

Regulation R: The Tug And Pull Over The Push-Out Rule Is Finally Over

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Eight years ago, Congress passed the Gramm-Leach-Bliley Act (GLBA), lowering many of the barriers that were erected between the banking and securities industries following the Great Depression. Although GLBA repealed the blanket exception that prevented banks from having to register as brokers, it provided conditional exceptions for certain banking activities. In accordance with the Financial Regulatory Relief Act of 2006, the SEC and Federal Reserve have now adopted a uniform set of rules to implement those exceptions (72 Federal Register 56514-56568, 10/3/07). The rules become mandatory on the first day of a bank's fiscal year that commences after September 30, 2008. This BankingLaw@Manatt newsletter provides a brief history of the evolution of the long-stalled Regulation R and a summary of its requirements.

A Brief History Of The 8-Year Process

- GLBA was a political compromise that modernized the U.S. bank regulatory structure by removing restrictions on the involvement of U.S. financial organizations in banking, securities and insurance. It was a reaction, in part, to the envelope-pushing Citicorp-Travelers transaction and also a recognition of the global competitive advantages of less restricted foreign banks.
- GLBA repealed much of the separation of investment and commercial banking that was imposed by the Glass-Steagall Act in 1933, relying instead on the "functional regulation" of securities activities by the SEC to ensure investor protection. Congress provided conditional exemptions in 11 instances for banks, including:
 - networking arrangements with brokers
 - trust and fiduciary activities
 - permissible securities transactions (e.g., the purchase and sale of commercial paper, bankers' acceptances, commercial bills, and exempted securities)
 - certain stock purchase plans
 - safekeeping and custody services
 - identified banking products
 - sweep account transactions in money market funds
 - affiliate transactions
 - private securities offerings
 - municipal securities
 - de minimis number of other securities transactions
- GLBA directed the SEC to interpret and apply the bank broker exceptions to clarify which securities activities banks would have to cease or "push out" to broker-dealer affiliates. The SEC's efforts to do that over the next seven years were roundly criticized by both banks and the banking agencies as being too narrow, unnecessary and disruptive. The SEC first adopted and then suspended "interim rules" promulgated in 2001. It then proposed its own Regulation B in 2004 in response to the comments and criticism it received. Reg. B softened the SEC's restrictions on banks paying "nominal" compensation to bank employees for referrals to brokers and allowed more "relationship compensation" in bank trust and fiduciary operations. The banking agencies and banking industry still objected that the proposed Reg. B contradicted Congressional intent and would have required banks to significantly restructure trust, fiduciary and custodial operations from the way they had functioned for decades. The SEC was forced to delay the effective date for Reg. B three times

while it wrestled with the negative comments it received.

- The Financial Services Regulatory Relief Act of 2006 directed the Federal Reserve and SEC to cease their turf battle and issue a single set of rules, after consulting with the OCC, FDIC and OTS. The Act also provided that federal and state savings institutions were to fall within the scope of the broker exemption regulations.
- On December 26, 2006, the Federal Reserve and SEC jointly issued a single set of proposed rules to implement the broker exceptions for banks relating to third-party networking arrangements, trust and fiduciary activities, sweep activities, and safekeeping and custody activities. The proposal also addressed exemptions related to foreign securities transactions, securities lending transactions conducted in an agency capacity, and the execution of transactions involving mutual fund shares. The proposed rules were designed to accommodate the business practices of banks and ensure the protection of investors.
- The final rules were adopted jointly by the Fed (as new Regulation R) and by the SEC, effective September 28, 2007. Commenters on the proposed rules generally supported the agencies' compromise proposals, although some urged further reduction of the administrative burden of compliance, as well as further increasing protections for investors.
- The new regulations do not cover state or federal credit unions.
- Going forward, the SEC and Federal Reserve will issue joint interpretations and responses to requests for no-action letters or other interpretive guidance concerning the rules. Future regulations will address the recordkeeping rules for banks that operate under the broker exceptions. The SEC and Federal Reserve also will consult with each other in connection with enforcement actions taken against banks for violating the exceptions.

Key Provisions of Regulation R

Networking Exception. This exception allows a bank to enter into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to the bank's customers. Although the exception does not limit the amount of compensation a broker-dealer may pay the bank for referrals, it prohibits incentive compensation to unregistered employees and limits the amount they may receive for referrals. Employees may receive only a *nominal, one-time cash fee of a fixed-dollar amount* for each referral to a broker-dealer. Although unlicensed employees may not provide investment advice or make recommendations to customers regarding securities, they may describe in general terms the types of investment vehicles available from the bank and the broker-dealer under the arrangement.

- "*Incentive compensation*" means compensation that is intended to encourage a bank employee to refer customers to a broker or dealer or give the employee an interest in the success of a securities transaction at a broker or dealer. The limitation on referral fees does not prohibit compensation paid by a bank under a bonus or similar plan if it is paid on a discretionary basis, based on several factors (including several significant factors that are not related to securities transactions at the broker/dealer), provided (i) the referral made by an employee is not a factor in determining the employee's compensation and (ii) the employee's compensation under the plan is not determined by reference to referrals made by another person. The rule provides a safe harbor to bonus plans based on the overall profitability or revenue of the bank, either on a stand-alone or consolidated basis.
- "*Nominal*" is defined as: (i) twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee;

(ii) 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 job family that includes the employee; (iii) not in excess of twice the employee's actual base hourly wage or 1/1000th of the employee's actual annual base salary; or (iv) not in excess of \$25, as adjusted for inflation. A "job family" is any group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank or unit establishes in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion and compensation (e.g., tellers, loan officers and branch managers).

- "*One-time*" means once per referral, whether for a new or existing customer. A nominal referral fee may be paid for each referral, including separate referrals of the same individual or entity.
- "*Cash fee*" means just what it says. A referral fee may not be paid in non-cash forms, such as vacation packages, stock grants, annual leave, or consumer goods. This doesn't prohibit a bank from providing employees with non-cash items, such as pizza or coffee mugs, in connection with programs to familiarize bank employees with investment vehicles, provided it is not done in such a way as to compensate employees for referrals.

Referral fees cannot be contingent on the purchase or sale of a security, the opening of a brokerage account, or the type of security transaction. Fees can be contingent, however, on the customer contacting the broker, keeping an appointment, or meeting qualifying criteria (e.g., minimum assets, net worth or income).

Nothing in the networking exception limits or restricts the ability of a bank employee to refer customers to other departments of the bank itself, including, for example, the bank's trust or custodial departments. Likewise, the networking exception and the rules do not apply to referrals of retail, institutional or high net worth customers to a broker-dealer or other third party solely for transactions not involving securities, such as loans, futures contracts (other than a security future), foreign currency, over-the-counter commodities, or securities (such as U.S. government obligations) that would not require the other party to register under section 15 of the Exchange Act.

Institutional and High Net Worth Customer Exception. A bank may pay its employee a referral fee of more than a nominal amount for referring an "institutional customer" or a "high net worth customer" to a broker-dealer under a networking agreement with the bank.

- "*Institutional customer*" means any entity (including a living trust) that has, or is controlled by a non-natural person that has, at least (i) \$10 million in investments, (ii) \$20 million in revenues, or (iii) \$15 million in revenues if the bank employee refers the customer to the broker or dealer for investment banking services (e.g., underwriter or placement agent for an issuer, financial adviser in a merger, or venture capital provider).
- "*High net worth customer*" means a natural person who, either individually or with a spouse, has at least \$5 million in net worth, excluding the primary residence and associated liabilities of the person.

The bank must have a reasonable basis for believing the customer meets one of these definitions before the referral fee is paid to the bank's employee. The bank also must have an agreement in place with the broker/dealer which sets forth certain broker/dealer obligations outlined in the Regulation.

High net worth and institutional customers must receive a disclosure of: (i) the name of the broker/dealer, (ii) the fact that the bank employee participates in an incentive compensation program under which the employee may receive a fee for referring the customer to the broker/dealer, and (iii) the

fact that payment of the fee may be contingent on whether the referral results in a transaction. The agreement between the bank and the broker/dealer must require the broker/dealer to perform a suitability analysis when the referral fee is contingent on a transaction, and a sophistication analysis for non-contingent fee arrangements.

Employees who receive these higher-than-nominal fees must be primarily engaged in banking activities other than referrals and must encounter high net worth or institutional customers in the ordinary course of their assigned duties for the bank. They cannot be registered or approved (or otherwise be required to be registered or approved) by any self-regulatory organization.

Contingent referral fees under this exception must be (1) a predetermined dollar amount or a dollar amount based on a predetermined formula (e.g., a fixed percentage of total assets placed in an account with the broker/dealer) that does not vary based on (i) the revenue generated by the profitability of securities transactions conducted by the customer, (ii) the quantity, price, or identity of the securities transactions conducted over time by the customer, or (iii) the number of customer referrals; or (2) a fixed percentage of the revenues received by the broker/dealer for investment banking services provided to the customer.

Trust and Fiduciary Activities Exception. This exception allows a bank that is acting in a trustee or fiduciary capacity to effect securities transactions as long as it is “chiefly compensated” with (i) an administrative or annual fee, (ii) a fee based on the percentage of assets under management (including 12b-1 fees), (iii) a flat or capped per-order fee that does not exceed the bank’s execution cost for security transactions for trust or fiduciary accounts, or (iv) any combination of such fees.

- “*Chiefly compensated*” means the relationship-total compensation percentage for each trust or fiduciary account of the bank is greater than 50%. The percentage is determined on an account-by-account basis. The “relationship-total compensation” for an account is calculated by (1) dividing the relationship compensation attributed to the account for each of the immediately two preceding years by the total compensation attributable to the account during the relevant year, (2) translating the quotient obtained for each of the two years into a percentage, and (3) averaging the percentages for each of the two years. Banks also may use a bank-wide approach to the “chiefly compensated” condition, provided the aggregate relationship-total compensation percentage for the bank’s trust and fiduciary business as a whole is at least 70%, based on a two-year rolling average.

A bank must effect such transactions in its trust department or in another department that is regularly examined by bank examiners for compliance with fiduciary principles and standards. A bank that operates on a calendar-year basis must start monitoring its compliance on either an account-by-account or bank-wide basis beginning January 1, 2009, and would have to meet the applicable compensation restriction after the conclusion of 2010 (based on the average of the bank’s year-end compensation ratios for 2009 and 2010). Note: A bank that accepts securities orders as a directed trustee may do so under the custody exception in lieu of the trust and fiduciary exception.

In order to reduce administrative burdens, Regulation R permits banks to exclude the following from their calculation of the chiefly compensated test: accounts that have been open for less than three months; accounts acquired as part of a merger, acquisition, purchase of assets, or similar transaction for up to 12 months after the date of the acquisition; and accounts held at a non-shell foreign branches for the benefit of a U.S. person, provided they constitute less than 10% of the total number of trust and fiduciary accounts of the foreign branch (for the bank-wide test). It also provides that a bank that uses the account-by-account approach will not be considered a broker solely because a particular trust or fiduciary account does not meet the “chiefly compensated” test if, within three months of the end of the year in which the account fails to meet the standard, the bank transfers the account or the securities held by or on behalf of

the account to a registered broker-dealer or other unaffiliated entity that is not required to be registered as a broker-dealer. A bank using the account-by-account approach may exclude, for purposes of the chiefly compensated test, the lesser of (i) 1% of the total number of trust or fiduciary accounts held by the bank (with a minimum of 1 account) or (ii) 500 accounts. A bank can rely on this de minimis exclusion only if it did not rely on it during the immediately preceding year and conducted the transactions in the exercise of its trust or fiduciary responsibilities.

A bank operating under this exception may not advertise that it provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services. It also may not advertise the security brokerage services more prominently than the other aspects of the trust or fiduciary services provided to such accounts.

Sweep Accounts and Transactions in Money Market Funds. This exception allows a bank to sweep funds from a deposit account to a "no-load" open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund.

- "No-load" means that the class or series is not subject to a sales load or a deferred sales load, and the total charges against net assets for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts does not exceed 0.25 of 1% of average net assets annually (the Regulation lists a number of charges that are not covered by this limitation).

Banks also are allowed, without registering as a broker, to effect transactions on behalf of a customer in securities issued by a money market fund, provided that:

(1) The bank provides the customer, directly or indirectly, with some other product or service, the provision of which would not, in and of itself, require the bank to register as a broker-dealer (e.g., an escrow, trust, fiduciary or custody account, a deposit account, a loan, or an extension of credit), and

(2) If the class or series of securities is not "no-load," the bank may not characterize or refer to it as no-load, and the bank must provide the customer with a prospectus no later than at the time the customer authorizes the securities transactions.

Safekeeping and Custody Exception. Regulation R has separate rules for safekeeping and custody services, depending on whether the bank is undertaking transactions for (i) an employee benefit plan account, an IRA account, or a similar account for which it acts as a custodian, or (ii) any other account for which it is acting as a custodian.

- "Account for which it acts as a custodian" means: an employee benefit account or IRA or similar account for which the bank acts as a custodian; an account established by a written agreement between the bank and the customer that sets forth the terms that will govern the fees payable to, and rights and obligations of, the bank regarding the safekeeping or custody of securities; or an account for which the bank acts as a directed trustee.

IRA and Employee Benefit Plan Accounts. Regulation R permits a bank, under certain conditions, to accept orders for securities transactions from IRA, employee benefit plan, and similar accounts for which the bank acts as custodian. This includes pension plans, retirement plans, profit sharing plans, bonus plans, thrift savings plans, and incentive plans, among others.

(1) *Employee Compensation.* No bank employee may receive compensation from the bank or any other person that is based on (i) whether a securities transaction is executed for the account, or (ii) the quantity, price or identity of the securities purchased or sold by the account. This condition does not prohibit an employee from receiving compensation that is based on (a) whether a customer establishes a custodial

account with the bank, (b) the total amount at account opening or at any other time, or (c) a bonus or similar plan that complies with Regulation R restrictions.

(2) *Advertising Restrictions.* A bank may not advertise that it accepts orders for securities transactions for which the bank acts as custodian, except in connection with its marketing of other custodial or safekeeping services. A bank may not advertise its services as a securities brokerage account service or as a substitute for a securities brokerage account. Sales literature used by a bank may not describe the services more prominently than other aspects of the custodial service.

(3) *Other Restrictions.* A bank may not act in a trustee or fiduciary capacity with respect to the account, other than as a directed trustee (i.e., a trustee that does not exercise investment discretion with respect to the account). A bank must: (i) direct the trade to a registered broker-dealer for execution, or (ii) the trade must be a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary and is not in contravention of fiduciary principles established under applicable Federal or State law, or (iii) the trade must be conducted in some other manner permitted under the rules, regulations, or orders as the SEC may prescribe or issue. Finally, a bank may not act as a "carrying broker" for a broker-dealer other than with respect to government securities.

Other Accommodation Arrangements. A bank may accept orders for securities transactions on an accommodation basis from other types of custodial accounts, subject to the following conditions:

(1) *Accommodation.* Transactions may only be made as an accommodation to customers. The term "accommodation" is not defined, but will be addressed in later guidance. Presumably, it would not include trades solicited by a bank.

(2) *Employee Compensation.* A bank employee may not receive compensation from the bank or any other person that is based on (i) whether a securities transaction is executed for the account, or (ii) the quantity, price or identity of the securities purchased or sold by the account. This condition does not prohibit an employee from receiving compensation that is based on (a) whether a customer establishes a custodial account with the bank, (b) the total amount at account opening or at any other time, or (c) a bonus or similar plan that complies with Regulation R restrictions.

(3) *Bank Fees.* A bank may not charge or receive a fee for effecting securities transactions that is based on: (i) whether the bank accepted the order for the transaction, or (ii) the quantity or price of the securities to be bought or sold. A bank may charge or receive a fee that is based on the type of security purchased or sold (e.g., a foreign security).

(4) *Advertising Restrictions.* A bank may not advertise that it accepts orders for securities transactions for which the bank acts as custodian. A bank's sales literature: (i) may state that the bank accepts securities orders for such an account only as part of describing the other custodial or safekeeping services the bank provides to the account, and (ii) may not describe the securities order-taking services provided to such an account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account. The advertising restrictions on accommodation accounts are more restrictive than for IRA or employee benefit plan accounts.

(5) *Investment Advice and Recommendations.* A bank may not provide investment advice or research concerning securities, make recommendations concerning securities, or otherwise solicit securities transactions, except as described in the preceding "Advertising Restrictions" section. A bank may respond to inquiries, provided no research or investment advice is offered. Other exceptions exist in connection with registered investment companies.

(6) *Other Restrictions.* A bank may not act in a trustee or fiduciary capacity with respect to the account, other than as a directed trustee (i.e., a trustee that does not exercise investment discretion with respect to

the account). A bank must: (i) direct the trade to a registered broker-dealer for execution, or (ii) the trade must be a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary and is not in contravention of fiduciary principles established under applicable Federal or State law, or (iii) the trade must be conducted in some other manner permitted under the rules, regulations, or orders as the SEC may prescribe or issue. Finally, a bank may not act as a "carrying broker" for a broker-dealer other than with respect to government securities.

Other Exemptions. Regulation R incorporates a number of other exemptions:

- *Transactions with Non-U.S. Persons.* Banks may: (i) effect the sale of an eligible security to a purchaser who is not in the United States; (ii) effect, by or on behalf of a person who is not a U.S. person, a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside the U.S. in compliance with Rule 903 to a purchaser who is not in the U.S. or a registered broker or dealer; and (iii) effect, by or on behalf of a registered broker or dealer, a resale of an eligible security after its initial sale with a reasonable belief that the security was initially sold outside the U.S. in compliance with Rule 903 to a purchaser who is not in the U.S., provided the resale is made prior to the expiration of any applicable distribution compliance period and in compliance with Rule 904. An "eligible security" is any security that: (i) is not being sold from the inventory of the bank or its affiliate; and (ii) is not being underwritten by the bank or an affiliate on a firm-commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or its affiliate.
- *Non-Custodial Securities Lending.* A bank is exempt from the definition of "broker" to the extent that, as an agent, it engages in or effects securities lending transactions, and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be: (i) a qualified investor; or (ii) any employee benefit plan that owns and invests on a discretionary basis, not less than \$25 million in investments. A securities lending transaction is any transaction in which the owner of a security lends the security temporarily to another party pursuant to an agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed to by the parties. This exemption allows a bank to engage in securities lending transactions as agent in circumstances where the bank does not have custody of the securities or has custody of the securities for less than the entire period of the transaction.
- *Transactions in Certain Investment Company Securities and Variable Insurance Products.* Banks may effect transactions in open-end mutual funds, variable annuities and variable life insurance policies that are funded by a separate account that is registered under the Investment Company Act through the National Securities Clearing Corporation or the fund's transfer agent, rather than through a broker-dealer. To take advantage of the exemption: (i) the security must not be traded on a national securities exchange or traded through the facilities of a national securities association or an interdealer quotation system; (ii) the security must be distributed by a registered broker-dealer, or the sales charge must be no more than the amount permissible for a security sold by a registered broker-dealer pursuant to any applicable rules of a registered securities association; and (iii) the transaction must be effected through the NSCC, or directly with a transfer agent or with an insurance company or separate account that is excluded from the definition of "transfer agent" in the Exchange Act.
- *Transactions In A Company's Securities for Its Employee Benefit Plans.* A bank may effect a transaction in the securities of a company directly with a transfer agent acting for the company if: (i) no commission is charged; (ii) the transaction is conducted by the bank solely for the benefit of an employee benefit plan account; (iii) the security is obtained directly from the company or an employee benefit plan of the company, and (iv) the security is transferred only to the company or

an employee benefit plan of the company.

- *Other, Self-Implementing Exemptions.* Section 3(a)(4)(B) of the Exchange Act as amended by the GLBA provides conditional exceptions from the definition of “broker” for banks that engage in certain securities activities in connection with the following:
 - *Permissible Securities Transactions* -- commercial paper, bankers' acceptances, commercial bills, exempted securities, certain Canadian government obligations, and Brady bonds
 - *Certain Stock Purchase Plans* -- This exception permits banks, as part of their transfer agency activities, to effect transactions for certain issuer plans
 - *Affiliate Transactions* -- This exception permits banks to effect transactions for affiliates, other than broker-dealers
 - *Private Securities Offerings* -- This exception permits certain banks to effect transactions in certain privately placed securities, under certain conditions
 - *Identified Banking Products* -- This exception permits banks to buy and sell certain “identified banking products,” as defined in Section 206 of the GLBA (e.g., deposits)
 - *Municipal Securities*
 - *a de minimis number of other securities transactions* -- This exception permits banks to effect up to 500 transactions in securities in any calendar year in addition to transactions referred to in the other exceptions.

Regulation R is designed to accommodate the business practices of banks and protect investors. If more than one broker exception or exemption is available to a bank under the statute or rules for a securities transaction, the bank may choose the exception or exemption on which it relies to effect the transaction without registering as a broker-dealer. For example, if a bank effects a transaction in a security sold in an offshore transaction for a custody account that is permissible under either the Regulation S exemption in Rule 771 or the custody exemption in Rule 760, the bank may choose which exemption to rely on and comply with in effecting the transaction. Similarly, if a bank effects no more than 500 securities transactions as agent for its customers in a calendar year, the bank may rely on the de minimis exception in the Exchange Act in lieu of any other available exception or exemption for such transactions. The bank, of course, must comply with all of the requirements contained in the exception or exemption on which it relies.

Effective Date. Banks do not have to come into compliance with Regulation R until the first day after their fiscal year beginning after September 30, 2008 (i.e., January 2, 2009 for most banks). No contract will be void or voidable because a bank that is a party to the contract violated the Act or Regulation R based solely on its status as a broker when the contract was created: (i) for contracts entered into before March 31, 2009; or (ii) if, at the time the contract was entered, the bank acted in good faith, had reasonable compliance policies and procedures in place, and its violation did not result in any significant harm, financial loss or cost to the person seeking to void the contract.

Banks that conduct activities governed by new Regulation R should consult their bank regulatory counsel and their regulators to ensure compliance with the Regulation. Banks that contemplate expanding into securities activities with new products and services need to anticipate the administrative burden and cost

of complying with Regulation R.

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