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SECURITIES LAW

Proposed rules divide pie among bankers, brokers

Regulation R would give guidance to banks offering broker services.

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HISTORICALLY, THE Securities Exchange Act of 1934 offered a blanket exemption from its registration requirements for banks engaged in securities brokerage activities. In reliance on this exemption, banks have for many years offered a diverse range of securities brokerage services to their clients.

The Gramm-Leach-Bliley Act of 1999 (GLBA) eliminated this blanket exemption and replaced it with a scheme of "functional regulation," which requires that similar activities should be regulated by the same regulator. Therefore, securities activities should be supervised by the U.S. Securities and Exchange Commission (SEC), and banking activities by the bank regulators.

Notwithstanding the desire for functional regulation, many securities activities traditionally performed by banks had become intimate parts of the banking services provided to their clients, and banks desired to continue to offer them. Section 202 of GLBA recognized this distinction by providing certain limited exemptions from the definition of "broker" in § 3(a)(4) of the exchange act directed at traditional banking activities. In December 2006, the SEC and the board of governors of the Federal Reserve System voted to release joint proposed rules, Regulation

R, to implement the "broker" exceptions for banks. See 71 Fed. Reg. 77521-77550 (Dec. 26, 2006).

Following formal adoption of Regulation R (which will be required for banks on the first day of a bank's fiscal year following June 30, 2008), securities activities performed by banks within the exemptions from the definition of "broker" will be considered "banking" activities, in that they will be done by banks outside the scope of the securities laws and functionally regulated by bank regulators.

Proposed Regulation R offers interpretive guidance for exemptions listed in § 3(a)(4)(B) of the exchange act in four areas: networking, trust and fiduciary activities, sweep accounts and safekeeping and custody arrangements.

Regarding the first, networking, § 201 of GLBA permits a bank, without being considered a broker, to enter into certain contractual arrangements under which the broker provides securities brokerage services to bank customers, and a bank may pay to the broker a "nominal one-time cash fee of a fixed dollar amount."

The new proposed definition of "nominal one-time cash fee of a fixed dollar amount" includes three methods by which a bank can compensate its employees for referrals. Under the first, a fee may not exceed either twice the average of the minimum and maximum hourly wage or 1/1,000th of the average of the minimum and maximum annual base salary of the employee (or a similar employee). Under the second method, a fee may not exceed the employee's actual base hourly wage. Under the third, a fee may not exceed \$25, which will be adjusted for inflation every five years.

A referral fee may not be contingent on the

successful completion by the broker-dealer of a transaction. Proposed Regulation R defines "contingent" to cover fees whose payment is "dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker or dealer; whether the referral results in a transaction involving a particular type of security; or whether the referral results in multiple securities transactions." Fees may be contingent on whether a customer either actually meets a broker-dealer as a result of a referral, or whether the client satisfies the requirements of the bank or a broker-dealer for customers.

The Federal Reserve and SEC worked out an arrangement.

Incentive compensation, which is prohibited as part of a referral fee under the networking exemption, is defined as "compensation that is intended to encourage a bank employee to refer potential customers to a broker or dealer or give a bank employee an interest in the success" of a transaction.

Banks can pay any fees to employees in connection with a referral of a high net worth or institutional customer. "Institutional customer" is defined as any corporation, partnership, limited liability corporation, trust or other non-natural person that has at least \$10 million in investments or \$40 million in assets. However, an institutional customer may be referred solely for investment banking services if it has at least \$25 million in assets. "High net worth customer" is any person having at least \$5 million in net worth, excluding a primary residence.

The bank must have in place a written agreement with the broker to which it is referring customers. The written agreement must require the broker to perform "a suitability or sophistication analysis of a securities transaction

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or the customer being referred.” 71 Fed. Reg. at 77527. For contingent fee arrangements, a suitability analysis must be performed for any securities transaction that triggers a portion of the contingent fee. For noncontingent fee arrangements, either a “sophistication” or a “suitability” analysis must be performed before the fee may be paid. Finally, certain other conditions apply to the bank and its employees.

Trust and fiduciary activities

Section 201 of the GLBA permits a bank, without being considered a broker, to effect securities transactions in a trustee or fiduciary capacity for bank customers. Exchange act § 3(a)(4)(B)(ii). Such transactions must be effected from a trust department. The bank may be “chiefly compensated” for such transactions on the basis of an administrative or annual fee; a percentage of assets under management; a flat or capped per-order fee not to exceed the bank’s execution cost; or any combination of these fees (collectively, these are called “relationship compensation”).

Proposed Regulation R provides that a bank meets the chiefly compensated test if the “relationship-total compensation percentage” is more than 50%, calculated by dividing the relationship compensation attributable to the account during each of the two prior years by the total compensation attributable to the customer account over the prior two years; translating the quotient for each of the two years into a percentage; and averaging the percentages. Alternatively, a bank may calculate the compensation it receives from all of its trust and fiduciary accounts on a bankwide basis as long as the “aggregate relationship-total compensation percentage” of the bank’s trust and fiduciary business is at least 70%.

To calculate either of the above percentages, a bank must determine the relationship compensation attributable to its trust or fiduciary accounts. Fees paid by an investment company under 17 C.F.R. 270.12(b)(1) may be included by the bank. Regarding sweep accounts, GLBA § 201 permits a bank, without registering as a broker, to effect transactions as part of investing deposit funds into any no-load, open-end management registered investment company that holds itself out as a money market fund. Exchange act § 3(a)(4)(B)(v).

Proposed Regulation R includes a new exemption to permit a bank to effect transactions in securities issued by a money market fund.

Section 201 of GLBA permits a bank, without registering as a broker, as part of custodial or safekeeping services, to provide safekeeping services with respect to securities; facilitate the transfer of funds or securities in the clearance

and settlement of securities; effect securities lending or borrowing transactions; hold securities pledged by a customer or subject to a purchase or resale agreement if the bank maintains records separately identifying the securities and the customer; and serve as a custodian or provide similar services to any benefit plan. Exchange act § 3(a)(4)(B)(viii).

Proposed Regulation R provides that if a bank executes securities transactions for any employee benefit plan, individual retirement or similar accounts, no bank employee may receive compensation from the bank or any other person based on whether a securities transaction is executed or the quantity, price or identity of the securities. Compensation is permitted if based on whether a customer establishes a custodial account with the bank, or the total assets in the account.

Proposed Regulation R permits a bank to accept securities orders for custodial accounts subject to certain limitations. First, the order accepting function must be accepted solely as an accommodation to a custodial customer. Second, bank employee compensation must comply with the restrictions imposed on employee benefit and similar accounts described above.

Third, the fees may not vary based on whether the bank accepted the order for the transaction or the quantity or price of the securities at issue, although it can vary based on the type of security purchased or sold. Fourth, advertising restrictions apply. Fifth, no investment advice, research or recommendations may be provided, or solicitations made, regarding securities transactions. Finally, a bank may not rely on this exemption if it is acting in a fiduciary or trust capacity with respect to an account.

Other exemptions

Proposed Regulation R contains several other proposals:

- An exemption for a bank to sell to non-U.S. persons securities that are covered by Regulation S without having to register as a broker.

- An exemption for a bank to the extent that, as agent, it effects securities-lending transactions or provides securities-lending services to a qualified investor as defined in § 3(a)(54) of the exchange act, or an employee benefit plan that owns and invests on a discretionary basis not less than \$25 million.

- An exemption that permits a bank to use the networking exemption described above when it effects transactions under certain circumstances through the National Securities Clearing Corp.’s Mutual Fund Services.

- Two proposals defined to protect contracts entered into by banks from being considered void or voidable under § 29(b) of the Exchange act.

The SEC issued a separate proposed rule amending certain exemptions under § 3(a)(5) of the exchange act involving exemptions from registration a bank can claim when acting as a securities dealer.

Proposed Regulation R provides banks with significantly increased flexibility to act as brokers without registering under the exchange act. It includes material changes from the two prior proposals, and will permit banks to continue to provide continuity to customers through offering securities brokerage services tied to traditional banking activities.

For some banks, securities brokerage services have been an integral part of the experience they provided to their customers. Thus, implementation of Proposed Regulation R will represent a milestone in the history of financial services. While it is the result of compromise between the SEC and the Federal Reserve Board, the proposal illustrates the separate and distinct themes brought to the bargaining table by each regulator.

For the SEC, the Proposed Regulation R release, when coupled with comments by SEC commissioners and staff at the open meeting at which it was adopted, make clear the SEC’s concern to prevent banks from exceeding their authority to engage in securities brokerage activities.

In several places in Proposed Regulation R, the SEC voiced concern that appropriate investor protection be provided to bank customers. The SEC considers important that equal customer protection be applied regardless of the entity in which the securities transaction was effected.

The Federal Reserve Board went to great lengths to persuade the SEC that the “pushout” provisions of GLBA (§§ 201 and 202) were intended to preserve without disruption much of banks’ traditional securities activities. Banks should be pleased that the bulk of their traditional securities brokerage business that arose out of their banking activities is still permitted.

Finally, Proposed Regulation R makes several references to eliminating restrictions on banks’ brokerage activities in order to ease administrative or compliance difficulties. Proposed Regulation R was responsive to this concern in some places; in others, significant burdens remain. **NLJ**

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Securities activities had become integral to banking services.