Discussion of Certain Key Exemptions in Proposed Securities and Exchange Commission Regulation B

The Securities and Exchange Commission's (SEC) proposed rule on the securities activities of banks – proposed Regulation B – describes four primary statutory exceptions from the broker definition, plus provides several specific exemptions. Set forth below is a general discussion that broadly summarizes certain key exemptions in the proposed rule. The SEC's proposed rule text and the associated discussion should be fully reviewed in order to gain a complete understanding of the exemptions in conjunction with the statutory exceptions in the Gramm-Leach-Bliley Act of 1999 (GLBA).

Trust and Fiduciary Exception

The trust and fiduciary exception will allow banks to continue to effect securities transactions for trust and fiduciary customers provided that the transactions are conducted in a trust or other department of the bank that is regularly examined for compliance with fiduciary standards, and provided that the bank is "chiefly compensated" for its services on the basis of "relationship" compensation.

Under the SEC's proposed regulation, "fiduciary capacity" includes acting as an investment adviser if the bank receives a fee for its investment advice. The bank must owe the customer a duty of loyalty, including an affirmative duty to make full and fair disclosure of all material facts and conflicts of interest. The bank must have an ongoing responsibility to provide investment advice based upon a customer's individual needs. The bank's responsibilities must include selecting or making recommendations regarding specific securities. If the customer accepts such selections or recommendations, the bank must be responsible for directing the purchases or sales to a registered broker or dealer for execution.

The proposed regulation offers several methods for determining whether the bank is "chiefly compensated" on the basis of "relationship" compensation, which is defined as: (1) an administrative or annual fee; (2) flat or capped order processing fees that do not exceed the cost incurred by the bank for effecting a securities transaction; or (3) a fee based on a percentage of assets under management. Determination of whether a bank is "chiefly compensated" will require a bank to compare the ratio of "relationship compensation" to "sales compensation," which is defined as commission-type compensation, plus sales charges and service fees paid out of mutual fund assets under a 12b-1 plan.

The SEC's proposed rule provides banks with several options to avoid the regulatory burden of account-by-account compliance with the "chiefly compensated" requirement and instead to comply on a bank-wide or line-of-business basis. One option is for the bank to demonstrate that during the preceding year its ratio of "sales compensation" to "relationship compensation" was no more than 1:9 as determined on a bank-wide or a line-of-business basis. To illustrate, if a bank's trust department received $90 per year in "relationship compensation," and conducted no trades of securities in its accounts, but was paid $12 a year in fees under a 12b-1 plan on mutual funds held in trust accounts, the trust department would not qualify for this exemption from account-by-account compliance under the proposed rule.

The proposal would require a bank to maintain procedures reasonably designed to ensure that, after an account is opened or established, the bank is likely to receive more "relationship" than "sales" compensation. A bank's procedures must also be designed to ensure that, when a bank negotiates with an accountholder to increase "sales" compensation, the bank is likely to continue to receive more "relationship" compensation than "sales" compensation.

Banks will be allowed to measure compensation in one year in order to determine if they will be in compliance with the regulation for the following year. The SEC has also provided cure periods to address non-compliance with the "chiefly compensated" requirement.

The SEC is also proposing a personal trust account exemption for living, testamentary, or charitable trust accounts established before the adoption of this regulation.

Safekeeping and Custody Exception

The safekeeping and custody exception will allow banks acting in a custodial capacity to engage in specified securities transactions. Banks, acting as custodians, have traditionally conducted securities transactions (order-taking) for custodial customers, typically transmitting customer orders to registered broker-dealers for execution. The SEC has interpreted GLBA as generally prohibiting order-taking by custodian banks, but has provided several exemptions whereby, subject to certain restrictions, banks can continue to provide order-taking services to bank custodial customers.

The SEC has proposed a "small bank" custody exemption for banks with $500 million or less in total assets, which are not associated with a broker-dealer and are not part of a bank holding company having more than $1 billion in consolidated assets. A "small bank" could continue to take customer orders provided that annual revenues from that activity do not exceed $100 thousand. Under the proposed rule, bank custodians may take orders for any type of security. "Small banks" will also be permitted to use networking agreements with unaffiliated broker-dealers and use dual employees to effect securities transactions for custodial customers.

The SEC is also proposing a general bank custody exemption that would allow banks to effect securities transactions where the bank accepts securities orders if the bank charges the same custody fees for handling the account regardless of whether the bank places orders to buy or sell securities through the bank. This exemption would apply only to orders from a "qualified investor," as defined in the Act, or a customer with a grandfathered account (existing prior to 30 days after the date of the proposed rule's publication in the Federal Register). Under the general exemption, the bank would be allowed to receive 12b-1 and shareholder servicing fees from customers, subject to this restriction.

Networking Exception

Pursuant to GLBA, banks do not become "brokers" when they partner with registered broker-dealers to offer customers financial services. Banks that do business in this manner often make arrangements to compensate their employees for referring customers to their networking partners. GLBA allows unregistered bank employees to receive a "nominal one-time cash fee of a fixed dollar amount" as incentive compensation for broker-dealer referrals. The proposed rule defines the activities in which unregistered bank employees may engage, and provides three alternative definitions of "nominal" compensation:

- The employee's base hourly rate of pay;
- Twenty-five dollars; or,
- A dollar amount equivalent to $15 in 1999 dollars adjusted for inflation.

In addition, the proposed rule solicits comment on the merits of expanding "nominal" to include fees based on the incentive a bank would pay its employees for the sale or renewal of a certificate of deposit.

The proposed rule also strictly limits referral compensation paid under broader employee incentive programs such as those which award "points" for various accomplishments if they provide unregistered bank employees with a promotional interest in securities brokerage.

The proposed rule clarifies that non-bank subsidiaries or affiliates of a bank may not rely on a bank exception or exemption from broker-dealer registration.

Sweep Accounts Exception

GLBA allows banks to sweep deposit funds into "no-load" money market mutual funds. The proposed rule adopts the definition of "no load" that the National Association of Securities Dealers (NASD) has adopted in its Rule 2830(d) (4) with some minor adjustments. Under the NASD rule, a mutual fund may not be advertised as "no load" if it imposes asset-based sales and other charges in excess of 25 basis points. Notably, the preamble of the proposed rule explains that banks are not prohibited by GLBA's "no load" condition from directly charging their customers for sweep services, because those direct charges are not charges against fund assets.

However, the preamble interprets the sweep exception to apply only to arrangements for the automatic transfer of funds on a regular basis and the investment and reinvestment of deposit balances are held at the bank by the bank's own customers.

Additional Targeted Exemptions

The SEC has proposed **additional targeted exemptions** designed to support existing business practices under the statutory exceptions. They would permit banks to effect specified transactions for certain types of investors and accounts (e.g., ERISA), permit trustees and non-fiduciary administrators to receive certain charges and fees, and permit a bank under specified conditions to sell securities exempt from registration to non-U.S. persons located outside the United States (Regulation S exemption).

Another GLBA statutory exception allows for brokerage transactions by banks in "exempted securities" under the Exchange Act, which include government securities activities under section 15C of the Exchange Act.