Kirkpatrick & Lockhart Preston Gates Ellis LLP

Bank - Broker "Push Out" Rules:

Analysis Of Regulation R Implementation

January 2008

Bank - Broker "Push Out" Rules:

Analysis Of Regulation R Implementation

On September 24, 2007 – fully six years, four months, and twelve days after the date the "functional regulation" provisions of the Gramm-Leach-Bliley Act of 1999 ("GLBA") took effect – the Securities and Exchange Commission ("SEC") and the Board of Governors of the Federal Reserve System ("Board," and with the SEC, the "Agencies") jointly adopted final rules under "Regulation R" that describe activities in which a bank may engage without being considered a "broker" under the Securities Exchange Act of 1934, as amended ("Exchange Act").[1] The final rules are substantially similar to rules proposed in December 2006 (the "Proposed Rules").[2]

As comprehensive and detailed as it is, Regulation R directly addresses only three of the Exchange Act's eleven statutory exceptions (sometimes referred to as the "carve outs"). As more fully discussed below, Regulation R includes several new regulatory exemptions that are intended to be responsive to concerns expressed by the banking industry about the Proposed Rules.

Effective Date/Compliance Deadline. Regulation R is on the books effective as of December 3, 2007. However, most banks will continue to enjoy a blanket exclusion from the definition of a "broker" until January 1, 2009.[3]

Next Steps. Between now and 2009, a bank may consider a number of important action steps to ensure it is prepared to demonstrate compliance with the rules. First, the bank should identify and review all of its securities transaction activities, wherever they may be conducted within the bank, to ensure that each activity fits within at least one of the exceptions.[4] The bank will have some flexibility in that, if more than one exception applies, the bank may choose which one it wishes to rely on – any one will do, as long as the bank complies with all the applicable terms and conditions of the exception.

Second, the bank also should be prepared during the examination process to document its reliance on the various exceptions and rule exemptions or safe harbors.

Third, once the bank determines that a securities activity fits within an exception, the bank should consider developing procedures to ensure that the activity continues to satisfy the conditions of the applicable exception and for ongoing compliance monitoring. If a bank identifies a securities activity that does not conform with an exception, it essentially will have four options to consider: first, modify the activity as necessary to conform with the conditions of an exception; second, "push" the activity "out" to a registered broker-dealer; third, discontinue the activity; or, finally, request no action or exemptive relief from the Agencies.[5] The feasibility of any of these options will, of course, depend on the circumstances.

Overview

Exchange Act Section 3(a)(4) defines "broker" to include "any person engaged in the business of effecting transactions in securities for the account of others." However, the Exchange Act also provides that a bank (as defined) that effects certain securities transactions will not be considered a "broker" if the transactions conform with any of eleven specific types of securities activities described in Exchange Act Section 3(a)(4)(B).

Definitions and Exemptions. Regulation R essentially does two things. First, it defines certain key terms for exceptions applicable to "networking" activities, "trust and fiduciary" activities, and "sweep account" activities. Second, it supplements the exceptions with new regulatory exemptions for several discrete types of activities, including, among others, referral arrangements involving high net-worth and institutional customers under the "networking" exception; a "bank-wide" computation method for satisfying the "chiefly compensated" requirement of the trust and fiduciary activities exception; three exemptions for "order taking" activities (which the Agencies believe are not covered by the statutory exception for safekeeping and custody activities); agency transactions involving securities offered and sold outside the United States in accordance with Regulation S under the Securities Act of 1933 ("Securities Act"); certain securities lending transactions; and an exemption from the requirement that transactions effected pursuant to certain exceptions be directed through a registered broker for transactions in mutual fund shares and variable annuities. The new exemptions represent attempts by the Agencies to address specific industry comments on the Proposed Rules.

Definition of "Bank." The exceptions apply to a "bank." Under Exchange Act Section 3(a)(6), as amended by the Financial Services Regulatory Relief Act of 2006, the term "bank" now includes, in addition to most federal and state-chartered banks and trust companies, federal savings associations, FDIC-insured state savings associations, and U.S. branches and agencies of foreign banks.[6] The Agencies clarified that an employee of a bank that conforms with applicable exceptions is not individually considered a "broker" to the extent the employee's activities are covered by the relevant exception(s).

The exceptions and exemptions apply only to a bank and its employees' activities. Thus, for example, a bank that relies on the Trust Activities exception discussed below may use other persons, including affiliates and third parties, to assist the bank in handling securities transactions for fiduciary accounts. However, no party, other than the bank (and its employees to the extent their activities are covered by the relevant exemptions) may rely on the bank's exception(s) from status as a "broker." This applies regardless of the terms of any agreement between the bank and the third party.

Analysis Of Regulation R

Regulation R consists of numerous rules, restrictions, definitions, exceptions, and other requirements that fill almost 50 pages of three-column small print in the Federal Register. The detail and complexity of the rules is not entirely surprising given that the rules relate to statutory exceptions that reflect one of the major political compromises underlying the GLBA. When it repealed the blanket exception, Congress attempted to achieve two separate – but not entirely consistent – goals. A primary goal was to permit banks to continue to engage in securities activities that they traditionally conducted without being regulated as "brokers." A competing sentiment against maintaining the status quo for traditional bank securities activities was the notion of functional regulation, namely that institutions that engaged in the brokerage business should be subject to the SEC's comprehensive broker-dealer regulatory regime. As a result, the statute itself and Regulation R represent an attempt at compromise to craft flexible rules that preserve certain traditional bank securities activities, while at the same time establishing limits on those activities to prevent potentially abusive situations.

A. "Networking" Arrangements

The networking exception essentially codifies a long line of SEC staff no-action letters[7] and self-regulatory organization ("SRO")[8] regulations (e.g., Conduct Rule 2350) that specify the permissible conditions under which banks and bank employees (who are not registered and qualified under SRO rules, i.e., "unregistered employees") may participate in securities referral activities with a registered broker-dealer absent the bank itself registering with the SEC as a broker-dealer and unregistered employees registering and qualifying as registered representatives under SRO rules. By its terms, the networking exception applies solely to referrals of securities transactions that otherwise could cause a bank or its unregistered employees to violate the broker-dealer registration requirements of Exchange Act Section 15(a)(1). This exception does not restrict referral or other activities relevant to non-securities activities of a bank, such as loans, transactions in currency, commodities, and non-securities futures contracts, or government securities for which a bank may be regulated as a government securities dealer under Exchange Act Section 15C(a)(1).

The statutory exception requires, in relevant part, that (i) a bank enter into a written agreement with a registered broker-dealer,[9] (ii) securities brokerage services be kept clearly separate from the bank and its depository services, (iii) brokerage marketing materials clearly identify the broker-dealer as the securities service provider and comply with advertising regulations under the Exchange Act and SRO rules, (iv) unregistered employees solely perform clerical and ministerial functions with respect to brokerage transactions (i.e., no investment advice or securities recommendations), and (v) for referrals, unregistered employees not receive incentive compensation tied to securities transactions, although they are eligible to receive referral compensation of a "nominal one time cash fee of a fixed dollar amount" not contingent on any successful referral or transaction. The final rules clarify the scope of permissible compensation arrangements that are consistent with referrals for nominal referral fees, as well as provide an exemption to permit more robust compensation structures, under specific conditions, that would not be nominal in their amount or necessarily uncoupled from the consummation of a securities transaction.

The complexity of Regulation R in this context illustrates the evolution of securities referral activities from the early days when the SEC staff first issued no-action positions ostensibly for teller referrals involving "nominal" referral fees (a term that was undefined in the no-action letters) to the present, which reflects a broader group of banking professionals participating in securities transactions and more complex bonus systems and compensation structures of integrated financial institutions. It also reflects complexities in regulating compensation structures, rather than leaving their determination to ordinary market forces.[10]

1. Key Statutory Definitions

Rule 700 defines key terms designed to clarify permissible compensation structures related to "nominal" referral fees, allowable contingencies for paying referral fees, and acceptable bonus payments to unregistered employees.

Nominal One-Time Cash Fee of a Fixed Dollar Amount. As a preliminary matter, the Agencies require that nominal referral fees be paid to unregistered employees in cash, not in vacations, consumer goods, stock grants, annual leave or other forms of non-cash compensation. A bank, however, may permissibly track cash payments through a point system, provided the system translates to a fixed, cash payment that otherwise reflects a nominal amount. Although an unregistered employee may receive a nominal referral fee for each referral of the same bank customer or potential customer, the Agencies restrict payments solely to unregistered employees who personally participate in the referral. This revision to the original proposal is intended to permit referral fees to more than one unregistered employee, such as a supervisor who participated with his or her subordinate in a referral. It also is intended to clarify that a referral fee may not be paid, for example, to a supervisor solely because of his or her status as a supervisor or because he or she simply administers the bank's referral program.

At the core of the networking exception is the definition of the term "nominal." Rule 700(c) defines "nominal one-time cash fee of a fixed dollar amount" by reference to alternative measures, which (with a minor exception noted below) the Agencies adopted as proposed. These alternatives are intended to recognize the varying sizes and geographical locations of banks and, in this light, balance permissible payment structures with the goal of preventing potential sales practice abuses that might result from having a promotional or a "salesman's" stake in the outcome of a securities transaction.

The same bank may use any of the following measures to calculate nominal referral fees as the bank determines appropriate for its different business lines or operating units:

(1) Under the first alternative, a referral fee would be considered "nominal" if it did not exceed either (i) twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the employee's "job family," or (ii) 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 employee's "job family." "Job family" (defined in Rule 700(d)) generally means a group of jobs involving similar responsibilities, or which require similar skills, education, or training that the bank or a separate unit, branch, or department of the bank has established and will use in the ordinary course of its business to distinguish among employees for purposes of hiring, promotion, and compensation. Examples of "job families" include tellers, loan officers, or branch managers.

A bank may not deviate from its normal job-family classifications solely for purposes of determining referral fees. The Agencies noted that bank examiners would focus on job-family classifications as part of the examination process.

(2) The second alternative establishes a "nominal" fee to include an amount per referral not exceeding (i) twice the unregistered employee's actual base hourly wage, or (ii) 1/1000 of the unregistered employee's actual annual base salary. Although it is not entirely clear why, the Agencies indicated that the inclusion of (ii) from the original proposal is intended to promote comparability among the alternatives.

(3) The third alternative, presumably the least burdensome to apply, caps referral fees at $25 per referral. This amount will be adjusted every five years for inflation, beginning April 12, 2012, to reflect changes in values in the Cost Index for Wages and Salaries, Private Industry Workers (or any successor index) published by the Bureau of Labor Statistics.

Meaning of "Contingent." Referrals may not be contingent on a securities transaction. Rule 700(a) defines the phrase "contingent on whether a transaction results from the referral" generally to mean referral fee payments that are dependent on (i) a purchase or sale of a security; (ii) the opening of an account with a broker or dealer (regardless of whether any securities transactions are ever executed in the account); (iii) a transaction involving a particular type of security; or (iv) multiple securities transactions.

The Rule permits certain minimum qualifications that a bank may impose before paying a referral fee, which could be contingent on whether a customer (i) contacts or keeps an appointment with a broker-dealer; or (ii) meets any objective, base-line criteria for referrals established by the bank or broker-dealer, such as minimum assets, net worth or income requirements, marginal federal or state income tax rates, or citizenship or residency requirements.

The Agencies adopted this definition as proposed and declined to omit the opening of a brokerage account as an impermissible contingency to the payment of a referral fee. In their view, the opening of an account is the initial step that provides a "close link" to the execution of a securities transaction.

2. Bonus Payments

Although not expressly stated in the statutory exception or in the implementing rules, the payment of "incentive compensation" (e.g., success payments or other payments that encourage client referrals) for securities referrals is prohibited, presumably because incentive payments are inconsistent with the payment of "nominal" referral fees not contingent on securities transactions. The final implementing regulations preserve non-incentive-based bonus plans by reference to an exclusion (Rule 700(b)(1)). This exclusion clarifies that bonus plans are not prohibited forms of incentive compensation, provided they are discretionary and include multiple significant factors or variables that are not related to securities transactions at the broker-dealer. The language of the Rule itself is not entirely clear on this point and, if read out of context of the adopting release, might be read to suggest that securities transactions cannot be included as a factor at all. However, the adopting release appears to indicate that factors related to securities transactions may be considered, provided that the bonus calculation is based on other factors and variables as well. On this point, the Agencies noted that they did not "expect that actual payments under a bank's bonus or similar plan would, over time, be based *predominantly* on securities transactions conducted at a [networking] broker-dealer" (emphasis added).

Further clarification is prescribed by a safe harbor (Rule 700(b)(2)), which permits bonus plans, even if they are based on overall profitability or revenue of (i) the bank on a stand-alone or consolidated basis, (ii) any of the bank's affiliates (other than an affiliated broker-dealer) or operating unit of the bank or an affiliate (other than a broker-dealer), or (iii) a broker-dealer, but only if (1) such profitability is only one of "multiple factors or variables" used to determine the bonus, (2) the factors or variables include "multiple significant factors or variables" that are not related to the profitability or revenue of the broker-dealer, (3) the factors or variables do not include referrals in determining the bonus, and (4) the bonus does not consider the referrals of any other unregistered employee.

The complicated nature of the permissible bonus conditions reflects the apparently difficult balance to preserve certain non-incentive bank bonus plans against regulatory and policy limitations prohibiting unregistered employees from having a promotional interest or a salesman's stake in a securities transaction. The banking agencies are expected to review bank-bonus plans in the context of the networking exception as part of their examination. If bonus plans evolve over time to include payments predominantly related to securities transactions, the Agencies expect banks to modify the plans in reliance on the Rule's conditions.

3. Exemption for Referrals of Institutional and High Net-Worth Clients

Rule 701 creates an exemption for the payment of contingent, non-nominal referral fees (as permitted based on a complex set of conditions) from the limitations of the networking exception if (1) the unregistered bank employee making the referral satisfies prescribed eligibility requirements, (2) the client subject to the referral is an "institutional" or "high net-worth" customer (as defined in the Rule), and (3) disclosures and suitability/sophistication analyses are made to determine that the client satisfies the net worth conditions and that the securities transaction is suitable. The Agencies adopted this exemption largely as proposed with certain modifications made to the net worth standards relevant to a client's status as an institutional or high net-worth client. This exemption reflects a compromise intended to accommodate different compensation standards and activities relevant to a bank's private banking and wealth management clients – clients that are presumed sophisticated and capable of evaluating material aspects of their securities investments – and the potential conflicts associated with paid referrals.

Institutional and High Net-Worth Customers. The exemption requires that, prior to the payment of a referral fee, the bank must have a reasonable basis to believe that a customer is an "institutional customer." Similarly, the exemption requires, in the case of referrals of natural person customers, that the bank have a reasonable basis to believe the customer is a "high net-worth customer" prior to making the referral to a broker-dealer. The written agreement between the broker-dealer and the bank must allocate to the broker-dealer the responsibility also to have a reasonable belief that a referred customer is either an "institutional customer" or "high net-worth customer" prior to paying the referral fee. A signed acknowledgement from the customer, among other things, can satisfy the reasonable basis standards required of the exemption.

(1) Rule 701(d)(1) defines "high net-worth customer" for these purposes to include a natural person who, either individually or jointly with his or her spouse,[11] has at least $5 million in net worth, excluding primary residences and liabilities individually or together, if applicable, with the spouse. The Agencies modified the original proposal to include certain revocable, inter vivos or living trusts whose settlor is a natural person satisfying the $5 million net worth test.

(2) As modified from the proposal, Rule 701(d)(2) defines "institutional customer" to include a corporation, partnership, limited liability company, trust, or other non-natural person that has (or is controlled by a non-natural person that has) at least $10 million in investments, $20 million in revenues, or $15 million in revenues if the referral is made for "investment banking services" (e.g., services as a placement agent, an underwriter, or financial adviser with respect to mergers, acquisitions, tender offers, or similar transactions; providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments).

Unregistered Employee Eligibility. Unregistered employees may receive contingent referral fees of a non-nominal amount only if they satisfy the following conditions: (i) the employee making the referral must be unregistered and not approved for registration or otherwise required to be registered under SRO rules; (ii) the employee must deal with institutional and high net-worth clients in the ordinary course of his or her duties for the bank; and (iii) the employee must not be statutorily disqualified for purposes of the Exchange Act. The networking broker-dealer must determine, prior to paying the referral fee, that the unregistered employee is not subject to a statutory disqualification.

Written Agreement and Client Disclosures. The exemption requires that the networking arrangement be set forth in a written agreement that not only addresses the obligations described above, but also contains specific obligations related to client suitability and sophistication in the case of referrals for contingent and non-contingent referral fees. The Rule requires the networking broker-dealer to notify the bank if, in the case of certain contingent referrals, a client engages in unsuitable securities transactions. The written agreement also must obligate the broker-dealer to notify the bank if it determines that a client is not, in fact, an institutional or high net-worth customer or if an unregistered employee is statutorily disqualified.

Rule 701 also requires a bank to deliver to the institutional or high net-worth client written or oral disclosures prior to the referral (if oral disclosures are later followed by written disclosures delivered by the bank or the broker-dealer) that identify the name of the networking broker-dealer and material aspects of the unregistered employee's compensation (i.e., that it may be contingent, incentive-based, and non-nominal). If the broker-dealer, rather than the bank, is providing the written disclosures, the broker-dealer's disclosure delivery obligation also must be reflected in the written agreement between the bank and networking broker-dealer.

B. Trust and Fiduciary Activities

The trust and fiduciary activities exception permits a bank to effect securities transactions while acting in a "trustee" or "fiduciary" capacity in the bank's trust or other department "that is regularly examined by bank examiners for compliance with fiduciary principles and standards." The bank must be "chiefly compensated" for such transactions, consistent with fiduciary principles and standards, on the basis of an "administration or annual fee," a "percentage of assets under management," a "flat or capped per order processing fee" equal to not more than the cost incurred by the bank in connection with executing securities transactions, or any combination of such fees. The bank may not publicly solicit brokerage business, other than stating in the context of advertising its general fiduciary activities and services that it effects securities transactions. The bank also must direct transactions in the U.S. of publicly traded securities to a registered broker-dealer for execution or conduct the trade in some other manner permitted under SEC rules. (Regulation R in fact includes two such rules described under part E, "Other Exemptions" below.)

Exchange Act Section 3(a)(4)(D) defines "fiduciary capacity" for these purposes to include (i) the capacity of trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, custodian under a uniform gift to minor [sic] act, or investment adviser (if the bank receives a fee for its investment advice), (ii) any capacity in which a bank possesses investment discretion on behalf of another, or (iii) any other similar capacity.

1. The "Chiefly Compensated" Requirement

Regulation R defines several key terms relating to the "chiefly compensated" and "relationship compensation" concepts which are fundamental to the exception. Specifically, permissible fees for trust and fiduciary activities, listed in the statute and described in Regulation R as "relationship compensation," consist of compensation that is based on the overall relationship between a bank and its fiduciary customer. Transaction-based fees assessed on a per-transaction basis, which are viewed as akin to commissions more typical of a securities brokerage business, may be considered relationship compensation only to a limited extent.

Chiefly Compensated. As noted above, the statutory exception requires that the bank be "chiefly compensated" on the basis of relationship compensation. To meet the chiefly compensated test, Regulation R requires the bank to calculate its relationship compensation to total compensation on either an account-by-account basis or on a bank-wide basis.[12]

Under the account-by-account method, the chiefly compensated test will be satisfied if the relationship-total compensation percentage attributable to each trust or fiduciary account is greater than 50 percent.[13]

Alternatively, under the bank-wide method, the chiefly compensated test will be satisfied if the relationship-total compensation attributable to the bank's trust and fiduciary business as a whole is at least 70 percent of the bank's total compensation attributable to the trust and fiduciary business.[14] While each bank will need to evaluate its own circumstances, it is expected that most will opt for the "bank-wide" approach because of its relative simplicity as compared with the account-by-account method.

Under either approach, a bank's compliance with the "chiefly compensated" test would be based on a two-year rolling average of the bank's compensation attributable to its trust and fiduciary activities.[15] The two-year averaging is to allow a bank to experience normal fluctuations in its trust and fiduciary compensation, either on an account-by-account or bank-wide basis, without falling out of compliance with the Rule and provides a bank with a sufficient period of time to adjust its activities to ensure compliance with the Rule. Since Regulation R is effective beginning on the first day of the fiscal year after September 30, 2008, banks generally will have to start monitoring their compliance with Regulation R on January 1, 2009. However, the first date on which most banks would have to actually demonstrate that they meet the chiefly compensated test would be December 31, 2010.[16]

Relationship Compensation. Relationship compensation includes four separate categories of fees for fiduciary services (including effecting securities transactions for fiduciary accounts).

(1) "Administrative fees" include, without limitation, fees paid to the bank for personal services, tax preparation, or real estate settlement services. It also would include a fee paid for disbursing funds from, or for recording receipt of

payments to, a trust or fiduciary account and certain fees paid in connection with investment in mutual fund shares as described in the "percentage of assets fee" below. In response to comments, the examples of relationship compensation have been expanded to include fees associated with securities lending and borrowing and custodial fees separately charged for providing custody services to a fiduciary account.[17] Since the fees are charged by the bank in connection with the administration of the account and not on a per-transaction basis, the SEC and the Board determined that the fees were not the type of fee intended to be excluded by the law.[18]

(2) Regulation R does not elaborate the meaning of "annual fee," other than to repeat the statutory language that such a fee may be payable on a monthly, quarterly, or other basis. This presumably would include, for example, annual "minimum" account fees.

(3) "Percentage of assets under management" fees include, among others, fees paid to the bank by a mutual fund (or its investment adviser) (i) pursuant to a 12b-1 plan, (ii) for personal service or the maintenance of shareholder accounts, or (iii) based on a percentage of assets under management for transfer agent or sub-transfer agent services, processing purchase and redemption orders, providing account statements to shareholders, processing dividend payments, sub-accounting services, forwarding mutual fund communications to shareholders and processing shareholder proxies.

The final rules are clear that these fees are relationship compensation, regardless of who pays the fees. Thus, for example, a 12b-1 fee paid by a mutual fund in connection with an investment in the fund by a trust administered by a bank may (assuming the fee arrangements are consistent with applicable fiduciary requirements) be included in the bank's "relationship compensation" with respect to that account, even though the fee is not paid by the trust account or the trust customer.

Similarly, shareholder servicing and sub-accounting fees received in connection with the investment of fiduciary assets in a mutual fund may be included in relationship compensation attributed to investing trust accounts, regardless of whether the fund or the fund's investment adviser pays the fee.

In addition, an "assets under management fee" need not relate only to fiduciary services provided in connection with transactions in securities; such fees may be attributable to securities and non-securities assets held in a trust account, or only to non-securities assets.[19] Thus, for example, fees paid as a percentage of real estate assets under management (including, e.g., compensation for the costs of real estate settlement) should be includable as relationship compensation.

(4) Consistent with the statutory exception, Regulation R provides that a "flat or capped order processing fee" may be considered "relationship compensation," but only to the extent it does not exceed the cost incurred by the bank in connection with executing securities transactions for fiduciary accounts. This "cost" may include commissions or fees charged by a third-party broker in executing the transaction as well as any other "fixed or variable processing costs incurred by the bank." It is likely that, in most cases, banks will find it simpler and easier simply to exclude any "order processing" (i.e., transaction-based) fees from relationship compensation altogether. However, if a bank does wish (or need) to include order processing fees in its relationship compensation, it will need to keep and maintain adequate records showing that appropriate "costs" only are included in order processing fees.

Excluded Compensation. A bank may elect to exclude fees derived from securities activities carried on pursuant to other applicable statutory exceptions and regulatory exemptions (for example, in connection with safekeeping or custody, as described below) from its chiefly compensated calculations.[20]

Exemptions for Certain Accounts. In addition, Regulation R exempts from the chiefly compensated calculations: (i) fiduciary accounts which have been opened for less than 3 months; (ii) accounts acquired as part of a merger, consolidation, or acquisition (but only for 12 months); and (iii) accounts held at a non-shell foreign branch of the bank if the bank has a reasonable cause to believe that the trust or fiduciary accounts held for the benefit of U.S. persons constitute less than 10 percent of the total number of trust and fiduciary accounts of the foreign branch.[21] A "non-shell foreign branch" is a branch that is located outside the U.S., provides banking services to residents of the foreign jurisdiction in which the branch is located, and for which decisions relating to day-to-day operations and business are made at that branch and not by an office of the bank located in the U.S.

Thus, "relationship compensation" appears to have four primary characteristics: (i) it should be "attributable to" a trust or fiduciary account; (ii) it may be paid by any entity or person (i.e., it does not have to be paid solely from the fiduciary account or by the account principal); (iii) it may relate to securities or non-securities assets of the account; and (iv) it must be an administrative fee, annual fee, or assets under management fee, or per-order processing fee (not exceeding costs incurred by the bank in connection with executing securities transactions), or (v) any combination thereof.

2. Advertising Restrictions and Other Requirements

The trust and fiduciary exception also includes advertising restrictions. Regulation R includes a "safe harbor" that provides that a bank will be deemed in compliance with the advertising restrictions if it does not advertise that it provides securities brokerage services, except as part of advertising the bank's broader trust or fiduciary services, and does not advertise its securities brokerage services more prominently than other trust or fiduciary services provided to its fiduciary accounts.[22] "Advertisement" is defined very broadly to include "any material that is published or used in any electronic or other public media, including any website, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs, or billboards, motion pictures, or telephone directories (other than routine listings)."[23] It appears that this definition is limited to public media advertising, and does not include sales literature that is not distributed through the public media or e-mails to the bank's own customers.[24]

A bank intending to rely on the trust and fiduciary exception will need to identify and categorize compensation attributable to trust and fiduciary accounts in order to perform the "chiefly compensated" calculation. As noted above, the Board and the other banking agencies, in consultation with the SEC, are developing recordkeeping rules for banks to demonstrate compliance with the broker exceptions.[25] A bank will need to determine whether it will make its "chiefly compensated" computation on an account-by-account or bank-wide basis and develop associated policies, procedures, and systems for making the computation. In this regard, banks should be aware that the Board and other banking agencies are also expected to develop supervisory guidance to help ensure that banks have adequate policies and procedures for the conduct of their securities brokerage activities. Finally, if the bank intends to rely on the advertising safe harbor, it will need to review, and if necessary update, advertising guidelines and content.

C. Sweep Accounts

The statutory exception for "sweep transactions" applies to transactions effected by a bank as part of a program for the investment or reinvestment of deposit funds into a "no load" mutual fund registered under the Investment Company Act of 1940, as amended ("1940 Act") that holds itself out as a "money market fund." The Agencies adopted the implementing rules for the sweep exception as proposed.

1. No-Load Funds

Rule 740 defines various terms under the exception, the critical one being "no load." As adopted, "no load" means that the money market fund shares involved in the sweep program are not subject to a sales charge or deferred sales charge, but may be subject to charges for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts, if such charges are capped at 25 basis points annually.

Charges for the following types of services are not subject to the 25 basis point cap: (i) transfer agent or sub-transfer agent services for beneficial owners of fund shares; (ii) aggregating and processing purchase and redemption orders for fund shares; (iii) providing beneficial owners with account statements showing transactions and positions in the fund; (iv) processing dividend payments for the fund; (v) providing sub-accounting services to the fund for shares held beneficially; (vi) forwarding fund communications to beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; and (vii) receiving, tabulating, and transmitting proxies executed by beneficial owners of fund shares.

2. Exemption for "Non-No-Load" Funds

Rule 741 provides an exemption for transactions involving 1940 Act-registered money market funds that do not satisfy the technical definition of "no load" under Rule 740 if the following conditions are met:

First, the bank must either (i) provide the sweep customer with some other product or service (apart from the sweep service) that would not, by itself, trigger broker-dealer registration for the bank or (ii) provide the sweep service to another bank as a service to invest or reinvest deposit funds.

Second, if the fund is not a "no-load" fund, the bank must (i) provide the customer a prospectus for the fund no later than the time the customer authorizes the sweep transactions and (ii) not refer to or characterize the fund as a "no load" fund.

D. Safekeeping and Custody Activities

The statutory safekeeping and custody exception permits a bank – as part of its "customary banking activities" – to (i) provide safekeeping and custody with respect to securities, including the exercise of warrants or other rights of customers; (ii) facilitate the transfer of funds or securities as a custodian or a clearing agency in connection with clearing and settling customer securities transactions; (iii) effect securities lending or borrowing transactions for customers as part of the bank's safekeeping or custody activities or invest cash collateral pledged in connection with such transactions; (iv) engage in certain activities in connection with securities that are pledged by customers; and (v) act as a custodian or provider of other related administrative services to individual retirement account or pension, retirement, profit-sharing, bonus, thrift savings, incentive, or other similar benefit plans. Although banks historically have assisted their customers in purchasing and selling securities, the Agencies apparently did not consider securities order-taking activities to be within the statutory exception, and instead adopted various exemptions under Rule 760 to allow banks to continue those activities, subject to various conditions and limitations.

Rule 760 consists of three separate conditional exemptions that allow banks to engage in order-taking activities for three specific types of accounts: (i) employee benefit plan accounts, individual retirement accounts ("IRAs"), and similar accounts; (ii) accounts other than employee benefit plans or IRAs if the bank accepts orders on an "accommodation" basis only; and (iii) accounts for which the bank acts as a subcustodian for an account for which another bank acts as custodian, or for which the bank acts "as a non-fiduciary and non-custodial administrator or recordkeeper" for an employee benefit plan for which another bank acts as custodian. Under each of the conditional exemptions that allow the bank to accept orders for securities transactions, the bank must direct the transactions to a registered broker-dealer for execution or conduct the trade as otherwise permitted under SEC rules. (Regulation R includes two such rules as described under part E, "Other Exemptions" below.)

The limitations in Rule 760 generally are designed to help ensure that order-taking activities do not permit a bank to operate the functional equivalent of a securities brokerage business and, specifically for that purpose, include limits on advertising and employee compensation.[26] In evaluating a bank's compliance with the exemption, the Agencies will consider both the form and substance of the relevant accounts, transactions and activities, including advertising activities.

1. Order-Taking Exemption for Employee Benefit Plans and IRAs

The exemption for employee benefit plans, IRAs, and similar accounts in Rule 760(a) was adopted largely as proposed. The exemption applies specifically to an employee benefit plan account, an IRA account, or similar plans or accounts for which the bank acts as a custodian. Rule 760(h) defines these terms broadly to include, among other things, pension plans, retirement plans, profit sharing plans, bonus plans, thrift savings plans, incentive plans, individual retirement accounts, health savings accounts, Archer medical savings accounts, Coverdell savings accounts, or other similar accounts as defined in applicable sections of the Internal Revenue Code. Plans or accounts, such as "lifetime savings accounts," that may be established under the Internal Revenue Code in the future would be considered employee benefit plan accounts or individual retirement accounts for purposes of the exemption.

Employee Compensation Restrictions. Bank employees that accept orders for securities transactions pursuant to the exemption may not receive compensation, including fees paid under a 12b-1 plan, from the bank, the executing broker or dealer, 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 for the account.[27] However, these restrictions do not prevent employees from receiving compensation pursuant to the networking exception or under a bonus or similar plan that is otherwise permissible under other provisions of Regulation R. The employee compensation restriction also does not prohibit an employee from receiving compensation that is tied to whether customers establish custody accounts or the amount of assets customers place in such accounts. If the bank's compensation practices are not consistent with these limitations, the bank may not accept securities orders in a custodial capacity in reliance on the exemption.

Advertising Limitations. Banks relying on Rule 760(a), (i) may advertise order-taking capabilities for employee benefit plans, IRAs, or similar accounts for which the bank acts as custodian, only as part of the bank's advertising of its custodial or safekeeping services for these accounts generally, (ii) may not advertise that these custodial accounts are securities brokerage accounts or that the bank's safekeeping and custody services are a substitute for securities brokerage accounts, and (iii) may not describe the bank's securities order-taking services for individual retirement or similar accounts in advertisements and sales literature more prominently than other aspects of the bank's custody and safekeeping services for these accounts.

Additional restrictions that apply to a bank's order-taking activities pursuant to Rule 760(a) are discussed below.

2. Accommodation Transactions

Regulation R includes an additional exemption – Rule 760(b) – that allows banks to continue to accept securities transaction orders for custodial accounts other than employee benefit plans and IRAs on a so-called "accommodation basis." Under Rule 760(h), an "account for which the bank acts as a custodian" means "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." In response to comments that requested the Agencies to clarify whether the exemption would be available to banks that perform custodial functions in a non-trustee and non-fiduciary capacity (such as escrow agent, fiscal agent or paying agent), but where the bank is not formally designated as "custodian" in the agreement with the customer, the Agencies indicated that a bank's status as a custodian will be determined based on the services the bank provides to the account with respect to securities or assets, not on the label that is used to identify the bank's services.

Accommodation Basis. The Agencies declined to define "accommodation" because of what they consider to be great variations in the types, characteristics, and uses of custody accounts and in the size and operations of banks that provide order-taking as an accommodation. Instead, the federal banking agencies will develop guidance that examiners will use in evaluating banks' compliance with the exemption. The guidance will address policies and procedures and systems that a bank should have in place if it accepts orders as an accommodation. (The Agencies did not specify a time by which the banking agencies are expected to issue the guidance.)

Employee Compensation. Order-taking activities for accommodation transactions pursuant to Rule 760(b) are subject to the same limitations on employee compensation as described above with respect to employee benefit, IRA and similar accounts.

Bank Fees. Rule 760(b) also limits the fees a bank may charge for accommodation securities transactions by prohibiting variations in fees based on whether the bank accepts the order or on the quantity or prices of the securities to be bought or sold. For example, a bank cannot vary fees for transferring securities into or out of a custody account based on whether the customer places the order directly with the bank or with the securities broker to or from which the securities will be transferred. Unlike the limitations on employee compensation, which prohibit variations in employee compensation based on "the quantity, price, or identity of the securities purchased or sold for the account," the restrictions on bank compensation do not prevent a bank from varying its fee based on the type of security that is bought or sold (e.g., government debt, corporate equity, foreign securities), provided the fee otherwise complies with the Rule.

Advertising and Sales Literature. Rule 760(b) prohibits a bank from advertising that it accepts orders for securities transactions. This is more restrictive than the limits on employee benefit plan and IRA account advertising, which allow banks to advertise order-taking services as part of advertising custodial or safekeeping services for those types of accounts. Accommodation order-taking may be referenced in sales literature, however, as part of the description of the bank's other custodial or safekeeping services, provided the order-taking services are not described more prominently than other aspects of the bank's custody or safekeeping services.

Investment Advice and Recommendations. Banks that accept securities orders on an accommodation basis pursuant to Rule 760(b) may not provide securities investment advice or research to the account or otherwise solicit securities transactions from the account. This limitation does not, however, prohibit banks from using advertising and sales literature that is otherwise permitted, nor does it prohibit banks from responding to customer inquiries by providing a registered investment company's prospectus or describing the availability of the bank's other safekeeping or custodial services, such as sweep services, provided the bank does not provide advice or recommendations in doing so. The restriction does not prohibit the bank from providing advice or recommendations with respect to employee benefit plans, IRAs, or similar plan accounts, or to trust or fiduciary accounts, even if the customer also maintains a custodial account with the bank. However, the restriction would apply to the custodial account.

The restriction on advice, recommendations and solicitation activities was adopted, notwithstanding comments expressing concern that it would negatively affect banks' ability to cross market their trust, fiduciary or other custody services and/or that the limitations would interfere with banks' ability to share research with custody customers or the public. The Agencies did not consider this to be an issue, indicating that banks may include non-account-specific information in media such as newsletters and websites, and that the restriction does not prohibit banks from providing samples of research to custody customers that they also provide to other bank customers. Although banks that have customers with both custody accounts and other accounts to which the advice/recommendation limitation does not apply may not be able to control which account customers use to place orders that may result from the bank's advice and recommendations, banks' policies and procedures should be designed to prevent evasions of the limitations with respect to custody accounts. For example, the Agencies said that banks may not evade the restrictions by routinely sending research that is targeted to securities held in custody accounts to customers that have both custody and trust or fiduciary accounts. In determining banks' compliance with the exemption, both the form and substance of banks' activities will be considered.[28]

3. Directed Trustees

The order-taking exemptions in Rules 760(a) and 760(b) specifically do not apply to a bank that acts in a trustee or fiduciary capacity (in which case the bank may rely on the trust and fiduciary activities exception described above).[29] However, in response to comments that banks that act as "directed trustees" provide services that are functionally similar to custody services, the Agencies modified the exemptions to allow reliance by a bank that acts as a "directed trustee," i.e., "a trustee that does not exercise investment discretion."[30] Thus, a bank acting as a directed trustee may rely either on an order-taking exemption or the trust or fiduciary activities exception, provided it satisfies the applicable conditions of either.[31]

4. Carrying Broker Restriction

A bank may not rely on the custody and safekeeping exception if, in connection with its custodial activities, the bank engages in "carrying broker" activities for a broker-dealer. The Agencies declined to define the term "carrying broker," opting instead to suggest that banks look to certain key factors to help distinguish permissible custodial activities from impermissible carrying broker activities. These factors include the broker-dealer's own regulatory obligations and whether the broker-dealer either makes formal or informal arrangements with the bank or structures its operations or offerings to cause the broker-dealer's customers generally to use the bank's custody accounts, rather than maintaining funds and securities in securities accounts at the broker-dealer, to avoid the broker-dealer's financial and related responsibilities. The existence of a substantial number of common customers, in the absence of such arrangements, would not cause the bank to be deemed to be acting as a carrying broker.

Banks and broker-dealers may have other arrangements that will not necessarily make the banks carrying brokers. For example, a bank may perform (or share systems that perform) limited back-office functions on behalf of a broker-dealer, and a bank and an affiliated broker-dealer may share or coordinate risk management systems, such as those relating to Bank Secrecy Act and anti-money laundering compliance, without the bank becoming a carrying broker for the broker-dealer. Similarly, a broker-dealer, for example, may contract with a bank to send out transaction confirmations on behalf of the broker-dealer or have an arrangement with an affiliated bank to provide customers with combined statements, with the broker-dealer remaining responsible for the accuracy and completeness of those confirmations and the broker-dealer aspects of the statements, also without causing the bank to be deemed a carrying broker.

A broker-dealer, however, may not delegate to a bank (or other unregistered entity) core functions or functions that would require an individual to pass a qualification examination or register with an SRO. A broker-dealer also must maintain possession or control over the broker-dealer's proprietary cash or securities and its customers' cash or securities in accordance with the SEC's financial responsibility rules. Of course, a bank may serve as custodian for proprietary or customer cash or securities of the broker-dealer and may accept and use in the ordinary course of its banking business cash deposited with the bank by the broker-dealer or its customers.

5. Order-Taking for Non-Custodial Accounts

Rules 760(e) and 760(f) permit banks that act as non-fiduciary, non-custodial administrators or recordkeepers for employee benefit plans or as subcustodians for other types of accounts – where another bank acts as custodian for the account – to accept orders for securities transactions for the accounts. The Rules require both banks to comply with the provisions that apply to the particular type of account for which the banks are providing services (i.e., employee benefit plan account, IRA or similar account, or other types of custodial accounts).

Although the Rules generally prohibit cross-trades and netting orders, banks acting as administrator/recordkeepers or subcustodians for another bank may cross or net orders for shares of open-end investment companies that are not exchange traded and orders for the custody accounts of the custodian bank. The Agencies allowed for limited cross trade and netting activity for accounts at the same bank with the goal of eliminating the need for a broker intermediary, thereby allowing for some cost savings in these situations.

Conversely, the prohibition on cross-trades or netting orders between accounts at different custodian banks will help prevent banks from establishing a market for the securities. Note, the cross-trade and netting provisions that apply for administrator/recordkeeper and subcustodian banks do not apply when banks provide custody and order-taking services for trust and fiduciary accounts of another bank. In such cases, banks that provide custody services would be considered custodians, not subcustodians. As such, these custodian banks could provide securities order-taking services pursuant to the provisions of Rule 760(a) or (b) (regarding employee benefit, IRA or similar accounts or accommodation transactions).

E. Other Exemptions

1. Regulation S[32] Transactions

Generally, the SEC has applied a "conducts and effects" test in determining the extent to which it will regulate significant conduct that takes place either in the United States (even if there is no material effect on U.S. persons or markets) or that takes place outside the United States (but which may have a material effect on U.S. persons or markets). Consequently, the SEC has customarily required a person that conducts "broker" or "dealer" transactions in the United States to register, absent an applicable exemption. In their final form, Rule 771 under Regulation R, and Exchange Act Rule 3a5-2 (adopted in conjunction with Rule 771), which relates to "dealer" activities, deviate from this traditional approach and allow banks to engage in certain agency and principal transactions with non-U.S. persons and involving Regulation S[33] securities without being required to register as a broker-dealer.

In adopting these exemptions, the SEC recognized that non-"U.S. persons"[34] generally will not rely on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks and that non-U.S. persons can purchase the same securities from banks located outside the United States. In this regard, the SEC saw no compelling reason to disadvantage U.S. banks in competing with their non-U.S. counterparts.[35]

This realistic approach is consistent with the approach taken in Regulation S itself where, in light of the severe competitive disadvantages that might be faced by U.S. professional fiduciaries, the SEC excepted from the definition of "U.S. person" U.S. professional fiduciaries acting with discretion for the account of persons (other than trusts and estates) who are not themselves "U.S. persons."

The "Broker" Exemption. Rule 771 has three parts. The first part permits a bank to effect a sale of an eligible security[36] in compliance with the requirements of Rule 903 to a purchaser[37] who is not in the United States.

The second part permits a bank to effect, by or on behalf of a person who is not a U.S. person under Rule 902(k), a resale of an eligible security after its initial sale to a purchaser who is not in the United States or to a registered broker-dealer. To take advantage of this second exemption, a bank (i) must have a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of, and in compliance with, Rule 903 and (ii) if the resale is made prior to any applicable distribution compliance period specified in Rules 903(b)(2) or (b)(3), the resale must be made in compliance with the requirements of Rule 904.

The third part of Rule 771 permits a bank to effect, by or on behalf of a registered broker-dealer, a resale of an eligible security after its initial sale to a purchaser who is not in the United States. As under the second part, the bank must have a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of, and in compliance with,

Rule 903 and, if the resale is made prior to the expiration of any applicable distribution compliance period in Rules 903(b)(2) or (b)(3), the bank must effect the resale in compliance with the requirements of Rule 904. As Rule 771 makes clear, a bank effecting a resale of an eligible security under the exemption must effect the transaction in accordance with the conditions of Rule 904 if the transaction occurs during, but not after, any applicable distribution compliance period for the security under Rule 903(b)(2) or (b)(3).

The "Dealer" Exemption. Rule 3a5-2 provides a conditional exemption from the definition of "dealer" for a bank that only purchases and sells "eligible securities" under Regulation S on a "riskless principal" basis. Accordingly, Rule 3a5-2 permits U.S. banks to sell, overseas, securities that non-U.S. banks also sell, and intends to avoid placing U.S. banks at a competitive disadvantage with respect to eligible securities, while also safeguarding against investor protection risks associated with unregistered entities distributing eligible securities.

The exemption is available when a bank purchases a newly-issued eligible security from an issuer or a broker-dealer and sells that security in compliance with the requirements of Rule 903 to a purchaser who is not in the United States. The exemption also is available when a bank purchases, from a person who is not a U.S. person under Rule 902(k), an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of, and in compliance with, the requirements of Rule 903, and resells that security to a purchaser who is not in the United States or to a registered broker-dealer. If that resale is made prior to any applicable distribution compliance period specified in Rules 903(b)(2) or (b)(3), the resale must be made in compliance with the requirements of Rule 904.

Finally, the exemption is available when a bank purchases, from a registered broker-dealer, an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of, and in compliance with, the requirements of Rule 903, and resells that security to a purchaser who is not in the United States This provision also requires compliance with Rule 904 if the resale is made prior to the expiration of the security's distribution compliance period.

In adopting Rule 3a5-2, the SEC modified the proposal to provide that when the bank purchases an eligible security from a broker-dealer after the security's initial sale (for resale to a non-U.S. person), the bank may rely on its reasonable belief that the eligible security was initially sold outside of the United States consistent with Rule 903.

As revised, the provisions of Rule 3a5-2 that apply to a bank's resale of previously issued Regulation S securities (but not the provision related to a bank's sale of a newly issued security) require compliance with Rule 904, if the resale is made prior to the expiration of the security's distribution compliance period.

The SEC also clarified that Rule 3a5-2 (like Rule 771) requires the bank to meet the conditions of Rule 904 during, but not after, the distribution compliance period. During the distribution compliance period, a bank will have to comply with Regulation S to take advantage of the exception. Even after the end of the distribution compliance period, however, a bank may rely on this exemption from the dealer definition so long as it satisfies the other requirements of Rule 3a5-2. After the expiration of the applicable distribution compliance period, although the securities may be offered and sold in the United States pursuant to a registration statement declared effective under the Securities Act or pursuant to an available exemption from the registration requirements of that Act, the bank will not be permitted to sell them to persons other than a broker-dealer or a person who is not in the United States.

2. Securities Lending Transactions and Services

The "Broker" Exemption. Rule 772 provides banks engaged in certain securities lending transactions with a conditional exemption from the definition of "broker." The 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 such securities for less than the entire period of the transaction. This exemption reinstates, without modification, an exemption that the SEC adopted previously.[38]

Specifically, Rule 772 provides that a bank is exempt from the definition of "broker" to the extent that, as agent, it engages in or effects certain "securities lending transactions"[39] and "securities lending services"[40] in connection with such transactions. The exemption applies only to securities lending activities with or on behalf of a person that the bank reasonably believes to be (i) a "qualified investor,"[41] as defined in Exchange Act Section 3(a)(54)(A) or (ii) any employee benefit plan that owns and invests, on a discretionary basis, not less than $25 million in investments.

The exemption is intended to enable sizable and sophisticated customers to divide custody and securities lending management between two expert entities when the customer decides such actions are in the customer's interest, and permits banks to continue to provide the types of non-custodial securities lending services that they have provided without disruption. The statutory custody and safekeeping exception permits banks to effect securities lending transactions (and provide related securities lending services) when the bank has custody of the securities. A bank need not rely on the exemption in Rule 772 to engage in securities lending transactions when acting in this capacity. The Agencies rejected arguments from commenters that non-custody lending should be allowed for smaller clients, apparently reflecting concerns that securities lending for small clients are not part of the banking services customarily provided to such accounts and that such services for non-custodial customers may be regarded more typically as brokerage-type activities.

The "Dealer" Exemption. Rule 3a5-3 provides limited exemptions for a bank to the extent that, as a conduit lender,[42] it engages in certain "securities lending transactions"[43] and "securities lending services"[44] in connection with such transactions.

3. Exemptions from Broker Execution Requirement

The Exchange Act generally requires, subject to certain exceptions, that a bank effecting a transaction involving a "publicly traded security" in the United States pursuant to the trust and fiduciary, stock purchase plan, or custody and safekeeping exception must direct the trade to a registered broker for execution.[45] Regulation R contains two exemptions from this requirement, adopted and modified specifically in response to comments submitted in connection with the Proposed Rules.

Mutual Fund Shares and Variable Annuities. Rule 775 as adopted permits a bank to effect transactions in securities issued by mutual funds registered under the 1940 Act (i.e., open-end investment companies), through the mutual fund clearing and settlement system of the National Securities Clearing Corporation ("NSCC") (known as "Fund/SERV") or directly with a fund's transfer agent. In response to comments that transactions involving variable annuity and variable life products (which are considered "securities" for purposes of the securities laws) are effected directly with the relevant insurance company, the Agencies expanded the final Rule to include these products (specifically, variable insurance contracts funded by a "separate account" of an insurance company, as defined by 1940 Act Section 2(a)(37) and registered under the 1940 Act).

Other conditions of Rule 775 that must be satisfied in order for the exemption to apply include (i) the securities cannot be traded on a national securities exchange or through the facilities of a national securities association or an interdealer quotation system (e.g., Nasdaq), (ii) the securities must be distributed by a registered broker or, if self-underwritten, any sales charges assessed must be no more than what is permissible for a registered broker under applicable rules of a registered securities association[46], and (iii) the transaction must be effected through the NSCC (in the case of mutual fund shares) or directly with a mutual fund transfer agent or an insurance company or separate account that is excluded from the definition of "transfer agent" under Exchange Act Section 3(a)(25).

Employer Securities Transactions. The statutory exceptions for certain stock purchase plans, including employee benefit plans that invest in securities of the employer or its affiliates, dividend reinvestment plans, and certain other issuer stock purchase plans, require that securities transactions effected pursuant to those arrangements be directed to a registered broker, and the Proposed Rules did not provide an exemption from that requirement. In response to a comment, however, the Agencies acknowledged that banks, acting as trustees or custodians for employee benefit plans, may effect transactions in employer securities (e.g., in-kind contributions, purchases and sales, and distributions) for the plans directly with the employer's transfer agent, without the involvement of a broker. Accordingly, Rule 776 represents an additional exemption from the broker execution requirement for transactions in securities of a company if the following conditions are satisfied:

First, the transaction must be effected solely for an employee benefit plan of any kind (e.g., a pension, profit sharing, bonus, thrift savings, incentive, health and welfare, stock option, non-qualified deferred compensation, supplemental benefit, or other similar types of plan) maintained or sponsored by a private corporate employer, governmental entity, or church, or pursuant to a collective bargaining agreement.

Second, no commission may be charged with respect to the transaction.

Third, the security involved in the transaction must be obtained directly from, and must be transferred only to, the company or from an employee benefit plan of the company. Securities obtained from, or transferred to, a participant in an employee benefit plan on behalf of the plan are considered obtained from, or transferred to, the plan.[47]

4. Temporary and Permanent Exemption for Contracts Entered Into by Banks from Being Considered Void or Voidable

The Agencies adopted, as proposed, Rule 780, which grants one temporary and one permanent exemption from Exchange Act Section 29(b)[48] in order to address inadvertent failures by banks that could trigger rescission of contracts between banks and their customers. Under the temporary exemption, a contract entered into by a bank before June 3, 2009 will not be void or voidable by reason of Exchange Act Section 29 solely because the bank violated the registration requirements of Exchange Act Section 15(a) or other applicable provisions of, or rules and regulations under, the Exchange Act relating to the bank's status as a broker at the time the contract was created. The permanent exemption applies if two additional conditions are met.

First, at the time the contract was created, the bank must have acted in good faith and had reasonable policies and procedures in place to comply with the statutory exceptions described in Exchange Act Section 3(a)(4)(B) and the rules and regulations thereunder (including Regulation R).

Second, any violation of the registration requirements by the bank must not have resulted in any significant harm, financial loss, or cost to the person seeking to void the contract.

This exemption was provided because the Agencies determined that a bank that is acting in good faith and that has reasonable policies and procedures in effect at the time a securities contract is created should not be subject to rescission claims as a result of an inadvertent failure to comply if customers are not significantly harmed.

Regulation R is not the final word on the subject. As required by the GLBA, the federal banking regulators will, in consultation with the SEC, establish recordkeeping requirements "sufficient to demonstrate compliance" with the statutory exceptions and Regulation R.[49] The federal banking agencies also will develop guidance relating to "policies, procedures and systems" banks should implement to ensure they are in compliance with the new exemptions (discussed above) relating to "accommodation" order taking activities for certain custodial accounts[50] and generally conduct their securities activities in "a safe and sound manner and to help prevent evasions" of the exceptions.[51] Finally, the Agencies jointly will consider requests for future guidance and interpretations concerning the scope or terms of the statutory exceptions and Regulation R, and will consult one another, as well as other appropriate federal banking agencies, regarding formal enforcement actions.[52]

Authors:

Edward G. Eisert

Partner, New York

212.536.3905

edward.eisert@klgates.com

Rebecca Laird

Partner, Washington, D.C.

202.778.9038

rebecca.laird@klgates.com

Elaine A. Lindenmayer

Of Counsel, San Francisco

415.249.1042

elaine.lindenmayer@klgates.com

C. Dirk Peterson

Partner, Washington, D.C.

202.778.9324

dirk.peterson@klgates.com

William P. Wade

Partner, Los Angeles

310.552.5071

william.wade@klgates.com

End Notes

[1] SEC Release No. 34-56501 (Sept. 24, 2007), 72 Fed. Reg. 56514 (Oct. 3, 2007). On the same day, the SEC issued final rules relating to exemptions for banks from the definition of a "dealer" under Exchange Act § 3(a)(5). SEC Release No. 34-56502 (Sept. 24, 2007), 72 Fed. Reg. 56562 (Oct. 3, 2007).

[2] SEC Release No. 34-54946 (Dec. 18, 2006), 71 Fed. Reg. 77522 (Dec. 26, 2006). http://www.klgates.com/newsstand/Detail.aspx?publication=3649

[3] Under Rule 781, a bank will be expected to be in compliance with the statutory exceptions and the rules under Regulation R as of the first day of its first fiscal year beginning after September 30, 2008. For most banks, this will be January 1, 2009. However, see text accompanying note 16 regarding compliance with the trust and fiduciary activities exception.

[4] For convenience, and unless otherwise noted, references to "exceptions" are intended to include both statutory exceptions and regulatory exemptions.

[5] See text accompanying note 52. The Agencies have announced their intention to jointly issue any interpretations and responses to requests for no-action letters or other interpretive guidance regarding the scope or terms of the "broker" exceptions and the final rules.

[6] The amended definition of a "bank" does not include federal or state-chartered credit unions, although the SEC currently is considering requests to extend the exceptions in Section 3(a)(4)(B) to them.

[7] The SEC staff issued numerous no-action letters to various thrifts, federal savings banks and credit unions – institutions that did not previously satisfy the definition of bank in Section 3(a)(6) – permitting them to provide securities services similar to those permitted by banks. These letters culminated into a final no-action position on the subject of networking, which was issued in Chubb Securities Corp., SEC No-Action Letters (pub. avail. Nov. 24, 1993).

[8] Effective July, 2007, the member regulatory arms of the New York Stock Exchange and National Association of Securities Dealers, Inc. ("NASD") were combined. The combined SRO is the Financial Industry Regulatory Authority ("FINRA"). References hereinafter to "Conduct Rules" are to former NASD rules.

[9] The written agreement is important, not only because it is an essential element of the statutory exception, but also for compliance with permitted payment structures for referrals of institutional and high net-worth clients, as discussed below. In short, allocation of eligibility and disclosure obligations relevant to this part of the exception must be set forth in the agreement.

[10] See, e.g., Conduct Rules 2820(g) and 2830(l) setting forth complex regulations of permissible non-cash compensation arrangements in connection with the sale of variable annuities and mutual funds.

[11] The review of assets may include assets held individually, assets of a spouse (regardless of whether the assets are held jointly), if the spouses are acting jointly, or 50 percent of assets held jointly or shared as community property if one spouse is acting without the other.

[12] Rule 721.

[13] Rule 721(a)(1).

[14] Rule 722(a)(2). As in the proposed rule, the final rules do not define the term "total compensation."

[15] Rule 721(a)(7) defines "year" as the calendar year or fiscal year consistently used by the bank for recordkeeping and reporting purposes.

[16] Rule 721(a)(3)(ii). In a clarification of the proposed rules, Regulation R specifies that the bank must perform the required computation within 60 days of the end of the year.

[17] In addition, fees based on the performance (e.g., capital gains) of a trust or fiduciary account are included as examples of permissible relationship compensation. See Rule 721(a)(4)(i), (iii).

[18] Staff Memorandum to the Board of Governors of the Federal Reserve System, dated September 18, 2007 regarding "Final Rules Implementing the 'Broker' Exceptions for Banks Adopted as Part of the Gramm-Leach-Bliley Act of 1999," at 7.

[19] See 72 Fed. Reg. 56514, 56532 (Oct. 3, 2007).

[20] See Rule 721(b) and Rule 722(d).

[21] See Rule 723, which also exempts from the account-by-account compensation test accounts transferred to a broker dealer within 3 months of the calendar year end and a de minimis number of accounts not exceeding the lesser of 1 percent of the total number of the bank's trust and fiduciary accounts or 500.

[22] Rule 721(c).

[23] Rule 721(c)(2), referencing Rule 760(h)(2).

[24] 72 Fed. Reg. 56514, 56535 (Oct. 3, 2007).

[25] 12 U.S.C. §1828(t).

[26] The definition of "advertising" for purposes of the safekeeping and custody exemptions is the same as for the trust and fiduciary exception as described in part B, "Trust and Fiduciary Activities" above.

[27] Rule 760(c).

[28] Rule 760(g).

[29] Rule 760(d)(1).

[30] Rule 760(h)(3).

[31] Although a bank acting as a directed trustee is treated like a custodian for the purposes of the order-taking exemptions, the bank's relationship as directed trustee remains subject to fiduciary principles and standards applicable to such accounts (e.g., under the Employee Retirement Income Security Act of 1974).

[32] Regulation S is comprised of Rules 901 through 905 under the Securities Act.

[33] As used in Regulation R, "Regulation S securities" refers to securities offered and sold in reliance on Regulation S.

[34] As used in Regulation R, the term "U.S. person" has the same meaning as in Regulation S.

[35] This was explicitly stated by the SEC in the adopting release for Rule 3a5-2. 72 Fed. Reg. 56562, 56563 (Oct. 3, 2007).

[36] "Eligible security" means any security other than a security that is being sold from the inventory of the bank or an affiliate of the bank or that is being underwritten by the bank or an affiliate of the bank 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 an affiliate of the bank. A security that is issued by a bank or an affiliate of a bank, such as a structured note or share in a pooled investment vehicle, may be an eligible security if it otherwise meets the requirements of Rule 771.

[37] "Purchaser" means a person who purchases an eligible security and who is not a U.S. person under Rule 902(k) of Regulation S.

[38] 72 Fed. Reg. 56514, 56544 (Oct. 3, 2007).

[39] Rule 772 defines "securities lending transaction" to mean: "a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending 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 by the parties."

[40] Rule 772 defines "securities lending services" to mean: (1) selecting and negotiating with a borrower and executing or directing the execution of the loan with the borrower; (2) receiving, delivering, or taking custody of loaned securities; (3) receiving, delivering, or directing the receipt or delivery of collateral; (4) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (5) investing or directing the investment of cash collateral; or (6) indemnifying the lender of securities with respect to various matters."

[41] As defined in Section 3(a)(54)(a), a "qualified investor" includes, among others: a registered investment company, an investment company that is exempt from registration pursuant to Section 3(c)(7) of the 1940 Act, and any bank, broker, and dealer.

[42] Rule 3a5-3 defines a "conduit lender" as a bank that borrows (or loans) securities, as principal, for its own account, and contemporaneously loans (or borrows) the same securities, as principal, for its own account.

[43] Rule 3a5-3 defines a "securities lending transaction" as it is defined in Rule 772. See note 39, supra.

[44] Rule 3a5-3 defines "securities lending services" as it is defined in Rule 772. See note 40, supra.

[45] Exchange Act § 3(a)(4)(C)(i).

[46] Conduct Rule 2830 limits sales charges associated with mutual fund share transactions, but not variable insurance securities products.

[47] The Agencies noted that no additional exemption was required to accommodate transactions under which a bank, acting as trustee or custodian for different employee benefit plans involved in corporate spin-off transactions, would directly effect transactions with and for the plans through cross-trades within the bank. Although the Agencies did not so state, they presumably believed that such transactions would be covered by the Trust Activities exception for plans for which the bank acts as trustee and Rule 760(a) for plans for which the bank acts as custodian.

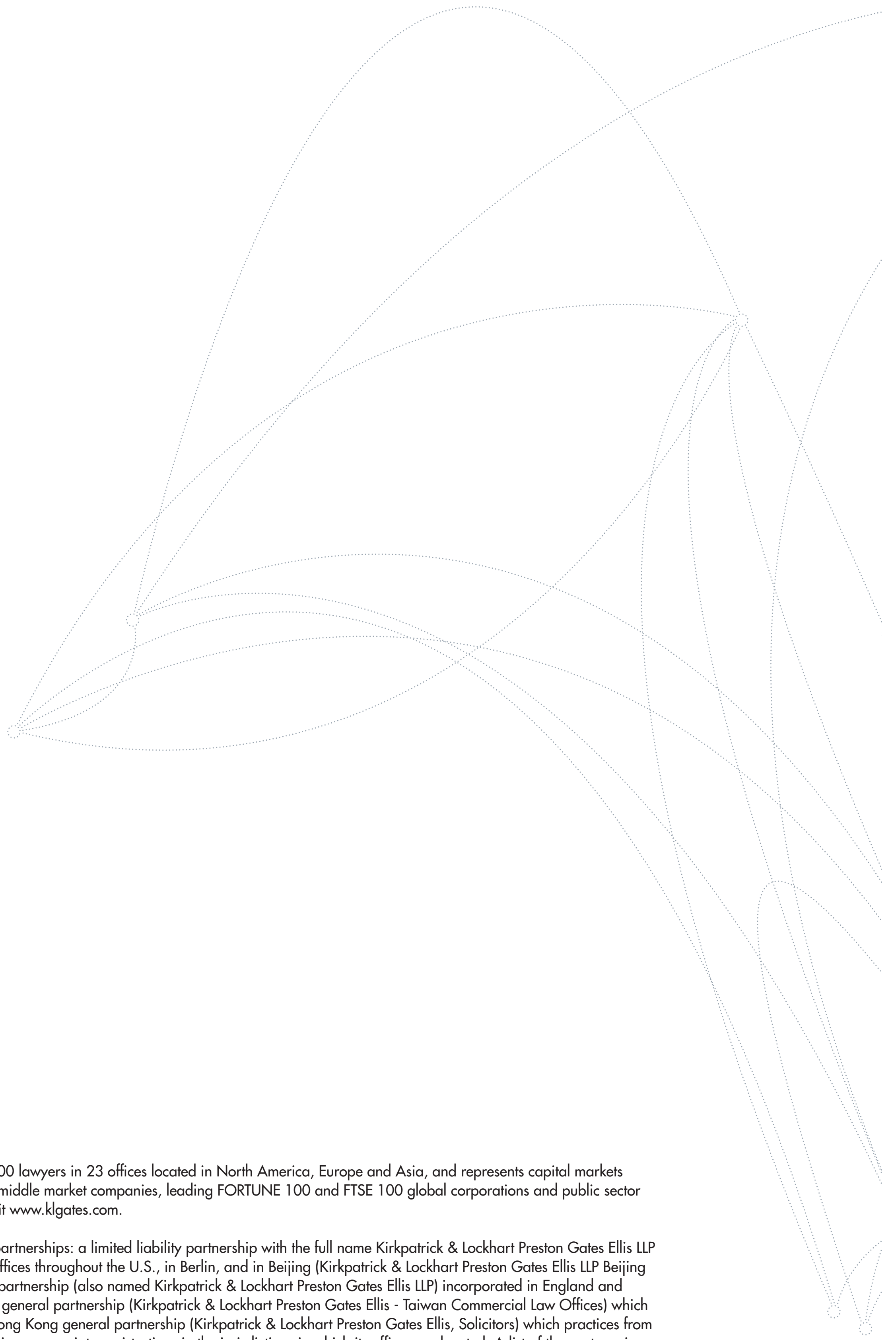
[48] Exchange Act Section 29(b) provides that, with limited exceptions:
Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract . . . the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation . . . .

[49] Federal Deposit Insurance Act § 18(t)(1), as amended by GLBA § 204.

[50] 72 Fed. Reg. 56514, 56538 (Oct. 3, 2007).

[51] Staff Memorandum to the Board of Governors of the Federal Reserve System, dated September 18, 2007 regarding "Final Rules Implementing the 'Broker' Exceptions for Banks Adopted as Part of the Gramm-Leach-Bliley Act of 1999," at 19.

[52] 72 Fed. Reg. 56514, 56516-17 (Oct. 3, 2007).



K&L | GATES

K&L Gates comprises approximately 1,500 lawyers in 23 offices located in North America, Europe and Asia, and represents capital markets participants, entrepreneurs, growth and middle market companies, leading FORTUNE 100 and FTSE 100 global corporations and public sector entities. For more information, please visit www.klgates.com.

K&L Gates comprises multiple affiliated partnerships: a limited liability partnership with the full name Kirkpatrick & Lockhart Preston Gates Ellis LLP qualified in Delaware and maintaining offices throughout the U.S., in Berlin, and in Beijing (Kirkpatrick & Lockhart Preston Gates Ellis LLP Beijing Representative Office); a limited liability partnership (also named Kirkpatrick & Lockhart Preston Gates Ellis LLP) incorporated in England and maintaining our London office; a Taiwan general partnership (Kirkpatrick & Lockhart Preston Gates Ellis - Taiwan Commercial Law Offices) which practices from our Taipei office; and a Hong Kong general partnership (Kirkpatrick & Lockhart Preston Gates Ellis, Solicitors) which practices from our Hong Kong office. K&L Gates maintains appropriate registrations in the jurisdictions in which its offices are located. A list of the partners in each entity is available for inspection at any K&L Gates office.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

Data Protection Act 1998—We may contact you from time to time with information on Kirkpatrick & Lockhart Preston Gates Ellis LLP seminars and with our regular newsletters, which may be of interest to you. We will not provide your details to any third parties. Please e-mail london@klgates.com if you would prefer not to receive this information.

©1996-2008 Kirkpatrick & Lockhart Preston Gates Ellis LLP. All Rights Reserved.