Regulation B Basics

by

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Peer reviewed

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Introduction

In June of 2004, the Securities and Exchange Commission (“the SEC”) voted to publish Proposed Regulation B[1] (“Regulation B”), which will implement provisions of the Gramm-Leach-Bliley Act of 1999 (“GLBA”) that identify activities which banks may engage in without registering as brokers or dealers under The Securities and Exchange Act of 1934 (“Exchange Act”);[2] effectively governing the manner in which banks, savings associations and savings banks effect securities transactions. By enacting the GLBA, Congress repealed most of the remaining vestiges of the ownership restrictions that prevented banks, securities and insurance firms from combining, thereby allowing them to adopt the universal banking model through the creation of financial conglomerates known as “financial holding companies.”[3]

Proposed Regulation B (“Regulation B”) supersedes the SEC's final interim rules issued in May of 2001 with respect to banking and brokering activities. However, the final interim rules were suspended after banks, banking regulators and members of Congress objected fiercely, claiming that, “the rules would disrupt traditional banking activities contrary to the intent of Congress.” In general, banks and their regulators have found Regulation B to be far more acceptable than the final interim rules of 2001; however, it remains complex and places heavy compliance burdens on banks. At a minimum, if banks wish to continue their traditional banking activities and simultaneously avoid becoming subject to the broker dealer regulation under the Exchange Act, they will have to dedicate significant time and financial resources to compliance. Reporting entities will have a one-year transition period after the amended rules are adopted in 2005 to complete compliance. Given this brief perspective, this article will highlight some of the major provisions of Regulation B as well as areas that are either nebulous or could be troublesome for reporting entities.

Background

Regulation B relates to amendments to section 3 (a) (4) of the Exchange Act made by the GLBA. In 1999 the GLBA eliminated the blanket exemption that banks and U.S. branches of foreign banks had previously enjoyed (with limited exceptions) from the definition of "broker" and "dealer" under the Exchange Act and other federal securities laws.[4] This elimination severely limited the broker-dealer activities that banks could partake in without having to register as a broker or a dealer under the Exchange Act.

The activities that banks are permitted to engage in without being subject to the Exchange Act are exceptions to the general rule. These exceptions are more commonly known as the 'push out exceptions.' They are labeled as such because they are the only broker or dealer activities that banks can engage in without being required to register under the Exchange Act; effectively 'pushing-out' most securities brokerage and dealing activities to individuals who are registered with the SEC. The compliance date for the 'pushing-out' of impermissible activities was May of 2001. Although they did not entirely achieve their aims, the interim (yet final) laws were created to help clarify the 'push-out exceptions' and provide guidance to the banking industry as a whole.[5]

Prior to Regulation B, the Exchange Act, the GLBA, and the interim final rules of 2001 were the main laws governing traditional banking and broker-dealer activities. Regulation B supersedes the SEC's 2001 final interim rules, replacing some existing 'push-out' exceptions and further proposing new-targeted ones.

New Law

The SEC proposes to revise and restructure the interim final rules of 2001 and finalize them in Regulation B. Regulation B is designed to clarify many of the existing statutory exceptions from the definition of 'broker.' In addition to amending the existing exemptions and activities, Regulation B includes three new-targeted exemptions.[6] The key provisions of Regulation B are outlined and discussed below.

Third- Party Networking Arrangements Exception

The Exchange Act provides an exception from the definition of "broker" for banks that enter into third-party brokerage, or "networking," arrangements.[7] More specifically, the exception provides that a bank will not be considered a broker, if, under certain circumstances, the bank enters into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers broker-dealer services to bank customers. Bank employees may make referrals of bank customers to a broker-dealer, but they may only be compensated with payments of a *"nominal one-time cash fee" or a "fixed dollar amount" that are not "contingent on whether the referral results in a transaction" with the broker-dealer.*

Although clerical activities can be performed by unregistered bank employees within the scope of the networking exception, it is not clear which activities in particular qualify as clerical activities. Scheduling appointments with broker-dealers is generally considered a clerical task; one that does not require special qualifications or licensing when performed by an employee of a broker-dealer. Furthermore, the scheduling of appointments with broker-dealers does not require familiarity with the securities industry, or the exercise of judgment concerning securities. The SEC has invited comment on the definition of clerical tasks, but to date has not issued additional guidance. For banks wishing to use the networking exception, it may be best to construe the definition of clerical tasks as traditionally and narrowly as possible to avoid complications in the future.

Nominal One-Time Cash Fee

There are many open issues with the definition of "nominal one-time cash fee of a fixed dollar amount" under the networking activities push-out exception. It can be argued that the definition is overly restrictive and may not even be needed, and the term "nominal" may unnecessarily limit referral fees. It may also be contended that the definition would unduly limit the fees banks could pay based on points for activities involving non-securities products and services. Such a definition of the term "nominal one-time cash fee of a fixed dollar amount" may in fact impose limits on networking compensation even beyond those contained within the Exchange Act. The banking industry generally opines that Congress did not intend for the limitations on incentive compensation included in the networking exception to affect year-end bank bonus programs even if those programs were in part based on the number of referrals made.

One alternative may be to leave the term "nominal" undefined. However, leaving the term undefined could lead some to read it as meaning "market rate." This, in turn, may further promote the incentive for unregistered bank employees to not only make referrals, but to also sell securities brokerage services to bank customers. The broker-dealer provisions of the federal securities laws have long required persons with this kind of incentive to register as broker-dealers, or be registered representatives of broker dealers; so how feasible this alternative is open to debate.[8] Tying fees to hourly wages is impractical or unworkable because it does not permit a single, flat fee that would be high enough to provide a meaningful incentive for tellers and platform personnel to make referrals to the broker-dealers.

Another alternative would be to allow market –rate referral fees up to a set amount. Although currently referral fees typically range from $5 to $50, it is not uncommon for banks to pay referral fees of as much as $100 for referrals of high net-worth customers. This creates the problem of having a range of dollar amounts rather than a fixed dollar amount. For precisely this reason, it may be more practical to quantitatively define "nominal one-time cash fee of a fixed dollar amount." Determining the dollar amount may take into account factors such as where the bank is located, how large the bank is, and what type of client is being referred. On a practical level, to determine if they are nominal, a bank may compare referral fees to fees that it would pay its employee for the sale or renewal of say, a certificate of deposit.

Contingent

The SEC generally requires that referrals made under the networking arrangement cannot be contingent on whether the referral results in a transaction. Under this rule, payments for referrals cannot be related to certain enumerated factors, including the value of any securities transaction or a customer's financial status. It may be argued that limitations on the conditions under which referral fees may be paid are unnecessary because the networking exception is clear that the payment of referral fees in reliance on this exception may not be contingent on a resulting transaction. However, an existing issue may be whether there are additional contingencies that banks currently place on referral fees that should be permissible under the proposed definition of "contingent on whether the referral results in a transaction." In addition to the asset, net worth, and income contingencies that are excluded from the SEC's definition, banks may be able to condition payment of referral fees on other criteria relating to other aspects of a customer's profile, such as tax bracket.

This narrow definition of "contingent" could prevent banks from continuing their existing network activities and may result in them eliminating the referral process completely. Another less extreme option for banks is to issue specific referral guidelines, which at a minimum, will be time consuming and costly. The SEC has not opined further on the definition of “contingent” and for now it may be safe to say that banks will need to make changes to their existing networking programs to comply with the amended rules or, in extreme cases, eliminate the referral process altogether.

Bank Subsidiaries

The SEC’s position is that the Exchange Act’s functional exception for banks from the definitions of “broker” and “dealer” applies to banks, under limited circumstances. Non-bank entities such as bank subsidiaries are not subject to the same level of regulation as banks, and so are not exempted from the Exchange Act’s broker-dealer registration requirements.[9] Despite the banking industry’s many requests to the contrary, the SEC has refused to expand the scope of the networking exception to apply to “any bank subsidiary expressly formed for the purpose of engaging in securities transactions.”[10] Expanding the scope of the exception to include bank subsidiaries would have significantly increased a bank’s ability to meet the requirements of the third-party networking arrangements. However, the SEC believes that to remain consistent with the language of the GLBA, non-bank entities that have contractual arrangements with banks would have to register as broker-dealers.[11] That is, non-bank entities that refer customers, including bank customers, to broker-dealers would generally have to register as broker-dealers.

Trust and Fiduciary Activities Exception

The Exchange Act permits a bank, under certain conditions to effect transactions in a trustee or fiduciary capacity without registering as a broker. To qualify for this exception, a bank must effect such transactions in its trust department, or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.[12] The bank must also 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 that does not exceed the cost the bank incurs in executing such securities transaction, or any combination of such fees.[13] The statutory conditions that a bank must meet to qualify for the trust and fiduciary exception are designed to ensure that bank trustees and fiduciaries conducting securities activities outside of the protections of the securities laws are compensated as trustees and fiduciaries.[14]

The GLBA does not provide a definition of “chiefly compensated.” The interim rules have provided a definition for “chiefly compensated” but it is not apparent whether or not such a definition has established clear standards for complying with the "chiefly compensated" requirement under the GLBA. Although designed to facilitate banks with meeting the "chiefly compensated" requirement while permitting them to continue many of their current practices, the costs of transition to the new statutory scheme may not necessarily be eased without compromising investor protection.

Chiefly Compensated

The chiefly compensated condition divides a bank's compensation into qualifying (traditional fees received by trustees and fiduciaries) and non-qualifying types (traditional fees received by broker-dealers), and limits the amount of non-qualifying compensation a bank may receive and still qualify for the exception. Under the Exchange Act, to qualify for the exception, a bank must limit its qualifying compensation and have a mechanism in place to determine whether it is succeeding in doing so. The Exchange Act defines "chiefly compensated" as meaning more of a bank's payments for securities transactions must come from qualifying or "relationship compensation,"[15] than from non-qualifying, or "sales compensation."[16] Due to the potential disruptions to existing relationships, certain types of accounts are exempted from the chiefly compensated test altogether. Under Regulation B, a bank would be exempt from meeting the requirements of the chiefly compensated test for a living, testamentary, or charitable trust account opened or established before July 30th, 2004 in a trustee or fiduciary capacity. Similarly, a bank effecting transaction such as an indenture trustee in a no-load money market fund is also exempted from the definition of "broker."

Under the Exchange Act, banks were required to calculate both sales and relationship compensation annually and on an account-by-account basis, an unduly costly and complicated method not expressly required by the GLBA. The SEC has relaxed this requirement in Regulation B by creating an elective alternative to the account-by-account analysis for banks that wish to compare on "a line-of-business" basis. Determining compliance on a line-of-business basis may be more in line with Congress' intentions. Therefore, rather than calculate account-by-account, a bank may aggregate all sales and relationship compensation by a particular line of business. A "line of business" is defined as an identifiable division, department, or unit of the bank, with similar types of accounts, for which the bank acts in a similar fiduciary capacity. A bank's line of business will meet the trust and fiduciary exception provided that it has, at least a 9:1 ratio of relationship to sales compensation. If a bank that is using the line-of-business method fails to meet the minimum 9:1 ratio of relationship to sales compensation, it may continue to use the line-of-business method for the following year, provided it meets certain requirements.

If a bank chooses not to use the line-of- business method or if it cannot meet the line-of- business method's requirements, it will default to having to evaluate compensation on an account-by-account basis.

Although having to default to evaluating compensation on an account-by-account basis is both time consuming and costly, it is consistent with implementing functional regulation to protect investors. It is also in line with the way in which both broker-dealers and banks establish their obligations and duties to their customers which, in turn, defines the capacity in which they will act. Bank trust departments primarily charge fees at the account level, the same level at which securities transaction fees are assessed. The account-by-account method is also consistent with accounting requirements and other fundamental determinations that trustees must make under state trust laws. The account-by-account method clearly helps protect the investors, but at what cost to the bank? With its stringent record-keeping rules, the administrative burden of applying the account-by-account method to calculate chiefly compensated income for purposes of the trust and fiduciary account exception is huge. Although any alternative to the account-by-account method would be preferred, the line-of-business approach may be restrictive and in practice would not provide any meaningful relief over the account-by-account method. Especially since the procedural conditions in the exception essentially require an account-by-account calculation, thereby defeating the purpose of the exemption altogether.

Sweep Accounts Exception

In general, any person that induces transactions in securities for the account of others by selling securities products or services together with other, non-securities products or services sold by that person would be a broker required to register with the SEC. Under new Regulation B's "sweep accounts exception," a bank is permitted to participate in a mixed products arrangement in which the bank offers a mutual fund "sweep" service. More specifically, the bank is excepted from the definition of broker-dealer to the extent it effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund.

For purposes of the sweep accounts exception, under Regulation B, an investment company is no-load if it does not have a sales load[17] or a deferred sales load, and its total charges against net assets to provide for sales-related expenses including 12b-1 fees are not more than one quarter of one percent of average net assets annually, and these fees are disclosed in the fund's prospectus. Although this definition is consistent with the NASD definition of "no-load," a more logical and appropriate approach might be to interpret it as a fund that is not subject to front-end or back-end sales charges. This latter definition may be more in line with the intent of Congress.

The current definition of “no-load” under Regulation B would require revision to banks’ existing sweeps programs that would involve significant administrative expense for banks, as well as inconvenience for bank customers. Mutual fund transactions in sweep programs are effected regularly, often on a daily basis, and banks usually charge monthly account-level fees for sweep services. To qualify for the statutory exception, banks may be required to modify some sweep arrangements involving funds that impose more than minimal charges against fund assets. In particular, some banks using the exception may begin to charge customers directly for sweep services if they wish to continue to receive fees for the services equivalent to what they currently may receive from funds in the form of sales loads, deferred sales loads, Rule 12b-1 fees and shareholder fees. Some banks may increase their account fees to offset losses of fees from money market funds or they may stop offering sweep accounts services altogether. From the investor’s perspective, if the bank charges its customers fees above the built-in fees of true no-load funds, they may need to reconsider their investment decisions altogether.

As a practical matter, banks are unlikely to eliminate sweep account services altogether. Generally speaking, sweep account services have incentives other than earning fees to sweep balances out of deposit accounts. Sweeping allows banks to reduce the amount of assets that they are required to hold in vault cash or reserve accounts, neither of which earns interest. Sweep accounts allow banks to use more of their assets to generate income and they provide a means by which a bank may direct investments into proprietary funds from which the bank or its affiliate may receive advisory fees and other revenues. Before charging the customer additional sweep account fees, a bank should weigh the subsequent loss of investor that such a fee would potentially result in against the potential advisory fees and other revenues that may be generated by directing investments into sweep account funds.

Affiliate Transactions Exception

This exception applies to all banks effecting trades for the accounts of its affiliates, with the exception of affiliates that are registered as broker-dealers. Subsidiaries of the bank itself may not use the affiliated transactions exception, and banks completing trades for non-affiliated customers may not use this exception at all. Under Regulation B, to qualify for the exception, the affiliate must be acting as a principal or as a trustee or as a fiduciary purchasing or selling securities for investment purposes.[18] Furthermore, the affiliate may not act as a riskless principal for another person, as a registered broker-dealer, or be engaged in merchant banking.[19] Finally, the bank would be required to obtain the securities to complete the subject transaction from a registered broker-dealer, from a person acting in that capacity that is not required to register, or pursuant to another exception or exemption from the Exchange Act.

If taken literally, this definition of an affiliate transaction would effectively negate the statutory exception by prohibiting a bank from completing a brokerage transaction with non-affiliated customers under the affiliate transaction exception. One option might be to expand the exception to cover transactions with non-affiliates if one of the parties to the transaction is an affiliate with the bank. The problem with this, however, is that a bank could avoid broker-dealer registration for a securities brokerage transaction if an affiliate is involved in the transaction.

Safekeeping and Custodial Activities Exception

Banks that hold funds and securities for their customers as part of "customary banking" activities are permitted to perform specified securities-related functions without having to register as a broker-dealer.[20] Specifically, banks that hold securities for their clients can: exercise warrants and other rights on behalf of their customers; facilitate the transfer of funds or securities in clearance and settlement of customer transactions; effect securities lending or borrowing transactions when the securities are in the custody of the bank; invest pledged collateral for customers and; and facilitate the pledging or transfer of securities that involve the sale of those securities.

The custody and safekeeping exception is not generally available to banks that act as "carrying brokers." Regulation B suggests that banks that take on significant responsibilities for a broker-dealer, such as assuming certain clearing and settlement function duties are at risk for becoming a carrying broker. The safekeeping and custody exception generally does not permit banks to accept their customers' securities orders. It can be contended that order taking is a customary banking activity in custody accounts, and that in adopting the GLBA Congress did not intend to disturb such activities. Since the exception permits banks to perform "related administrative services" for investors, it might follow that with respect to retirement and benefit plans a bank should be expressly permitted to handle orders effecting transactions in custodial IRAs.

One argument for permitting the taking of orders to execute securities transactions for custody clients is that historically it has been an important aspect of custody business that provides an accommodation and convenience for clients, rather than as a substitute for the brokerage business. However, the SEC believes that accepting orders to purchase or sell securities is generally a core broker-dealer function, and it will not likely be permitted under the safekeeping and custody exception.

General Exception

Regulation B creates a general exemption not tied to any of the GLBA exceptions that permits banks to buy and sell money market securities for bank customers who are "qualified investors," subject to certain conditions.[21] This exemption gives banks greater flexibility in offering some of their customers a wide range of cash management services that include investing in money market fund shares that do not qualify as "no-load." Banks may be generally exempt from registering as a broker-dealer for effecting transactions in no-load money market funds for a customer, provided that the customer has obtained other non-securities products from the bank and the customer is a qualified investor or a person who directs the cash flows that relate to an asset-backed security that has a minimum original asset amount of $25 million, and the bank effects the transactions in a trustee or fiduciary capacity or the bank effects the transactions as an escrow, collateral, depository, or paying agent capacity.

Banks will still be permitted to administer employer-sponsored retirement plans, and receive 12b-1 fees and other fees that meet the "sales compensation" definition. Since most banks do not charge plan participants management fees, banks very rarely meet the trust and fiduciary activities exception to be "chiefly compensated" through relationship fees.[22] To eliminate any conflict of interest in selecting investment funds, a bank relying on this new exemption is required to offset any compensation it receives from a fund complex related to securities in which plan assets are invested against fees and expense that the plan owes the bank. The bank is further required to clearly and conspicuously disclose to the plan sponsor or its designated fiduciary all fees and expenses assessed for services provided to the plan and all compensation received from a complex fund.

Credit Union Exception

Regulation B provides credit unions a new, limited exception from the definition of broker-dealer. Credit unions are not considered banks under the Exchange Act and, therefore, they are not subject to the same degree of regulation. However, they cannot utilize the bank exceptions from the definitions of broker or dealer either. A credit union is permitted to engage in activities governed by the networking and sweep account exceptions without registering under the Exchange Act, provided that it is not operated for the purpose of evading the Exchange Act. All credit unions, both federally and privately insured, are exempted from the definition of dealer under Exchange Act when engaging in activities exempted by the investment transactions exemption. This is clearly a triumph for credit unions, allowing them to basically continue to offer an array of services without having to register as a broker dealer.

Conclusion

Regulation B supersedes the SEC's final interim rules issued in May of 2001 with respect to banking and brokering activities. Reporting entities will have a one-year transition period after the amended rules are adopted in 2005 to complete compliance. Regulation B amends the rules governing third-party brokerage arrangements, the provisions governing trust and fiduciary activities, and the safekeeping and custody exemption. It provides three new exemptions, including, in certain instances, the approval for banks to receive 12b-1 fees, permission for bank trustees and non-fiduciary administrators to receive asset-based sales charges, and permission for banks to sell securities exempt from SEC registration to non-U.S. persons. This article has highlighted some of the major provisions of Regulation B as well as areas that are either nebulous or could be troublesome for reporting entities.

Endnotes

[1] Exch. Act Rel. No. 49,879 (June 17, 2004) (Proposing Release) at www.sec.gov/rules/proposed/34-49879.htm.

[2] 69 Fed. Reg. 39682 (published June 30th, 2004).

[3] Wilmarth, Arthur E, *The Transformation of the U.S. Financial Services Industry, 1975:2000: Competition, Consolidation, and Increased Risks,* 2002 U. Ill. L. Rev. 215 at 225-6 (2002).

[4] Pub. L. No. 106-102, 113 Stat. 1338, 1999.

[5] Exch. Act Rel. No. 44,291 (May 11, 2001), 66 Fed. Reg. 27,760 (May 18, 2001).

[6] Exch. Act Rel. No. 47,649 (Apr. 8, 2003).

[7] 15 U.S.C. § 78c (a) (4) (B) (i).

[8] See Exchange Act Sectopm 15(a)(1). See also SEC v. Hansen, Fed. Sec. L. Rep. 91,426 (S.D.N.Y. 1984).

[9] See The Exchange Act Section 3(a) (6) which defines "bank."

[10] See letter dated July 17, 2001 from Neil Milner, President and CEO, Conference of State Bank Supervisors ("CSBS letter").

[11] In general, absent an exception or exemption, a person who regularly refers securities business prospects for compensation to broker-dealer would be a broker required to be registered with the SEC. See Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013, 30017-18 (July 18, 1989).

[12] 15 U.S.C. §78c (a) (4) (B) (ii).

[13] *Ibid* at (ii) (I). Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities in conjunction with advertising their other trust activities 15 U.S.C. §78c(a)(4)(B)(ii)(II). The exception also provides that a bank's trust and fiduciary activities that result in a transaction in the United States of any security that is publicly traded must meet the conditions of The Exchange Act. 15. U.S.C §78c (a) (4) (C). These conditions require a bank to trade to a registered broker or dealer for execution, to effect the trade through a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary that is not in contravention of fiduciary principles established under applicable federal or state law, or to effect the trade in some other manner permitted by the SEC. 15 U.S.C §78c (a) (4) (C) (i)-(iii). The term "assets under management" is not defined in The Exchange Act or in the proposed rules.

[14] The question of when a bank may be acting in a fiduciary capacity is separate and distinct from the question of whether a specific account is established for a fiduciary purpose. See Section 3(c) (s) of the Investment Company Act of 1940.

[15] See The Exchange Act Rule 3b-17(i). The term "relationship compensation," an amended version of which the commission is proposing to codify in Proposed Regulation B rule 724, includes administrative or annual fees (payable on a monthly, quarterly, or other basis), fees based on a percentage of assets under management, a flat or capped per order processing fee limited by the bank's cost in effecting the transaction, or any combination of such fees.

[16] Any fee that a bank receives that is not related to effected securities transactions is considered "unrelated compensation," and is not included in the definition of "relationship compensation." This excludes any payment made to the bank or one of its employees pursuant to the networking exception. See The Exchange Act Section 3(a) (4) (B) (i) (VI).

[17] For purposes of determining whether a fund is a “no-load” fund, “sales loads” includes any charges related to the offering price of a fund, such as contingent deferred sales charges.

[18] The securities laws and rules distinguish “dealers” (which buy and sell securities for investment and not as part of a regular business) from “traders” (which buy and sell securities for investment and not as part of a regular business). See Exchange Act Release Nos. 46745 (Oct. 31, 2002) 67 FR 67496, 67498 (Nov. 5, 2002) and 47364, (Feb. 14, 2003), 68 FR 8686, 8688 (Feb. 24, 2003).

[19] The affiliate may not be a registered broker-dealer or be engaged in merchant banking because the statute contains these conditions Exchange Act Section 3 (a) (4) (B) (vi). The affiliate may not act as a riskless principal because that would effectively be acting for another person who would be a customer of the affiliate.

[20] Holding customer funds and securities in connection with securities transactions typically requires broker registration, absent an exception. See SEC. v. Margolin [1992] Fed. Sec. L. Rep. (CCH) 97, 025 S.D.N.Y. 1992).

[21] “Qualified Investor” is defined in Exchange Act Section 3 (a) (54). 15 U.S.C. 78c (a) (54).

[22] See ERISA Advisory Opinion 97-15A.