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Regulation R: Exceptions for Banks from the Definition of "Broker"

On September 24, 2007, the Securities and Exchange Commission ("Commission") and the Board of Governors of the Federal Reserve System adopted final rules intended to implement the bank-broker provisions of the Gramm-Leach-Bliley Act of 1999 ("GLBA").[1] The purpose of these final rules, codified as Regulation R, is to clarify certain definitions of the GLBA, and thereby further the GLBA's stated purpose of encouraging banks to offer a wide array of services at lower prices.[2] Also on September 24, 2007, the Commission adopted rules under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which rules were intended to complement the provisions of Regulation R.[3] Banks are exempt from complying with the rules until the first day of the banks' fiscal years that commence after September 30, 2008.[4]

I. Background

Prior to the GLBA, banks were generally excluded from the definition of a "broker" under the Exchange Act, and, therefore, did not have to register with the Commission as broker-dealers. The GLBA replaced that general exclusion with exceptions for certain traditional banking activities. Enough ambiguity existed in the scope of these excepted activities, and therefore the definition of "broker," to prompt Commission rulemaking. In May 2001, the Commission issued "interim final rules,"

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1 Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Rel. No. 34-56501; File No. S7-22-06 (Sept. 24, 2007), *available at* http://www.sec.gov/rules/final/2007/34-56501.pdf (the "Adopting Release"). The first part of the Adopting Release discusses the rationale behind the new rules. The text of Regulation R begins at page 172 of the Adopting Release.

2 *See* Gramm-Leach-Bliley Act, Pub. L. 106-102, enacted November 12, 1999, codified at 15 U.S.C. § 6801 *et seq.* (stating that its purpose is "to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes").

3 Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules, Release No. 34-56502; File No. S7-23-06 (September 24, 2007) *available at* http://www.sec.gov/rules/final/2007/34-56502.pdf

4 Adopting Release at 2.

designed to clarify the GLBA.[5] The Commission's proposal met with criticism from the banking industry and federal banking regulators, which resulted in repeated postponement of the adoption of definitive rules.[6] In June 2004, the Commission offered Regulation B for comment.[7] Proposed Regulation B also met with a barrage of criticism and therefore was not adopted.[8] In the absence of any binding rules, banks continued to act as they had before the GLBA, offering securities while enjoying exemption from Exchange Act registration.[9]

Owing to the difficulty in creating rules acceptable to the banking industry and regulators, Congress passed the Financial Services Regulatory Relief Act of 2006 ("FSRRA"). This required the Commission and the Federal Reserve Board "to jointly issue a proposed single set of rules or regulations to define the term 'broker'" as defined in the Exchange Act within 180 days.[10]

In response to this ultimatum, the Commission and the Federal Reserve Board proposed Regulation R in December 2006. A brief summary of the final rules follows.

II. Summary

Key provisions[11] of Regulation R as adopted include:

- Clarifications of the networking exception. The networking exception prohibited bank employees from receiving incentive compensation for referrals to broker-dealers other than via a nominal fee. Regulation R defines circumstances under which bank employees may receive compensation for referring bank customers to broker-dealers.

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5 Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Rel. No. 34-44291; File No. S7-12-01 (May 11, 2001), *available at* http://www.sec.gov/rules/final/34-44291.htm

6 *See* SEC, Summary of Commenters' Remarks on Securities Exchange Act No. 44291, http://www.sec.gov/rules/extra/s71201summary.htm (last modified June 2, 2004). There were six occasions when the Commission extended the temporary exemption for banks, giving such banks the continued ability to offer securities without the need to register, as had been the practice before the GLBA. *See* SEC, Final Rules Archive, http://www.sec.gov/rules/final/finalarchive/finalarchive2001.shtml (last modified June 28, 2007).

7 Regulation B, Rel. No. 34-50056; File No. S7-26-04 (June 17, 2004), *available at* http://www.sec.gov/rules/proposed/34-50056.pdf.

8 *See, e.g.*, Joint letter from Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, to Jonathan Katz, Secretary of the SEC (Oct. 8, 2004) (noting that the "Proposed Rules reflect a profound misinterpretation of the language and purposes of the 'broker' exceptions in the [GLBA]"), *available at* http://www.sec.gov/rules/proposed/s72604/frb100804.pdf.

9 *See, e.g.*, Order Extending Temporary Exemption of Banks, Savings Associations, and Savings Banks from the Definition of "Broker" under Section 3(a)(4) of the Securities Exchange Act of 1934, Rel. No. 34-52504; File No. S7-12-01 (Sept. 9, 2005), *available at* http://www.sec.gov/rules/exorders/34-52405.pdf

10 *See* FSRRA § 101(a)(2) (2006). The FSRRA also requires consultation with other federal banking agencies. *Id.* § 101(b).

11 This list summarizes the key rules adopted. For the complete text of the rules, see the Adopting Release at 172 and following.

  - Under the new rules, incentive compensation does not include discretionary compensation in the form of bonuses or wages, so long as the bonuses are based on "multiple factors or variables" and neither bonuses nor wages are related to referrals. Bonus programs fall under a safe harbor if the plan is based on the profitability or revenue of the bank or an affiliate. Additionally, the bonus may be based on the profitability of a broker-dealer if it is only one factor of many and individual referrals are not factors.

  - The new rules define "nominal" as a payment that is less than or equal to any of the following: (1) $25 (adjusted for inflation); or (2) twice the employee's actual base hourly wage; or (3) twice the average hourly wage established by the bank for the "job family" that includes the employee; or (4) 1/1000th of the average annual salary for the employee's job.

- Permitting banks to pay higher than nominal fees for referrals of "institutional customers" and "high net worth customers," as long as the bank and broker-dealer meet certain criteria to protect these customers.

  - An institutional customer is a non-natural person with: (1) $10 million in investments; (2) $20 million in revenues; or (3) $15 million in revenues if the customer is referred to the broker-dealer for investment banking services.

  - High net worth customers are those with over $5 million in assets, with some exceptions.

  - These figures will be adjusted for inflation.

- Permitting banks to perform securities transactions in a trustee or fiduciary capacity without a requirement to register as a broker-dealer if the banks are "chiefly compensated" for such transactions, consistent with fiduciary principles and standards, on the basis of: (1) an administration or annual fee; (2) a percentage of assets under management; (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions; or (4) any combination of such fees. The rules also provide that a bank would also meet the "chiefly compensated" condition in the trust and fiduciary exception with respect to the bank's relationship compensation attributable to each trust or fiduciary account if: (1) the compensation from the relationship (as determined by a formula) is greater than 50 percent of the total compensation attributable to the account over the last two years (account-by-account approach); or (2) the compensation from the relationship is greater than 70 percent of the total compensation attributable to the bank's trust and fiduciary business over the last two years (bank-wide approach).

- Allowing banks to sweep deposits into no-load, money market funds without registering as brokers. Furthermore, banks may sweep deposits into funds that are not no-load, as long as the bank provides customers with a prospectus showing the fund's fees.

- Permitting banks to take orders for securities transactions from employee benefit plan accounts or retirement accounts if the bank is a custodian over such accounts, without requiring the banks to register as broker-dealers. For such services, no bank employee may receive compensation from the bank or executing broker. Banks may not advertise such services, provide investment advice, or make recommendations regarding securities to the custody accounts.

- Permitting banks to effect transactions in mutual funds and insurance products that are not traded on a national securities exchange, through a national securities association, or through an interdealer quotation system.

- Permitting banks to effect transactions in securities for a company directly with a transfer agent acting for the company if: (1) no commission is charged; (2) the transaction is conducted solely for the benefit of an employee benefit plan; (3) the security must be obtained directly from the company or the company's employee benefit plan; and (4) the security must be transferred only to the company or an employee benefit plan.

- Allowing banks to perform transactions involving Regulation S[12] securities, provided the purchaser is not in the United States or the banks have a reasonable belief that the securities were initially sold in compliance with Regulation S.

- Preventing existing bank contracts from becoming void or voidable under Exchange Act Section 29(b).[13] If the bank has acted in good faith, had reasonable policies in place to comply with bank-broker rules, and any actual violation did not result in any significant harm, financial loss, or cost to the person seeking to void the contract, the bank has a permanent exemption from Section 29(b).

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jon Mark at (212) 701-3100 or jmark@cahill.com.

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12 Regulation S defines when securities offered and sold outside the United States come to rest so that a distribution of securities would no longer be subject to the registration requirements of Section 5 of the Securities Act of 1933.

13 Section 29(b) voids any contract made in violation of the Exchange Act or any rule or regulation adopted pursuant to the Exchange Act, with certain exceptions.