high net worth customer.

## III. Trust and Fiduciary Activities

The Trust Activities Exception in Exchange Act Section 3(a)(4)(B)(ii) permits a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without registering as a broker. To qualify, the bank must, among other requirements, (1) be "chiefly compensated" for such transactions on the basis of an annual fee, a percentage of assets under management ("AUM"), or a flat or capped per order processing fee that does not exceed the cost to the bank for executing the transaction (collectively referred to in the proposed rules as "relationship compensation"), and (2) avoid public solicitation of brokerage business. Important details are presented below:

### *A. "Chiefly Compensated" Test – Two Approaches*

The proposed rules provide two means for determining whether a bank has met the "chiefly compensated" standard. Under the account-by-account approach, the chiefly compensated standard would be met for an account where the percentage of "relationship compensation" (as defined above) exceeds 50% of total compensation. Under the bank-wide method, the "chiefly compensated" test would be satisfied if the "relationship compensation" for the bank's trust and fiduciary business as a whole were at least 70% of total compensation.

Proposed Regulation R includes two changes that will likely allow a greater number of banks to rely on the bank-wide methodology. In the first instance, both approaches use a new two-year rolling average to allow for short term fluctuations that might otherwise cause a bank to fall out of compliance. Second, Rule 12b-1 fees from mutual funds, previously considered "sales compensation," are now considered "relationship compensation."

### *B. Exemptions for Special Accounts, Transferred Accounts, and a De Minimis Number of Accounts*

The proposed rules would allow a bank to exclude certain types of accounts for purposes of determining compliance with the "chiefly compensated" tests described above. With respect to both tests, a bank would be able to exclude any trust account open for less than three months (for the relevant year) and any trust account acquired from another person (e.g., by merger or consolidation) for up to 12 months after acquisition. Regarding the account-by-account approach:

- A bank may transfer a trust account that fails to meet the "chiefly compensated" test within three months of the end of the relevant year, to a registered broker-dealer or another unaffiliated entity that is not required to register as a broker-dealer; and
- A bank may exclude a small number of trust accounts, not to exceed the lesser of one percent of the total number of trust accounts held by the bank, or 500 accounts.

## IV. Sweep Accounts

Exchange Act Section 3(a)(4)(B)(v) would except a bank from the definition of a "broker" in connection with transactions for the investment or reinvestment of deposit funds into any money market fund registered under the Investment Company Act of 1940, provided that the fund is not subject to a sales charge or deferred sales charge and does not charge sales or shareholder service expenses of more than .0025 of average net assets annually. The proposal provides a list of charges that would not be subject to this limitation.

The proposal would also allow banks, without registering, to effect transactions for customers in securities issued by a money market fund. To qualify, the bank must provide another product or service, the provision of which by itself, would not require the bank to register as a broker or dealer under Section 15(a) of the Exchange Act. In addition, the class or series of money market fund securities sold by the bank would have to be no-load, or if not, the bank would have to provide a prospectus to the customer.

## V. Safekeeping and Custody

Section 3(a)(4)(B)(viii) of the Exchange Act excepts a bank from the definition of "broker" in conjunction with certain order-taking activities in connection with its safekeeping and custody functions. The proposed rules would permit banks to effect securities transactions for employee benefit plans and individual retirement accounts or similar accounts for which the bank acts as custodian. The proposed rule would place restrictions on employee compensation and on advertising of such brokerage services.

Banks also would be permitted to accept securities orders on an accommodation basis for other custodial accounts (in addition to employee benefit plans and individual retirement accounts), subject to conditions designed to prevent a bank from operating a securities broker out of its custody department.

## VI. Comment Period and Effective Date

Comments are due on or before March 26, 2007, and may be made by email or by paper to the addresses provided in the proposing release.

The SEC has extended the temporary exclusion of banks from the definition of "broker" until July 2, 2007. If adopted, Regulation R would become effective on the first day of the bank's first fiscal year beginning after June 30, 2008.
The proposing release can be found at http://www.sec.gov/rules/proposed/2006/34-54946fr.pdf

## We Can Help

If you would like to discuss further the proposed rules and their implications from a banking perspective, please contact:

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