MAYER • BROWN

FINANCIAL SERVICES REGULATORY & ENFORCEMENT UPDATE

Regulation R – Broker "Push-out" Rules

October 22, 2007

Regulation R was jointly adopted by the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System (FRB) in September of 2007 to implement provisions of the Gramm-Leach-Bliley Act of 1999 (GLBA) governing bank brokerage activities.[1] Regulation R defines key terms in some of the exceptions for banks from the definition of "broker" under the Securities Exchange Act of 1934 (the "Exchange Act"),[2] as well as provides certain related exemptions.

Regulation R will generally become effective on December 3, 2007, except for Rule 781, which became effective on September 28, 2007. As discussed below, Rule 781 exempts banks from complying with the regulation during a transitional period that will last until the first day of a bank's fiscal year commencing after September 30, 2008.

Prior to passage of GLBA, US banks (including US branches and agencies of non-US banks)[3] enjoyed blanket exception from the definitions of "broker" and "dealer" under the Exchange Act. GLBA replaced these blanket exceptions for banks with 11 functional exceptions – exceptions largely based on the capacity in which the bank is acting or the type of security involved in the bank's activity. Although the SEC adopted final rules to implement the dealer exceptions four years ago,[4] final rules to implement the broker exceptions were not promulgated until now due to substantial adverse reactions to previous proposals from the banking industry, their regulators and key members of Congress.[5]

On October 13, 2006, President Bush signed into law the Financial Services Regulatory Relief Act of 2006 (the "Regulatory Relief Act") to break the regulatory impasse created by the SEC's repeated yet unsuccessful efforts to adopt the so-called broker "push-out" rules under GLBA and to assure active banking regulatory agency participation in the SEC rulemaking process. Section 101 of the Regulatory Relief Act effectively set aside the SEC's then outstanding rules relating to the broker exception and required the SEC and the FRB, after consulting with the other federal bank regulatory agencies, to adopt joint rules to implement the broker exceptions. The Regulatory Relief Act required proposed rules to be issued within 180 days. The SEC and the FRB issued a release proposing Regulation R in December 2006.[6]

Some of the core criticisms of the SEC's prior regulatory proposals were that these proposals, if adopted, would unnecessarily intrude on long-established bank securities activities, disrupt existing and prospective bank customer relationships and operations, and increase compliance costs for banks active in trust, custody and other securities-related lines of business that Congress intended to exclude under GLBA. The provisions of proposed Regulation R were a significant improvement over the rules previously proposed, and to a large extent addressed the concerns of the banking industry and the federal banking agencies. Final Regulation R substantially adopts the December proposal. In response to comments received during the rulemaking period, however, the agencies adopted several changes to the proposed regulation and added one new exemption in the final regulation.

Key Aspects of Regulation R

To implement the broker push-out exceptions under GLBA, Regulation R defines certain statutory terms and provides exemptions for banks in several areas, including: (i) third-party brokerage ("networking") arrangements; (ii) trust and fiduciary activities; (iii) safekeeping and custody; and (iv) sweep accounts. These particular aspects of bank securities activities were the subject of the greatest controversy during the SEC's previous rulemaking proceedings.[7]

Regulation R also provides a number of conditional exemptions to accommodate other bank securities activities including certain mutual fund, insurance and employee benefit plan transactions, certain securities lending activities and transactions in "eligible securities" involving non-US counterparties conducted pursuant to Regulation S. Importantly, Rule 780 of Regulation R provides banks with an exemption, until March 31, 2009, from possible third-party rescission rights under Section 29 of the Exchange Act pursuant to contracts entered into by such banks in violation of the Exchange Act's broker-dealer registration requirements—i.e., for a bank acting as an unregistered broker.[8] After that time, an exemption from Section 29 will continue to be available with respect to any contracts entered into by a bank if, at the time the contract was entered into, such bank acted in good faith and had reasonable policies and procedures in place to comply with Regulation R and any violation of the registration requirements did not result in any significant harm, financial loss, or cost to the person seeking to void the contract.

NETWORKING EXCEPTION (EXCHANGE ACT SECTION 3(A)(4)(B)(I) AND RULES 700 AND 701)[9]

Under the networking exception, a bank may refer a bank customer to an affiliated or third-party broker-dealer in return for a share of the commissions earned from the customer's securities account without being deemed a "broker" under the Exchange Act, so long as certain conditions are met. Regulation R contains complex provisions concerning compensation of the bank employee who makes such a referral. Rule 700 defines the type and limit of compensation that a bank employee may receive for making a customer referral under the statutory exception (i.e., nominal one-time

cash fee of a fixed dollar amount), as well as the conditions under which bank employee bonus plans will be exempt from the restrictions on payment of referral fees to bank employees. In addition, exemptive Rule 701 allows payment of higher-than-nominal fees to bank employees for referral of high net worth and institutional customers, subject to certain conditions.

Nominal Fees.

GLBA provides that any bank employee who is not also an associated person of a registered broker-dealer generally may not receive "incentive compensation" for making referrals, other than a "nominal one-time cash fee of a fixed dollar amount." Congress included this general prohibition on, and limited exception to, incentive compensation to reduce concerns regarding the securities sales practices of unregistered bank employees.

Rule 700(c)(1) defines "nominal one-time cash fee of a fixed dollar amount" to mean any amount paid only once for a referral not exceeding the greatest of: (1) $25 (adjusted for inflation every five years beginning on April 1, 2012); (2) twice the average hourly wage for the employee's "job family" (such as loan officers); (3) 1/1000th of the average annual base salary for the employee's job family; (4) twice the employee's actual base hourly wage; or (5) 1/1000th of the employee's actual annual base salary. The last of these criteria was added to the final rule in response to comments after the proposing release was published. These fees for securities referrals under the rules can only be paid in cash, but the final rules clarify that banks may use a points system to track nominal cash referral fees payable to an employee so long as the points translate into a cash fee and the amount of cash ultimately received for a referral does not vary based on the number or type of securities referrals made by the employee. These fees cannot be contingent upon an actual transaction occurring.

Bonus Plans.

To accommodate banks' bonus plans, the definition of "incentive compensation" excludes discretionary bonuses based on multiple factors or variables. In particular, Rule 700(b)(1) provides that a bonus is excluded from incentive compensation if it is paid on a discretionary basis and based on multiple factors or variables, provided that: (i) those factors or variables include multiple, significant factors or variables that are not related to securities transactions at a broker-dealer; (ii) a referral made by the employee receiving the bonus is not a factor or variable in determining the employee's compensation; and (iii) the employee's compensation is not determined by reference to referrals made by other persons (e.g., the employee's subordinates). Such bonus programs may take into account the full range of banking, securities or other business that customers bring to the bank and its broker-dealer affiliate through the efforts of an employee.

In addition, Regulation R includes a safe harbor intended to allow banks to avoid having to analyze whether a particular bonus program meets the multiple factors and variables test described above. Rule 700(b)(2)

allows bank to pay bonuses based on overall profitability or revenue of: (i) the bank, either on a stand-alone or consolidated basis; (ii) any affiliate of the bank (other than a broker-dealer) or any operating unit of the bank or an affiliate (again, other than a broker-dealer) provided that the affiliate or operating unit does not over time predominantly engage in the business of making referrals to a broker-dealer; or (iii) a broker-dealer. If a bonus is based on the overall profitability or revenue of a broker-dealer, however, it is further limited in that it can only be one of multiple factors or variables with the same conditions as described above under Rule 700(b)(1).

Exemption for Referrals of High Net Worth and Institutional Customers.

Rule 701 introduces a new exemption that allows banks to pay contingent, higher-than-nominal fees for referrals of high net worth and institutional customers. Rule 701 defines high net worth customers as individuals (or couples) with $5 million or more of net worth excluding their primary residence and associated liabilities. It also includes any revocable, *inter vivos* or living trust if the settlor thereof is a natural person who, either individually or jointly with his or her spouse, meets the $5 million net worth test. The rule defines institutional customers as entities with $10 million in investments, or $20 million in revenues (or $15 million in revenues if the customer is referred for investment banking services). Because this rule does not limit the fees to nominal amounts, the exemption is subject to several conditions intended to address the SEC's concerns about unregistered bank employees having a salesman's stake in securities transactions. The bank and the networking broker-dealer must enter into a written agreement that includes provisions addressing certain conditions of the exemption.

First, the rule imposes an affirmative obligation on banks and networking broker-dealers to evaluate a customer's eligibility as a high net worth or institutional customer. Banks must have a "reasonable basis to believe" that a customer is a high net worth customer at or before the time that a customer is referred to the broker-dealer and/or that a customer is an institutional customer before a referral fee is paid to a bank employee.[10]

Second, the rule places limits on the types (but not the amount) of referral fees that bank employees may receive. Under this rule, bank employees may receive a fixed percentage of the revenue received by the broker-dealer for providing investment banking services to the customer. In addition, bank employees may receive fixed referral fees or referral fees that are based upon a fixed formula so long as the formula does not permit the amount of the fee to vary based on the revenue generated, or the profitability of a transaction, by the price or volume of any securities transactions effected for the customer, by the identity of any securities purchased or sold for the customer, or by the number of referrals made by the employee.

Third, if the payment of a referral fee is contingent upon the completion of a transaction, then the broker-dealer must determine, prior to effecting a securities transaction, that the transaction is suitable

for the customer pursuant to the standards that are applicable to recommendations made by the broker-dealer under existing self-regulatory organization rules. If payment of a referral fee is not contingent on completion of a transaction, the broker-dealer must either: (a) determine that the customer is sophisticated and has the ability to make an independent assessment of the risks associated with the transaction; or (b) assess the suitability of the transaction requested by the customer at time of the referral. In any event, the broker-dealer must notify the customer (but not the bank) if it determines that the customer or the requested transaction does not satisfy the suitability or sophistication requirements set forth above.

Fourth, a referring employee (i) must not be qualified, or required to be qualified, with a self-regulatory organization;[11] (ii) must not be statutorily disqualified from associating with a broker-dealer under Section 3(a)(39) of the Exchange Act (except under paragraph (E) of that section);[12] (iii) must be engaged predominantly in banking activities; and (iv) must encounter the referred customer in the normal course of his or her duties.

Fifth, the bank must make certain disclosures to a customer that its employee referred under this exemption. A bank has two options for disclosing referral fee arrangements to a high net worth or institutional customer. Under the first option, the bank may elect to provide the high net worth or institutional customer the disclosure in writing prior to or at the time of the referral. Under the second option, the bank may provide the disclosure to the customer orally prior to or at the time of the referral. However, if the bank provides the customer the required disclosures only orally, then either (i) the bank must provide the disclosure to the customer in writing within three business days of the date of the referral; or (ii) the broker-dealer must be obligated, under the terms of its written agreement with the bank, to provide the disclosures in writing to the customer.

Observations about the Networking Exception under Regulation R.

Regulation R provides banks with welcome flexibility in structuring employee referral and bonus arrangements under the networking exception. In particular, the accommodation of contingent, higher-than-nominal fees for high net worth and institutional business is an important acknowledgment that certain types of compensation arrangements present lower levels of investor protection concern and therefore should be allowed. However, the new rules still will not be fully harmonious with many banks' current incentive-based compensation programs, including bonus and rewards programs that are designed to encourage overall relationship-building. Therefore, aspects of such programs that reward bank employees for the generation, directly or indirectly, of actual securities business or revenues may have to be modified. Interestingly, the net-working compensation rules do not address, and therefore would not apply to, incentive compensation arrangements between broker-dealer firms and banks under which the bank receives organization-level incentive compensation, provided that it does not share this compensation with its employees.

TRUST AND FIDUCIARY ACTIVITIES EXCEPTION (EXCHANGE ACT SECTION 3(A)(4)(B)(II) AND RULES 721 TO 723)[13]

Under the trust and fiduciary activities exception, a bank may effect securities transactions for its trust and fiduciary customers without being deemed a "broker" if it is "chiefly compensated" for these transactions by "relationship compensation." The purpose of this test is to ensure that banks are not principally compensated for these securities transactions by per-transaction fees. A bank may not publicly solicit brokerage business under this exception other than in conjunction with advertising its trust or fiduciary services.

Relationship compensation includes administration fees, annual fees, fees based on a percentage of assets under management, flat or capped per order processing fees that do not exceed the bank's cost for executing the transactions, and any combination of such fees. More specifically, examples of relationship compensation include fees paid by investment companies (such as "12b-1" fees), fees charged in connection with securities borrowing and lending transactions for a trust or fiduciary account, fees separately charged for providing custody services to a fiduciary account, and fees based on the performance of a trust or fiduciary account.[14]

A bank may use one of two distinct methods to determine whether it is chiefly compensated by relationship compensation attributable to its trust and fiduciary business. Under Rule 721, a bank may conduct an account-by-account review using a two-year rolling average comparison of the fees from the account to determine whether more than 50 percent of the compensation associated with each account was permissible relationship compensation. Alternatively, under Rule 722, a bank may compare relationship compensation to total aggregate trust activities compensation on a bank-wide basis using a two-year rolling average to determine whether at least 70 percent of the bank's compensation from trust-related brokerage activities was relationship compensation.

Under either method, banks may exclude from the relationship compensation calculation fees from certain special types of accounts, including accounts held for fewer than three months during a relevant year under Rule 723(a) and accounts acquired within the prior 12 months as part of a business combination or asset acquisition under Rule 723(b). On a similar note, Rule 723(c) is a new exemption that permits banks to exclude from the bank-wide calculation trust and fiduciary accounts held at a "non-shell" foreign branch of a US bank so long as the bank has reasonable cause to believe that less than 10 percent of the total number of trust and fiduciary accounts of the foreign branch are held by or for a US person.

Under Rule 723(e), banks using the account-by-account method of applying the chiefly compensated test may exclude a *de minimis* number of accounts (no more than the greater of 500 accounts or 1 percent of the bank's trust or fiduciary accounts) provided that no particular account is excluded from the calculations under this *de minimis* exception for two consecutive years. Last, under Rule 723(d), a bank will not be

deemed a broker solely because a particular trust or fiduciary account does not satisfy the account-by-account chiefly compensated test if the bank elects to transfer such account to a broker-dealer or nonaffiliated entity that is not required to be a broker-dealer within three months of the end of the year in which the account fails to meet this standard.

Regulation R represents a significant step forward from Regulation B both in the broader definition of relationship compensation under Rule 721 and the more flexible method of applying both the bank-wide and the account-by-account chiefly compensated tests under exemptive Rules 722 and 723. That being said, the trust and fiduciary exception, as implemented by Regulation R, will likely impose a significant burden on banks in maintaining appropriate records of their application of the "chiefly compensated" test.

EXCEPTION FOR SWEEP ACCOUNTS AND TRANSACTIONS IN MONEY MARKET FUNDS (EXCHANGE ACT SECTION 3(A)(4)(B)(V) AND RULES 740 AND 741)[15]

Under the Exchange Act's sweep accounts exception, a bank may sweep deposits into no-load money market mutual funds without being deemed a "broker." Rule 740 defines key terms used in the sweep accounts exception such as "money market mutual fund" and "no-load." A fund is "no-load" if no sales load or deferred sales load is charged by the fund and no more than 25 basis points are charged against the fund's average net assets for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts. Certain enumerated shareholder and other service charges are excluded from the 25-basis-point limit.

Rule 741 creates a general exemption for transactions in money market mutual funds. A bank may rely on this exemption in two situations. First, a bank will be exempt to the extent that it effects transactions on behalf of a customer in securities of a money market mutual fund if the bank provides the customer, directly or indirectly, any other product or service that would not require the bank to register as a broker-dealer, such as escrow, trust, fiduciary or custody account, a deposit account, or a loan or other extension of credit. Second, the final rules also provide that a bank may utilize this exemption if it effects transactions on behalf of another bank as part of a program for the investment or reinvestment of deposits held or collected by the other bank. Moreover, sweeping deposits into "load" money market funds is also exempt subject to the condition in Rule 741 that if the money market mutual fund is not "no-load," the bank would have to disclose that fact and deliver a copy of the fund's prospectus to the customer when the customer approves transactions in securities of the fund.

SAFEKEEPING AND CUSTODY ACTIVITIES EXCEPTION (EXCHANGE ACT SECTION 3(A)(4)(B)(VIII) AND RULE 760)

The safekeeping and custody exception permits banks to perform specified services in connection with safekeeping and custody of securities without being deemed to be a "broker."[16] On its face, this Exchange Act exception does not address securities order-taking by custodial banks, which

the staff of the SEC has long viewed as a brokerage function. Nevertheless, under the exemption in Rule 760, banks may take orders for securities transactions (a) from employee benefit plan accounts and individual retirement accounts for which the bank acts as a directed trustee and similar accounts for which the bank acts as a custodian,[17] and (b) from other safekeeping and custody accounts on an accommodation basis (for ease of reference, "other accounts").

If a bank accepts securities orders under this exemption with respect to a custody account, no bank employee may receive compensation from the bank, the executing broker or dealer, or any other person, that is based on whether a securities transaction is executed for the account, or on the quantity, price, or identity of the securities purchased or sold by the account. However, these restrictions do not prevent a bank employee from receiving payments under a bonus plan that would be permissible under the networking rules discussed above. A bank cannot advertise that it accepts orders for securities transactions for employee benefit plan accounts or IRAs, except as part of advertising the bank's overall custodial or safekeeping services. Such accounts may not be advertised as "securities brokerage accounts." In addition, under Rule 760(e), a bank acting as a non-fiduciary/non-custodial administrator or recordkeeper for a plan for which another bank acts as custodian may accept securities orders from such a plan provided that the non-fiduciary/non-custodial bank and the custodian bank both comply with the conditions explained above.

Additional conditions apply when a bank accepts securities orders for "other accounts" on an accommodation basis under Rule 760(b). In particular, the bank will not be able to advertise securities order-taking at all in public media. However, it will be permitted to distribute sales literature to customers and others that describes the order-taking services provided to these accounts so long as the order-taking services are not described independently of, or more prominently than, the bank's other custody services. The bank will not be able to provide investment advice or research or make recommendations concerning securities to the account or otherwise solicit securities transactions from the account. In addition, the bank's charges for effecting a securities transaction for the account cannot vary based on whether the bank accepted the order for the transaction, or on the quantity or price of the securities to be bought or sold. For example, the bank must charge the same securities movement fee for transferring securities into or out of the custody account regardless of whether the customer places the securities order with the bank or a securities broker.

In response to comments on proposed Regulation R, the agencies have added Rule 760(f), which permits a bank that acts as a sub-custodian for another custodial bank to accept securities orders under the custody exemption under the same conditions as the custodial bank for which the sub-custodian acts. They also clarified that banks may rely on the custody exemption when acting as a directed trustee for an account and that the restrictions in the custody exception do not prohibit cross-marketing a bank's trust, fiduciary and other services to its custody customers.

EXEMPTION FOR CERTAIN INVESTMENT COMPANY SECURITIES TRANSACTIONS (RULE 775)

Section 3(a)(4)(C)(i) of the Exchange Act requires a bank to execute the transactions that it effects under the push-out exceptions for trust activities, stock purchase plan transactions and safekeeping and custody transactions through a registered broker-dealer, if the transactions involve publicly traded securities. Rule 775(a)(3) provides that, notwithstanding this statutory mandate, a bank may effect transactions in "covered securities" (i) through the National Securities Clearing Corporation (NSCC) or (ii) directly with a transfer agent or with an insurance company or "separate account."[18] As proposed, covered securities included any securities issued by an open-end investment company. In response to comments, the agencies expanded this definition to include any variable insurance contracts, such as variable annuities or variable life insurance, that are funded by separate accounts that are registered under the Investment Company Act of 1940.

Thus, a bank will not need to direct trades in these covered securities to a registered broker-dealer for execution provided that the covered securities are traded neither on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system.[19] As a practical matter, this will, among other things, allow banks to effect transactions in mutual fund shares through NSCC Mutual fund Services (Fund/SERV) and to effect transactions in variable insurance contracts through NSCC Insurance Processing Service.

SECURITIES LENDING EXEMPTION (RULE 772)

Rule 772 exempts banks from the definition of the term "broker" for certain noncustodial securities lending activities to the extent that they act as agents in effecting securities lending transactions and provide any securities lending services in connection with such transactions. The exemption only covers transactions conducted on behalf of a "qualified investor."[20]

Commenters on the proposed rules recommended that banks be exempt from the definition of broker for effecting repurchase and reverse purchase transactions in non-exempt securities, as these transactions are functionally equivalent to securities lending transactions. In response, the agencies are requesting comments on various matters relevant to their consideration of such transactions, including: the nature, structure, and purpose of these transactions; the types of customers and financial institutions currently involved in these transactions; the extent to, and the manner in, which banks currently engage in these transactions as agent or principal; recent developments and trends in the market for these transactions; and any material similarities and differences between, on the one hand, these transactions and repurchase and reverse purchase transactions in exempt securities and, on the other hand, securities lending transactions in non-exempt securities.

REGULATION S SECURITIES EXEMPTION (RULE 771)

Rule 771 provides an exemption for banks from the definition of broker for agency transactions in Regulation S securities with

non-US persons. The exemption covers sales of eligible securities to a purchaser who is outside of the United States,[21] and resales of eligible securities after their initial sale by a non-US person or a registered broker-dealer outside the United States to a purchaser who is also outside the United States. A bank may conduct a transaction so long as it complies with Regulation S and does not conduct the transaction with any US person other than a registered broker-dealer.

NEW EXEMPTION FOR EFFECTING CERTAIN EXCEPTED OR EXEMPTED TRANSACTIONS IN A COMPANY'S SECURITIES FOR ITS EMPLOYEE BENEFIT PLANS (RULE 776)

Rule 776 is a new exemption from the definition of broker for transactions in a company's securities for its employee benefit plans. It allows a bank to buy or sell, as transfer agent, securities of a company for the account of the company's employees as part of a pension, profit-sharing, bonus, dividend reinvestment, or issuer purchase plan. A bank must satisfy four conditions in order to be able to rely on this exemption. First, no commission may be charged with respect to the transaction. Second, the transaction must be conducted solely for the benefit of an employee benefit plan. Third, the security must be obtained directly from the company or an employee benefit plan of the company. Fourth, the security must be transferred only to the company or an employee benefit plan of that company.

TRANSITION PERIOD EXEMPTION (RULE 781)

Regulation R also provides banks with a temporary exemption under Rule 781 extending the compliance date for the regulation until the first day of each bank's respective first fiscal year commencing after September 30, 2008. For example, a bank with a fiscal year that runs from January 1 to December 31 would have until January 1, 2009 (almost 15 months), to comply with the new exemptions. This period should provide banks with ample time to push out of the bank any brokerage activities that will not qualify for an exception or exemption.

NEXT STEPS BY THE SEC AND THE BANKING AGENCIES

As noted in the Adopting Release, the FRB and other banking agencies, in consultation with the SEC, will develop recordkeeping rules, which they will propose for public comment. The FRB and other banking agencies also expect to develop supervisory guidance to help ensure that banks have adequate policies, procedures, and systems in place to conduct their securities brokerage activities in a safe and sound manner and to help prevent evasions of GLBA's "broker" exceptions and implementing rules. Finally, going forward, the FRB and the SEC will jointly issue any interpretations or "no-action" letters relating to the bank brokerage exemptions and will consult with each other and any other appropriate federal banking agency concerning any formal enforcement actions that are proposed to be taken against individual banks.

Changes to the Dealer Rules

The SEC also adopted a number of mostly clarifying and technical amendments to its rules relating to the exemptions for banks from the definition of "dealer." Importantly, these rules include some exemptions from

the definition of dealer that parallel certain exemptions provided from the definition of broker. Exchange Act Rule 3a5-2 (17 C.F.R. §240.3a5-2) exempts from the definition of dealer a bank's riskless principal transactions in "eligible securities" conducted with non-US persons pursuant to Regulation S. Eligible securities are securities that are neither in the inventory of the bank or an affiliate, nor underwritten by the bank or an affiliate on a firm commitment basis (apart from securities acquired from an unaffiliated distributor). For the purposes of determining whether an eligible security was initially sold outside of the United States as required by Regulation S, a bank may rely on its "reasonable belief" that this condition is satisfied. The exception also extends to resales of the eligible securities, provided that the bank complies with Regulation S.

The dealer rules will also redesignate the bank/dealer exemption for conduit securities lending activities from Exchange Act Rule 15a-11 to Exchange Act Rule 3a5-3 (17 C.F.R. §240.3a5-3).[22] The exemption allows banks to conduct conduit securities lending transactions with a qualified investor or an employee benefit plan with discretionary investments of at least $25 million, without registering with the SEC as a dealer.[23]

Amendments to Exchange Act Rule 15a-6

The SEC also amended Exchange Act Rule 15a-6 (17 C.F.R. §240.15a-6) to align the language of that rule with the exceptions and exemptions for banks from the definitions of broker and dealer under the Exchange Act. The amendment clarifies that a non-US broker may, without registration with the SEC, engage in a securities transaction with a US bank *to the extent that the bank is relying on an exception or exemption from the definition of broker or dealer* (as opposed to "engaging in transactions with bank in a broker or dealer capacity," as the rule previously read.) This amendment is not intended substantively to change the rule. Thus, foreign broker-dealers will be exempt from registration with the SEC so long as the US banks (or US branches and agencies of foreign banks) that act as their counterparties rely on an exception or exemption under Regulation R or the dealer push-out rules.[24]

Concluding Observations

Viewed in the context of the SEC's prior efforts to regulate bank securities activities, Regulation R is a significant improvement, from the perspective of reducing disruption to bank operations and customer relationships, over prior SEC efforts in this area. The Congressional mandate in the Regulatory Relief Act that the SEC and the banking agencies reach concordance on the regulation of bank securities activities has led to a relatively successful outcome. Despite this result, the final product falls short in some areas. For example, the networking exception does not adequately accommodate current bank bonus plans, as most of these plans are based on transaction revenues, rather than overall profitability. Accordingly, most banks will be required to substantially restructure their bonus plans in order to comply with Regulation R. In addition, and as described above, the trust and fiduciary exception will impose a significant recordkeeping burden on banks in applying

the “chiefly compensated” test with the exact recordkeeping requirements yet to be drafted by the banking agencies.

Endnotes

1 *See* 72 Fed. Reg. 56,514 (Oct. 3, 2007); *see also* Exch. Act Rel. No. 56,501 (Sep. 24, 2007) (the “Adopting Release”). Regulation R is codified in the SEC’s regulations at 17 C.F.R. Part 247.700 *et seq.* and the FRB’s regulations at 12 C.F.R. Part 218.700 *et seq.* For ease of reference, this memorandum cites rules within the regulation without reference to the C.F.R. (e.g., Rule 701).

2 *See* Section 3(a)(4) of the Exchange Act (15 U.S.C. § 78c(a)(4)). *See also* Section 3(a)(5) of the Exchange Act (15 U.S.C. § 78c(a)(5)), which defines “dealer.” The SEC also issued a companion release making certain conforming and technical amendments to its existing rules relating to the bank exceptions from the definition of “dealer” under the Exchange Act. *See* Exch. Act Rel. No. 56,502 (Sep. 24, 2007); 72 Fed. Reg. 56,562 (Oct. 3, 2007).

3 The Exchange Act defines “bank” in section 3(a)(6) (15 U.S.C. § 78c(a)(6)) as: (A) a banking institution organized under the laws of the United States or a federal savings association, (B) a member bank of the Federal Reserve System, (C) any other banking institution or savings association, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency pursuant to section 92a of Title 12, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

4 *See* Exch. Act Rel. No. 47,364 (Feb. 14, 2003), 68 Fed. Reg. 8,686 (Feb. 24, 2003). In contrast to Regulation R, the bank dealer rules were not adopted as part of a unified regulation, but rather are interspersed under various sections of the Exchange Act and designated accordingly.

5 *See* Exch. Act Rel. No. 44,291 (May 11, 2001), 68 Fed. Reg. 27,760 (May 18, 2001) (proposing interim final rules) and Exch. Act Rel. No. 50,056 (June 17, 2004), 69 Fed. Reg. 39,682 (June 30, 2004) (proposing never-adopted and since-withdrawn Regulation B). For an analysis of and commentary on proposed Regulation B, see *SEC Issues Proposed Rules Implementing the GLB Act “Push-Out” Provisions for Banks*, Mayer, Brown, Rowe & Maw LLP, The Financial Services Regulatory Report, vol. 11, No. 4, July/August 2004, available at http://www.mayerbrown.com; Charles Horn & Jeffrey P. Taft, *SEC Is in a Can’t-Win Position With Broker-Dealer Proposal*, American Banker Online, July 16, 2004; David Sahr & Lisa Byington, *Must private banking be “pushed” out of banks? Implications of the SEC’s proposed Regulation B*, The Investment Lawyer (September 1, 2004).

6 *See* Exch. Act Rel. No. 54,946 (Dec. 18, 2006), 71 Fed. Reg. 77,522 (Dec. 26, 2006) (proposing Regulation R). *See also* Exch. Act Rel. No. 54,947 (Dec. 18, 2006); 71 Fed. Reg. 77,550 (Dec. 26, 2006) (proposing conforming changes to the bank/dealer rules).

7 Regulation R, however, does not provide further guidance with respect to all of the statutory exceptions available to banks from the definition of broker because commenters have not generally sought further guidance on those exceptions. In particular, Regulation R does not interpret the exceptions for: effecting transactions in, among other things, commercial paper, bankers acceptances, and exempted securities under Exchange Act Section 3(a)(4)(B)(iii); effecting transactions, as part of transfer agency activities, in the securities of an issuer as part of certain stock purchase plans under Exchange Act Section 3(a)(4)(B)(iv); effecting transactions for the account of affiliates (other than registered broker-dealers or merchant banks) under Exchange Act Section 3(a)(4)(B)(vi); effecting sales as part of a primary offering of securities not involving a public offering under Exchange Act Section 3(a)(4)(B)(vii); effecting transactions in identified banking products under Exchange Act Section 3(a)(4)(B)(ix); effecting transactions in municipal securities under Exchange Act Section 3(a)(4)(B)(x); and the *de minimis* exception that permits no more than 500 securities transactions in any calendar year under Exchange Act Section 3(a)(4)(B)(xi).

8 Section 29 of the Exchange Act (15 U.S.C § 78cc) provides that contracts made in violation of any provision of the Exchange Act or the implementing regulations of the Exchange Act are generally void with regard to the rights of any person who has made, or with knowledge of such violation acquired any rights under, such contract.

[9] Rule 700 defines the terms of the statutory exception for networking, and Rule 701 provides an exemption from the general conditions of the statutory exception for referrals of high net worth and institutional customers.

[10] In the Adopting Release, the agencies state that a bank or broker-dealer would have a "reasonable basis to believe" that a customer is a high net worth customer or institutional customer if, for example, the bank or broker-dealer obtains a signed acknowledgment from the customer (or, in the case of an institutional customer, from an appropriate representative of the customer) that the customer meets the applicable standards to be considered a high net worth customer or an institutional customer, respectively, and the bank employee making the referral or the broker-dealer employee dealing with the referred customer does not have information that will cause the employee to believe the information provided by the customer is false.

[11] To the extent that bank employees are qualified and act in their capacity as registered persons of a broker-dealer ("dual" employees), and therefore, are subject to the supervision of such broker-dealer, the bank does not need to rely on the networking exception for paying these employees an incentive fee for referring bank customers to a broker-dealer. In the new rules, the SEC and FRB did not address the applicability of the Financial Industry Regulatory Authority (FINRA) rules governing private securities transactions of FINRA member employees (so-called "trading away" rules) to the dual employees. The release notes that the agencies expect to continue to work on this issue with FINRA.

12 Section 3(a)(39)(E) of the Exchange Act (15 U.S.C. § 78c(a)(39)(E)) refers to a person who is statutorily disqualified for having "associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person" disqualified under subparagraph (A)-(D) of section 3(a)(39).

[13] Rule 721 elaborates on the definition of terms of the statutory exception for trust and fiduciary activities exception; Rule 722 provides banks with the ability to calculate their relationship compensation on a bank-wide basis; and Rule 723 enumerates the accounts that a bank may exclude from calculation of its relationship compensation.

[14] The types of fees that are counted toward relationship compensation are much broader than those proposed in SEC releases predating Regulation R. For example, under the 2004 Regulation B proposal, 12b-1 fees would have counted as transaction fees that are not includable in relationship compensation, whereas under Regulation R they are part of relationship compensation.

[15] Rule 740 defines the terms relating to the sweep accounts exception, and Rule 741 provides an exemption for banks effecting transactions in money market funds.

[16] A bank may only rely on this exception if it does not act in a trustee or fiduciary capacity, and complies with the SEC's guidance regarding carrying broker activities. In response to various comments pointing out the lack of guidance in the Regulation R proposal about the prohibition on acting as carrying broker, the adopting release provides that a bank would be acting as a "carrying broker" for a broker-dealer, if the broker-dealer has established arrangements with the bank that cause the broker-dealer's customers generally to use the bank's custody accounts instead of maintaining funds and securities in accounts at the broker-dealer, thereby allowing the broker-dealer to avoid its financial and related responsibilities under SEC rules. *See* Adopting Release at 56540.

[17] For this purpose, employee benefit plan accounts are defined broadly to include a wide range of tax advantaged accounts, including 401(a) employer-sponsored plan; a 457 governmental or other plan; a 403(b) tax-deferred plan; a church plan, governmental, multiemployer or other plan described in section 414(d), (e) or (f) of the Internal Revenue Code (IRC); a 422 incentive stock option plan; a Voluntary Employee Beneficiary Association Plan (VEBA) under Section 501(c)(9) of the IRC; a non-qualified deferred compensation plan (including a rabbi or secular trust); and a supplemental or mirror plan, and a supplemental unemployment benefit plan. "Individual retirement account" or similar account means an individual retirement account as defined in Section 408 of the IRC; a Roth IRA; a health savings account; an Archer medical savings account; a Coverdell education savings account; or other similar account.

[18] "Separate account" means an account established and maintained by an insurance company under which income, gains, and losses from assets allocated to such account are credited to or charged against such account without regard to other income, gains, or losses of the insurance company. *See* section 2(a)(37) of the Investment Company Act of 1940 (15 U.S.C. § 80a-2(a)(37)). For purposes of the Rule 775 exemption, a separate account must be registered under the Investment Company Act, and excluded from the definition of transfer agent in section 3(a)(25) of the Exchange Act (15 U.S.C. § 78c(a)(25)).

[19] In addition, the covered securities have to be underwritten by a registered broker-dealer or the sales charge has to be equal to or less than the amount a registered broker-dealer may charge pursuant to the rules of FINRA.

[20] Section 3(a)(54)(A) of the Exchange Act (15 U.S.C. § 78c(a)(54)(A)) defines a qualified investor generally as financial institutions or entities with $25 million of investments to invest on a discretionary basis, or an employee benefit plan that owns and invests on a discretionary basis, at least $25 million in investments.

[21] *See* 17 C.F.R. § 230.903-904.

[22] Exchange Act Rule 15a-11 also provided an exemption to banks from the definition of broker for banks with respect to their securities lending activities. This exemption, however, was voided by the Regulatory Relief Act, and the SEC and the FRB have adopted it as Regulation R Rule 772. *See* discussion supra *Securities Lending Exemption (Rule 772)*.

[23] Commenters have asked the agencies to exempt banks from the definition of dealer for repurchase and reverse purchase securities transactions, as these transactions are functionally equivalent to securities lending. Although the agencies have not taken any action on this request, they are asking for comments on various aspects of repurchase and reverse purchase transactions. *See* discussion supra *Securities Lending Exemption (Rule 772)*.

[24] The effective date of the amendment to Rule 15a-6 is November 2, 2007, while compliance with substantive provisions of Regulation R will not begin until after September 30, 2008. Until that date, however, a foreign bank will be exempt from registration as a dealer to the extent that its counterparty US bank is relying on the temporary exemption under Rule 781 of Regulation R, which took effect on September 28, 2007, and allows banks to start compliance with substantive rules of Regulation R after September 30, 2008.

For more information or questions concerning the Regulation R and dealer rules, please contact the following attorneys.

Charles Horn
202-263-3219
chorn@mayerbrown.com

David Sahr
202-263-3332
dsahr@mayerbrown.com

Jerome Roche
202-263-3773
jroche@mayerbrown.com

Ross Pazzol
312-701-7168
rpazzol@mayerbrown.com

Scott Anenberg
202-263-3303
sanenberg@mayerbrown.com

Babback Sabahi
202-263-3451
bsabahi@mayerbrown.com

Mayer Brown is a leading international law firm with more than 1,500 lawyers across the Americas, Europe, and Asia. The firm is known for its client-focused approach to providing creative solutions to complex problems on behalf of businesses, governments, and individuals. Clients include global industry leaders, a significant proportion of the Fortune 100, FTSE 100, and DAX companies, and more than half of the world's largest investment banks. Mayer Brown is particularly renowned for its Supreme Court and appellate, litigation, corporate and securities, and finance practices.

Office Locations: Berlin, Brussels, Charlotte, Chicago, Cologne, Frankfurt, Hong Kong, Houston, London, Los Angeles, New York, Palo Alto, Paris, São Paulo, Washington
Representative Office: Beijing
Alliance Law Firms: Mexico City (Jáuregui, Navarrete y Nader), Madrid, (Ramón & Cajal), Italy and Eastern Europe (Tonucci & Partners)
Please visit our web site for comprehensive contact information for all Mayer Brown offices.

www.mayerbrown.com

This Mayer Brown LLP publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

© 2007 Mayer Brown LLP. Mayer Brown is a combination of two limited liability partnerships, one named Mayer Brown LLP and established in Illinois, USA, and the other named Mayer Brown International LLP and incorporated in England.