SEC-Federal Reserve Board Regulation R: The Gramm-Leach-Bliley Bank Broker Exception Rules

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Introduction

Ending eight years of stalled negotiations and impasse, the SEC and the Federal Reserve Board have adopted rules that will finally implement the bank broker provisions of the Gramm-Leach-Bliley Act of 1999. The joint rules, codified as Regulation R, are designed to accommodate the business practices of banks while protecting investors. (See Release No. 34-56501 (SEC 2007).)

In the view of Fed Governor Randall Kroszner, the rules provide a flexible framework for banks to continue to serve the demands of their customers for banking services that include securities products while ensuring consumer protection. The rules are expressly designed to ensure that banks may continue to conduct securities transactions for customers as part of their banking activities, thereby achieving the broad, historic goals of Gramm-Leach-Bliley of promoting competition and efficiency in the markets for financial services while recognizing the functional regulatory structure in place for banks. Echoing these sentiments, SEC Director of Market Regulation Erik Sirri emphasized that the joint rules are consistent with Gramm-Leach-Bliley's bank broker exceptions and the Act's underlying policies of functional regulation and investor protection. Regulation R also takes into account banking industry implementation and compliance concerns.

The Gramm-Leach-Bliley Act repealed the blanket exemption banks had historically enjoyed from the Exchange Act definition of broker and replaced it with a set of limited exemptions that allow the continuation of traditional activities performed by banks. Thus, a bank will be considered a broker under the Exchange Act and subject to the full panoply of SEC regulation if it engages in the business of effecting transactions in securities for the accounts of others. However, at the same time, the Act carves out a number of exemptions from the definition of broker.

The joint SEC-Fed rules are designed to implement GLB's removal of the blanket exemption from SEC registration for banks that engage in securities activities. The exemptions embrace a number of activities and transactions traditionally performed by banks and those involving identified excepted banking products. If a bank limits its brokerage activities to those described in the exceptions, the bank will not be subject to broker-dealer registration.

The rulemaking process that culminated in the Commission's vote of final approval for Regulation R has been an arduous one. After a series of interim proposals and regulatory actions that proved mostly fruitless between 1999 and 2005, the SEC made a fresh start 18 months ago. Congress also helped end the logjam by directing the SEC to work with the Fed to promulgate joint regulations to fully implement the functional regulation vision of the Gramm-Leach-Bliley Act. The Financial Services Regulatory Relief Act was designed to ensure that regulators did not create a new and burdensome maze of requirements that would disrupt the business practices of banks that offer traditional bank products and services.

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Identical sets of the final rules were adopted by the Fed and SEC and will be published by the Board in Title 12 of the Code of Federal Regulations and by the SEC in Title 17 of the Code of Federal Regulations. Banks will have until the first day of their first fiscal year commencing after September 30, 2008, to come into compliance with the Exchange Act bank broker provisions.

Pursuant to the Regulatory Relief Act, this single set of final rules supersedes any and all other proposed or final rules issued by the Commission on or after the date of enactment of the GLBA with regard to the definition of broker under Exchange Act Section 3(a)(4). Further, Section 401 of the Regulatory Relief Act amended the definition of "bank" in Exchange Act Section 3(a)(6) to include any federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, as used in the final rules, the term bank includes any savings association that qualifies as a bank under Section 3(a)(6).

Overview of Regulation R

Regulation R defines terms used in the Gramm-Leach-Bliley exceptions relating to networking, trust and fiduciary activities, safekeeping and custody, and sweep accounts. It also provides conditional exemptions from certain of the statutory requirements of these exceptions. In addition, Regulation R provides banks with targeted exemptions for particular securities activities, as well as one new exemption pertaining to employee stock plans.

A principal exception is the networking exception permitting banks to pay their unregistered employees, such as tellers, loan officers, and private bankers, incentive compensation to refer bank customers to their networking broker-dealer partners. The statute limits these payments to a nominal one-time cash fee of a fixed dollar amount when the payment of the fee is not contingent on whether the referral results in a transaction. The joint rules define certain terms used in the networking exception, and provide an exemption to allow banks to pay higher fees for referrals of institutional and high net worth customers

The joint rules define incentive compensation to better accommodate typical bank bonus programs. A bank may generally pay bonuses that are based on the overall profitability *or* revenues of the bank or operating units so long as the unit over time does not predominately engage in making referrals to broker-dealers. The bank regulators will examine bank bonus programs for compliance with these requirements.

The rules also include an exemption for high net worth and institutional customers, which broadly encompasses referrals for institutional customers controlled by other institutions. Bank employees may orally provide a customer with information about the bank-broker relationship, if either the bank or the broker follows up with written disclosure. A key safeguard of this exemption is the requirement that the broker-dealer perform a suitability analysis when a referral fee is contingent on a transaction and a suitability or sophistication analysis for other referrals. Taken together, the conditions applicable to

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this exemption provide additional investor protections in those circumstances where the bank employee making the referral may receive a higher-than-nominal referral fee. A bank may rely on the exemption if it has a reasonable basis to believe the customer qualifies as high net worth or institution.

The trust and fiduciary exception permits a bank to effect securities transactions in a trustee or fiduciary capacity if it is chiefly compensated for those transactions, consistent with fiduciary principles, on the basis of specifically enumerated types of fees, which are referred to as relationship compensation. These fees may be considered relationship compensation even if paid by a service provider rather than directly by an investment company.

The rules establish a test to determine how a bank is chiefly compensated, and permit a bank to choose either an account-by-account or bank-wide approach. Either alternative allows banks to exclude the compensation associated with a securities transaction conducted in accordance with any of the other exceptions or exemptions as long as the bank excludes that compensation from both relationship compensation and total compensation. The revenues of certain foreign branches of U.S. banks are excluded for purposes of the chiefly compensated test. Notably, a bank that does not have trust powers may rely on the trust and fiduciary exception if its appropriate federal regulator examines its fiduciary accounts for compliance with trust and fiduciary principles.

The custody and safekeeping exception permits banks to perform certain securities-related services if they constitute customary banking activities. The rules permit a bank to accept orders for securities transactions from employee benefit plan accounts and individual retirement accounts for which the bank acts as a custodian, record keeper or administrator, and to accept certain accommodation orders, as well.

The rules also permit a bank to rely on these provisions when it acts as a directed trustee without investment discretion, and extends the exemptions to subcustodians. Administrators, record keepers and subcustodians will be able to engage in cross-trades to the same extent that the custodian bank could, which means they can cross or net orders between the accounts of a particular custodian bank, but not among the accounts of multiple banks. The SEC and Fed also identify the circumstances under which a bank might be considered an impermissible carrying broker.

The sweep account exception permits a bank to sweep funds from bank accounts into no-load money market funds without registering as a broker-dealer. The rules also include an exemption that permits banks to effect mutual fund trades through a clearing agency system or transfer agent, rather than routing those trades to a broker-dealer. The exemption also includes transactions in registered variable insurance products. Moreover, the rules provide a new exemption permitting banks to effect certain company stock transactions for employee stock plans.

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In addition, the rules allow a bank to engage in certain securities lending transactions as agent when it either does not have custody of the securities, or has custody of the securities for less than the entire period of the transaction. Additional comment is solicited on banks' transactions involving repurchase agreements.

Finally, Regulation R also includes an exemption to allow banks to effect certain agency transactions involving Regulation S securities. Banks may rely on the rule if they have a reasonable belief that securities were initially sold in compliance with Regulation S when they effect resales of a security obtained from a broker-dealer for one of its non-U.S. customers who is not in the U.S.

Networking Exception

The third-party brokerage exception, popularly called the networking exception, in Exchange Act Section 3(a)(4)(B)(i) permits a bank to avoid being considered a broker if, under certain conditions, it enters into a written arrangement with a registered brokerage firm under which the firm offers brokerage services to bank customers. The statutory networking exception does not address the type or amount of compensation that a bank may receive from its broker partner under a networking arrangement. However, the networking exception provides that a bank may not pay its unregistered employees incentive compensation for brokerage transactions. In this context, an unregistered bank employee is generally one not registered under SRO rules.

Nevertheless, the statutory exception does permit a bank employee to receive a nominal one-time cash fee of a fixed dollar amount for referring bank customers to the broker if payment of the referral fee is not contingent on whether the referral results in a transaction. Congress included this general prohibition on, and limited exception to, incentive compensation to reduce concerns regarding the securities sales practice of unregistered bank employees.

Nominal Fee

Fleshing out the interstices of the statutory networking exception, Rule 700(c) provides that a referral fee paid to any bank employee will be considered nominal if it does not exceed $25. This dollar amount will be adjusted for inflation on April 1, 2012, and every five years thereafter. The SEC and Fed selected the $25 amount because it is consistent with the level of referral fees generally paid to tellers and other bank employees engaged in making referrals of retail customers under existing banking agency guidance, which also includes a nominal standard.

A referral fee will also be considered nominal under Rule 700(c) if it does not exceed twice the employee’s actual base hourly wage; twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee; or 1/1000th of the average of the minimum and

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maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee.

To provide comparability between the alternative based on an employee's actual compensation and those based on the compensation established for the employee's job family, the rule provides that a referral fee also will be considered nominal if it does not exceed 1/1000th of the employee's actual base annual salary. In addition, a bank may use a different nominal methodology in its different business lines or operating units and may alter the methodology it uses within a given year.

Rule 700 defines a job family as a group of jobs or positions involving similar duties, or requiring similar skills, education or training, that a bank, or a separate unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation. The requirements that a job family include jobs with similar responsibilities, or that require similar skills, education and training, and be used by the bank in the ordinary course of its business for hiring, promotion and compensation purposes are designed to prevent a bank from establishing special job family classifications to evade the nominal standard.

Also, a bank may not deviate from its ordinary classification of jobs for purposes of determining whether a referral fee is nominal under this standard. Federal banking regulators will monitor the job family classifications used by banks for nominal determination as part of their risk-focused examination process. Depending on a bank's internal employee classification system, examples of a job family may include tellers, loan officers, or branch managers.

Other provisions of the networking exception also provide significant protection to customers. For example, the networking exception provides that unregistered bank employees may perform only clerical or ministerial functions in connection with brokerage transactions. Thus, bank employees referring a customer to a broker-dealer under the exception may not provide investment advice concerning securities or make specific securities recommendations to the customer. A bank employee, however, may describe in general terms the types of investment vehicles available from the bank and the broker under the arrangement.

Rule 700 clarifies that the networking exception permits a bank employee who personally participated in a referral to receive a fee for the referral. Thus, for example, a supervisory employee may receive a separate, nominal one-time cash fee for a referral made by another individual supervised by the employee only if the supervisor personally participated in the referral. A supervisor may not, however, receive a referral fee merely for supervising the employee making the referral or administering the referral process. An officer or director of a bank who makes or personally participates in making a referral may receive a nominal fee for the referral as a bank employee.

Since the networking exception provides for a nominal, one-time cash fee of a fixed dollar amount, the rules require that referral fees paid under the exception be paid in cash.

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This means that a bank may not pay referral fees in non-cash forms, such as vacation packages, stock grants, annual leave, or consumer goods.

The rules do not, however, prevent a bank from paying an employee on a quarterly or more frequent periodic basis the total amount of nominal, fixed cash fees the employee earned during the period. For example, if a bank employee is entitled to receive a $25 referral fee for each securities referral and the employee makes three qualifying referrals in a given quarter, the bank may pay the employee $75 at the end of the quarter instead of three individual payments of $25. A bank also may use a points system to keep track of the number of qualifying securities referrals made by the employee during a quarterly or more frequent period and the total amount of nominal, fixed cash fees that the employee is entitled to receive at the end of the period.

In all cases, however, points must translate into cash payments on a uniform basis and the cash amount that an employee will receive for a qualifying securities referral, such as twice the employee's actual base hourly wage, must be fixed before the referral is made and may not be contingent or vary based on whether an employee makes a specified number or type of securities referrals during a quarterly or more frequent period.

The statutory exception and the rules do not prohibit a bank from providing its employees non-cash items, such as pizza or coffee mugs, in connection with programs to familiarize bank employees with new types of investment vehicles offered by the bank or the broker-dealer through the arrangement, provided that the programs or items given to employees do not reward or compensate an employee for making a referral to a broker. Thus, for example, a pizza party that is made available only to those employees that have made one or more referrals to a broker would not be permissible.

Definition of "Referral"

The statutory networking exception permits bank employees to receive a nominal one-time cash fee of a fixed dollar amount for the referral of a customer to a broker. Rule 700(e) defines a referral as an action taken by one or more bank employees to direct a customer of the bank to a brokerage firm for the purchase or sale of securities for the customer's account. For purposes of the networking exception, the term customer includes both existing and potential customers of the bank.

A bank employee may receive a referral fee under the networking exception and Rule 700 for each referral made to a broker-dealer, including separate referrals of the same individual or entity. In addition, there are no restrictions on the ability of a bank employee to refer customers to other departments or divisions of the bank itself, including, for example, the bank's trust, fiduciary or custodial department. Likewise, the networking exception and the rules do not apply to referrals of retail, institutional or high net worth customers to a broker-dealer or other third party solely for transactions not involving securities, such as loans, futures contracts (other than a security future), foreign currency, or OTC commodities, or solely for transactions in securities (such as U.S.

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Government obligations) that would not require the other party to register under Exchange Act Section 15.

But note that a bank that acts as a government securities broker is not exempt from and must comply with the notification and other applicable requirements of Exchange Act Section 15C.

Contingency of Whether Referral Results in a Transaction

Under the statutory networking exception, a nominal fee paid to an unregistered bank employee for referring a customer to a broker-dealer may not be contingent on whether the referral results in a transaction. This limitation is designed to allow banks to reward bank employees for introducing customers to a broker without giving unregistered bank employees a direct financial interest in any resulting securities transaction at the firm.

The rules provide that a referral fee will be considered contingent on whether the referral results in a transaction if payment of the fee is dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker; whether the referral results in a transaction involving a particular type of security; or whether the referral results in multiple securities transactions. The rules expressly provide that a referral fee may be contingent on whether a customer contacts or keeps an appointment with a broker as a result of the referral or meets any objective, base-line qualification criteria established by the bank or broker for customer referrals, including minimum assets, net worth, income, or marginal income tax rate, or any requirement for citizenship or residency that the broker or the bank, may have established generally for referrals for securities brokerage accounts.

In addition, a bank or brokerage firm may establish and use different objective, base-line qualification criteria (including citizenship or residency requirements) for different classes of customers or for different business lines, divisions or units of the bank or the firm. The rules also provide that payment of a referral fee may not be contingent on whether the customer opens an account at the broker-dealer.

In addition, the broker exceptions in Exchange Act Section 3(a)(4)(B) are available only to banks. Thus, a referral to a broker for a securities transaction within the scope of Exchange Act Section 15 still involves a broker transaction at the broker-dealer even if a bank could conduct the transaction itself without registering as a broker, and a referral fee may not be contingent on the occurrence of such a transaction or the opening of an account to engage in such transactions. For similar reasons, a referral to a broker-dealer for such a transaction is a referral for purposes of the networking exception and Rule 700.

Incentive Compensation

The networking exception prohibits an unregistered employee of a bank that refers a customer to a broker-dealer under the exception from receiving incentive compensation for the referral or any securities transaction conducted by the customer at the broker other than a nominal, non-contingent referral fee.

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The rules create a safe harbor for certain types of bonus plans that are not likely to give unregistered bank employees a promotional interest in the brokerage services offered by the firm with which the bank networks. The safe harbor was crafted to accommodate existing types of bank bonus programs in general. Nevertheless, a plan's longevity or the number of banks that utilize similar plans are not factors in determining whether a plan constitutes incentive compensation. Thus, banks that have networking arrangements with a broker-dealer should review their existing bonus programs in light of the standards set forth in the rule to evaluate whether they may constitute impermissible incentive compensation.

Under the rules, compensation paid by a bank under a bonus or similar plan is specifically excepted from incentive compensation if it is paid on a discretionary basis and based on multiple factors provided that the factors include multiple, significant factors unrelated to securities transactions at the broker-dealer; a referral made by the employee is not a factor determining the employee's compensation under the plan; and the employee's compensation under the plan is not determined by reference to referrals made by any other person.

In addition, a multi-factor plan must include multiple, significant factors unrelated to securities transactions at the broker-dealer. Also, the requirement that an employee's compensation not be based on a referral made by the employee or another person means that the employee's compensation under the bonus or similar plan may not vary based on the fact that the employee or other person made a referral to a broker or the number of securities referrals made by the employee or other person to a broker.

Each factor unrelated to securities transactions at the broker-dealer will be considered significant for purpose of Rule 700(b) if it plays a material role in determining an employee's compensation under the bonus or similar plan. For example, the amount of the employee's bonus could be reduced or increased by a material amount based on the non-securities factor.

This clarification gives banks greater certainty and allows them to more readily identify the types of factors unrelated to securities transactions that must be included within a discretionary, multi-factor bonus plan. Thus, a bank's bonus program may take account of the full range of banking, securities or other business of one or more customers brought to the bank and its partner broker by an employee so long as the bonus is paid on a discretionary basis, the banking and other factors unrelated to securities transactions at the broker are significant factors under the bonus program, and a referral made by the employee or others is not a factor under the program.

In this way, the rules are designed to accommodate discretionary bank bonus programs that are based on general measures of the business or performance of a bank or a particular customer, branch or other unit of the bank, that are not based on referrals made by bank employees and that include some inputs based on securities transactions at a broker as well as multiple significant factors unrelated to securities transactions at the broker. Further, a bank may not establish sham non-securities factors in its bonus plan for

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the purpose of evading the restrictions in Rule 700(b). Banking regulators will review the bonus plans of banks participating in networking arrangements as part of their risk-focused supervisory process.

In considering if a bonus program contains sufficient banking or other factors unrelated to securities transactions at a broker, the banking agencies will consider, among other things, whether such factors relate to banking or other non-broker business actually being conducted by the bank or its employees, the resources devoted by the bank to such business, and whether such business materially contributes to the payments made under the plan over time.

The SEC and Fed do not expect that the actual payments made under a bank's bonus or similar plan would, over time, be based predominantly on securities transactions conducted at a brokerage firm. If such a situation were to occur, the bank would be expected to make appropriate modifications to its bonus plan going forward.

A bonus plan will be considered discretionary under the rules if the amount employees may receive under the plan are not fixed in advance and they does not have an enforceable right to payments under the plan until the amount of any payments are established and declared by the bank. A plan may, however, include targets that must be met in order for any bonus to be paid, provided the plan is otherwise a discretionary plan.

A bonus plan cannot be based on the fact of a referral or the number of referrals made by bank employees. In the view of the SEC and Fed, doing so would allow a direct linkage between a referral and an employee's bonus compensation and be contrary to the purposes of the exception.

The safe harbor is designed to allow banks to avoid having to analyze whether a particular bonus program meets the requirements of the exception in circumstances where the general structure of the program clearly reduces the potential for sales practice concerns in connection with a referral to a broker-dealer.

When a bonus program is based on the overall profitability of a bank or one of its operating units, any relationship between a referral made by a bank employee and the amount of payments that the employee may receive under the plan are likely to be attenuated. In these circumstances, any potential connection between the revenue received by a bank from its partner broker as a result of a referral and the payments made to the referring bank employee under the plan likely would be tenuous and largely speculative given the number of other employees, business and actions that contribute to the overall profitability of the bank.

The SEC and Fed believe this attenuation effectively addresses any potential that payments under the plan would give an employee an undue promotional interest in any securities transactions that may occur at the broker-dealer as a result of a referral. A bonus plan based on the overall revenue of a bank would be similarly attenuated and, for this reason, the safe harbor covers plans based on either the overall profitability or revenue of a bank or a qualifying affiliate (other than a broker-dealer) or operating unit.

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This would include plans based on an entity's earnings per share or stock price, both of which are directly related to the entity's overall profitability or revenue.

Because other, more granular measures of the financial performance of a bank could create an unduly close connection between the employee's expected payment under the bonus plan and referrals made to the broker-dealer or the securities transactions that result from those referrals, the rules provide for plans structured in more granular ways to be analyzed under the multi-factor, discretionary criteria in Rule 700(b)(1).

However, the potential connection between a referral made by a bank employee and the payments made to the employee under a bonus plan may be particularly strong if payments under the plan are based on the profitability or revenue of the partner broker-dealer or one of its branches or an operating unit of the bank that is predominantly engaged over time in referring customers to the broker-dealer. To address the potential for improper incentives in these situations, the rules allow a bonus program to be based on the overall profitability or revenue of a broker-dealer only if the program meets four conditions:

- Overall profitability or revenue is only one of multiple factors used to determine the compensation of the employee;
- The factors used to determine the employee's compensation include multiple significant factors unrelated to the profitability or revenue of the broker-dealer;
- A referral made by the employee is not a factor variable in determining the employee's compensation under the plan; and
- The employee's compensation under the plan is not determined by reference to referrals made by any other person.

These conditions resemble those that would apply to a discretionary bonus plan under paragraph (b)(1) and are designed to ensure that the profitability or revenue of the broker-dealer is only one of multiple significant factors or variables in determining the employee's compensation and that a referral or number of referrals made by the employee is not a factor under the program.

The safe harbor is not available to bonus plans based on the profitability or revenue of a particular branch, division or operating unit of the partner broker-dealer. In addition, the rules exclude bonus plans based on the profitability or revenue of an operating unit of a bank or non-broker-dealer affiliate that over time predominantly engages in the business of making referrals to a broker-dealer. This exclusion is intended to prevent a bank from basing a bonus plan on the overall profitability or revenue of a bank unit that is focused solely or predominately on making referrals to a broker-dealer.

This restriction, however, is not intended to prevent a bonus plan from being based on the overall profitability or revenue of a bank unit, such as a call center, that in fact markets,

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sells or supports a range of bank products in addition to making referrals to a broker-dealer and which is not, over time, predominantly engaged in the business of making referrals to a broker-dealer.

Referrals Involving Institutional and High Net Worth Customers

An exemption from the nominal and contingency limitations in the networking exception was provided for referrals that institutions and individuals that meet certain financial criteria and that occur under other conditions designed for investor protection. When provided appropriate information, such institutions and individuals are more likely to be able to evaluate the relationship between a bank and its employees and the bank's broker partner and the impact of that relationship on any resulting securities transaction with the broker.

The conditions in the exemption are designed to ensure that institutional and high net worth customers receive information enabling them to understand the financial interest of the bank employee so that they can make informed choices. Moreover, a bank operating under the exemption also must comply with the statutory networking exception terms and conditions requiring the disclosure of the uninsured nature of securities and that limit the role that a bank employee may have in a brokerage transaction. These conditions provide additional protections to institutional and high net worth customers that may be referred to a broker under Rule 701.

The rules provide banks and brokers greater flexibility in complying with the disclosure requirements and to make the exemption more workable in practice. Thus, banks that pay their employees only nominal, non-contingent fees in accordance with Rule 700 for referring customers, including institutional or high net worth customers, to a broker do not need to rely on, or comply with, the exemption provided in Rule 701.

The rules require that the written agreement between a bank operating under the exemption and its partner broker include terms that obligate the broker to take certain actions. Banks and brokers are expected to comply with the terms of their written networking arrangements. If a bank or broker do not comply with the terms of the agreement, however, the bank would not become a broker under Exchange Act Section 3(a)(4) or lose its ability to operate under the exemption.

Institutional customers are defined as any corporation, partnership, limited liability company, or trust that has at least: $10 million in investments; or $20 million in revenues; or $15 million in revenues if the bank employee refers the customer to the broker for investment banking services. The thresholds are based on revenues rather than assets in order to eliminate the potential for borrowings to influence the status of a corporate customer and to promote the equivalent treatment of non-financial companies and financial companies. In addition, the rule provides that a company controlled by an institutional customer will itself be considered an institutional customer. A company controlled by another company should generally have access to the resources and sophistication of the controlling company.

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The lower revenue threshold for referrals involving investment banking services is designed to facilitate access to the capital markets by smaller companies. Investment banking services are defined to include acting as an underwriter in an offering for an issuer, acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction, providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments, serving as placement agent for an issuer, and engaging in other similar activities. The phrase “other similar services” would include, for example, acting as an underwriter in a secondary offering of securities and acting as a financial adviser in a divestiture. These examples are not exhaustive and are provided solely for illustrative purposes.

A high net worth customer is defined as a natural person who, either individually or with their spouse, has at least $5 million in net worth excluding their primary residence and associated liabilities. Customers meeting the net worth, investment and revenue thresholds should have the ability to understand and evaluate the financial interest of the bank employee making a referral to a broker-dealer under the exemption.

The SEC and Fed rejected the suggestion that any person advised by a bank or a registered investment adviser should be treated as an institutional or high net worth customer. The existence of such an advisory relationship generally is not, by itself, sufficient to show the financial sophistication of an individual or corporate entity for purposes of the other similar standards developed under the federal securities laws.

Determining that Customer Meets Relevant Thresholds

The status of the referred customer as a high net worth or institutional customer is a fundamental aspect of the exemption and the rules provide for both the bank and the broker-dealer to determine that the customer meets the necessary qualification criteria to provide added assurance that these criteria are met. The rules also provides for a written agreement between the bank and the brokerage firm to require the firm to inform the bank if it determines that a referred customer does not meet the relevant eligibility thresholds.

In addition, less information typically is in the public domain concerning the financial resources of an individual than of a corporation or other business entity and, accordingly there is a greater likelihood that a bank employee, without further investigation, will be able to preliminarily identify corporate or other business customers that are likely to satisfy the rule’s eligibility criteria than in the case of individuals. For these reasons, the rules provide for the bank to determine that a natural person is a high net worth customer before a referral is made and before the employee potentially develops expectation of a higher-than-nominal fee.

The rules are also flexible enough to allow banks and brokerage firms to satisfy their customer eligibility requirements if they have a reasonable basis to believe that the customer is an institutional customer or high worth customer before the time specified in the rule. Banks and brokerage firms would have a reasonable basis to believe that a

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customer is a high net worth customer or institutional customer if, for example, they obtain a signed acknowledgment from customers that they meet the applicable standards to be considered a high net worth customer or an institutional customer and the bank employee making the referral and the broker dealing with the referred customer do not have information that would cause them to believe that the information provided by the customer is false.

Conditions Relating to Disclosures

Banks must disclose to referred high net worth or institutional customers the name of the broker-dealer. Banks must also disclose that the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker and that payment of the fee may be contingent on whether the referral results in a transaction with the broker. This requirement ensures that customers receive notice of the financial interest the referring employee may have in the transaction so they can make informed choices.

The rules provide two options for providing the required disclosures. Under the first option, the bank must provide the high net worth or institutional customer written disclosure prior to or at the time of the referral. The second option allows the bank to orally provide the disclosure to the customer prior to or at the time of the referral. However, if the bank provides the customer the required disclosure only orally then either the bank must provide the disclosure to the customer in writing within three business days of the date of the referral; or the broker must be contractually obligated to provide the disclosure in writing to the customer.

If the broker-dealer is responsible for providing the written disclosure, then it must provide the disclosure to the customer prior to or at the time the customer begins the process of opening an account at the broker or prior to the time the customer places an order for a securities transaction with the broker as a result of the referral. In this way, the rules provide a mechanism for customers to receive the disclosures in writing when they initially are provided with only oral disclosure. But whether provided orally or in writing, the required disclosure will be considered to have been made in the mandated clear and conspicuous manner if it is provided in a manner designed to call attention to the nature and significance of the information.

Suitability or Sophistication Analysis by Broker-Dealer

The exemption also requires that a written agreement between the bank and the brokerage firm provide that the firm perform a suitability analysis of a securities transaction and appropriately a sophistication analysis of the customer being referred.

The type and timing of the analysis needed to be conducted by the broker depends on whether the referral fee was contingent on the completion of a securities transaction at the firm. Thus, the broker must perform a suitability analysis when a referral fee is contingent on a transaction and a suitability or sophistication analysis for other referrals.

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The suitability and sophistication standards included in the rule are based on the standards that broker-dealers currently must use under applicable SRO rules and, thus, should be familiar to those brokers partnering with banks operating under the exemption.

Specifically, for contingent referral fees payable under the exemption, the written agreement between the bank and the broker must provide for the broker to conduct a suitability analysis of each securities transaction that triggers any portion of the contingency fee in accordance with the rules of the broker-dealer's applicable SRO as if the firm had recommended the securities transaction. This analysis must be performed by the broker-dealer before each securities transaction on which the referral fee is contingent is conducted.

For non-contingent referral fees payable under the exemption, the written agreement must provide for the broker-dealer to conduct, before the referral fee is paid, either a sophistication analysis of the customer being referred or a suitability analysis with respect to all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the applicable SRO as if the broker had recommended the securities transaction.

Under the sophistication analysis option, brokers must determine that their customers have the capability to evaluate investment risk and exercise independent judgment based on their own independent assessment of the opportunities and risks presented by a potential investment. This sophistication analysis is based on elements of FINRA IM-2310-3 (Suitability Obligations to Institutional Customers).

The rules provide for the brokerage firm to notify the customer, rather than the bank, if the firm determines that a high net worth or institutional customer, or a securities transaction to be conducted by such a customer, does not meet the applicable sophistication or suitability standard. Providing such notification to customers should assist them in deciding whether or not to conduct the transaction.

Conditions Relating to Bank Employees

The rules include limitations on the types of bank employees that may receive a higher-than-nominal referral fee. In particular, the bank employees must be predominantly engaged in banking activities, other than making referrals to a broker-dealer; must encounter the customer in the ordinary course of their assigned banking duties, must not be registered under SRO rules, and must not be subject to statutory disqualification under 3(a)(39) of the 1934 Act

The requirement that bank employees encounter high net worth or institutional customers in the ordinary course of their assigned duties is designed to ensure that when they make a referral they do so as part of their duties as bank employees and not as a sales representative of the brokerage firm. However, the SEC and FED recognize that, in the ordinary course of their assigned duties, bank employees may encounter customers or potential customers outside the employee's regular business hours or at locations outside of the bank, such as at social or civic functions or gatherings.

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Good Faith Compliance by Banks

The exemption provides that a bank that acts in good faith and that has reasonable policies in place to comply with the requirements of the exemption will not be considered a broker under the Exchange Act solely because the bank fails, in a particular instance, to determine that a customer is an institutional or high net worth customer, fails to provide the customer the required disclosures, or fails to provide the broker the required information concerning the bank employee receiving the referral fee. In addition, if the bank is seeking to comply and takes reasonable and prompt steps to remedy the error, such as by promptly making the required determination or promptly providing the broker the required information, the bank will not lose the exemption from 1934 Act registration.

Similarly, to promote compliance with the terms of the exemption, the bank must make reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for a referral that does not, following any required remedial actions, meet the requirements of the exemption and that exceeds the amount the bank otherwise would be permitted to pay under the statutory networking exception and Rule 700. It was reasoned that requiring a bank to reclaim the higher-than-nominal portion of a referral fee would give employees an incentive to comply with the rule.

Referral Fees Permitted

The rules place limits on the types of referral fees a bank employee may receive under the exemption. These limitations are designed to reduce the potential salesman's stake of the bank employee in securities transactions conducted at the broker-dealer. Specifically, the exemption provides that a referral fee paid under the exemption may be a dollar amount based on a fixed percentage of the revenues received by the broker-dealer for investment banking services provided to the customer.

Alternatively, the referral fee may be a predetermined dollar amount, or a dollar amount determined in accordance with a predetermined formula, so long as the amount does not vary based on the revenue generated by, or the profitability of, securities transactions conducted by the customer with the broker; the quantity, price, or identity of securities purchased or sold over time by the customer with the broker; or the number of customer referrals made. For these purposes, "predetermined" means established or fixed before the referral is made. Also, the requirement that the amount of the referral fee not vary based on the number of customer referrals made does not prohibit an employee from receiving a referral fee for each referral made by the employee under the exemption.

As the exemption provides, these restrictions do not prevent a referral fee from being paid in multiple installments or from being based on a fixed percentage of the total dollar amount of assets placed in an account with the broker-dealer. Additionally, these restrictions do not prevent a referral fee from being based on a fixed percentage of the total dollar amount of assets (including securities and non-securities assets) maintained by the customer with the brokerage firm.

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Fees structured in this manner do not provide a bank employee an incentive to recommend the purchase or sale of particular securities. In fact, the bank employee would have no special incentive to recommend the purchase of any security, as the addition of cash or other non-security instruments to the account would count equally towards the employee's compensation as any addition of securities to the account.

Permissible Bonus Compensation Not Restricted

The exemption for high net worth and institutional customers expressly provides that nothing in the exemption prevents a bank from paying, or a bank employee from receiving, any type of compensation under a bonus or similar plan that would not be considered incentive compensation. These types of bonus arrangements do not tend to create the kind of financial incentives for bank employees that the statute was designed to address.

Trust and Fiduciary Activities

The trust and fiduciary exception recognizes the traditional securities role banks have performed for trust and fiduciary customers and includes conditions to help ensure that a bank does not operate a securities broker in the trust department. Specifically, Exchange Act Section 3(a)(4)(B)(ii) permits a bank to effect securities transactions in a trustee or fiduciary capacity without being registered as a broker. 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. In addition, the bank must be chiefly compensated for such transactions, consistent with fiduciary principles, on the basis of: (1) an administration or annual fee; (2) a percentage of assets under management; (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions; or (4) any combination of such fees.

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. In addition, a bank that effects a transaction in the United States of a publicly traded security under the exception must execute the transaction in accordance with Exchange Act Section 3(a)(4)(C), which requires that the bank direct the trade to a registered broker-dealer for execution, effect the trade through a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary in a manner that is not in contravention of fiduciary principles established under applicable federal or state law, or effect the trade in some other manner that the SEC permits.

Rule 775 permits banks, subject to certain conditions, to effect trades in securities issued by an open-end investment company and certain variable insurance contracts without sending the trade to a registered broker-dealer.

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Chiefly Compensated Test

The rules provide for two alternative approaches to satisfy the "chiefly compensated" test. Rule 721 provides that a bank meets the "chiefly compensated" condition in the trust and fiduciary exception if the relationship-total compensation percentage for each trust or fiduciary account of the bank is greater than 50 percent.

The relationship-total compensation percentage for a trust or fiduciary account is calculated by: (1) dividing the relationship compensation attributable to the account during each of the immediately preceding two years by the total compensation attributable to the account during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.

Rule 722 also allow a bank to use a bank-wide approach to the "chiefly compensated" condition as an alternative to the above account-by-account approach. To use this bank-wide methodology, the bank must meet two conditions. First, the aggregate relationship-total compensation percentage for the bank's trust and fiduciary business as a whole must be at least 70 percent. The aggregate relationship-total compensation percentage of a bank operating under the bank-wide approach is calculated in a similar manner as the relationship-total compensation percentage of an account under the account-by-account, except that the calculations would be based on the aggregate relationship compensation and total compensation received by the bank from its trust and fiduciary business as a whole during each of the two immediately preceding years. In other words, the percentage would be determined by: (1) dividing the relationship compensation attributable to the bank's trust and fiduciary business as a whole during each of the immediately preceding two years by the total compensation attributable to the bank's trust and fiduciary business as a whole during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.

Second, the bank must comply with the conditions in the trust and fiduciary exception (other than the compensation test in Section 3(a)(4)(B)(ii)(I)) and comply with Section 3(a)(4)(C) (relating to trade execution) of the Exchange Act. The SEC and Fed believe that providing banks these two alternatives is consistent with the purposes of the trust and fiduciary exception. In this regard, the availability of these two alternatives is designed to avoid disrupting the trust and fiduciary operations of banks.

The compensation tests in both the account-by-account and bank-wide approaches are designed to ensure that a bank's trust department is not unduly dependent on the types of securities-related compensation not permitted by the statute. The 70 percent compensation threshold in the bank-wide exemption is higher than that required under the account-by-account approach in order to compensate for the loss of particularity when the chiefly compensated test is implemented and monitored on a bank-wide basis, rather than on an account-by-account basis.

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The SEC and Fed also believe that the bank-wide alternative as structured provides banks flexibility in conducting their trust and fiduciary operations while meeting the statute's goals. The bank-wide approach is designed to reflect both the relationship compensation and total compensation received by a bank through the conduct of its full range of trust or fiduciary services, and, thus, allow banks to avoid tracking their trust or fiduciary revenue back to one or more specific accounts. At the same time, the use of two uniform methodologies (account-by-account or bank-wide) should facilitate the review of bank compliance during the supervisory process and aid the development of software and related systems by banks and their service providers for compliance purposes.

A bank operating under the bank-wide approach may use different systems across its trust or fiduciary business lines, units or regions to monitor its compensation within those business lines, units or regions, provided that such information is then aggregated on a bank-wide basis as provided in Rule 722.

Relationship Compensation

Both the account-by-account and bank-wide approaches are based on the ratio of the relationship compensation attributable to a trust or fiduciary account or a bank's trust and fiduciary business to the total compensation attributable to the account or business. The rules define relationship compensation as any compensation that a bank receives that is attributable to a trust or fiduciary account and that consists of: (1) an administration fee, (2) an annual fee (payable on a monthly, quarterly or other basis), (3) a fee based on a percentage of assets under management; (4) a flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or (5) any combination of these fees.

For banks operating under the bank-wide alternative, fees of these types are relationship compensation if they are attributable to the bank's trust or fiduciary business as a whole.

The rules list all Rule 12b-1 fees that are paid on the basis of assets under management and attributable to a trust or fiduciary account (under the account-by-account test) or the bank's trust and fiduciary business as a whole (under the bank-wide test) as examples of asset under management fees that are relationship compensation. The SEC and Fed believe that treating 12b-1 fees in this manner is consistent with both the language and purposes of the trust and fiduciary exception.

When paid on the basis of a percentage of assets under management, these fees fall within the types of fees expressly permitted by the trust and fiduciary exception. Rule 12b-1 fees that are paid on the basis of assets under management also are distinguishable from the types of non-relationship compensation, such as front-end or back-end sales loads or per-order transaction fees that exceed a bank's costs, that are limited by the statute's "chiefly compensated" test.

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Treating 12b-1 fees in this manner also will avoid significant disruptions to the trust and fiduciary operations of banks and is consistent with investor protection. Many bank trust and fiduciary departments, particularly those that act as a corporate trustee or as a fiduciary for employee benefit plans, receive a significant portion of their trust and fiduciary compensation through payments made under a 12b-1 plan.

Importantly, as provided in the trust and fiduciary exception, all 12b-1 fees received by a bank must be consistent with the fiduciary principles governing the bank-customer relationship, and the bank's compliance with these principles will continue to be regularly examined by bank examiners during the examination process. In addition, the treatment of 12b-1 fees that are paid on the basis of assets under management and service fees as relationship compensation for purposes of the trust and fiduciary exception does not affect the treatment of such fees under other provisions of the federal securities or banking laws, or the rules of an SRO.

Thus, the treatment of 12b-1 fees that are paid on the basis of assets under management and service fees as relationship compensation for purposes of these rules does not alter or affect the treatment of, or limitations imposed on, these fees under FINRA Rule 2830. The rules also do not alter or affect the ability of a nonbank registered investment adviser to receive 12b-1 fees under the federal securities laws or the rules of an SRO. The broker exceptions for banks in Exchange Act Section 3(a)(4)(B), including the trust and fiduciary exception, are not available to nonbank entities such as nonbank investment advisers.

Rule 721 provides additional examples of the types of fees that qualify as relationship compensation under the statute and the rules. Examples of an administration fee include the compensation received by a bank: for disbursing funds from, or for recording payments to, a trust or fiduciary account; in connection with securities lending and borrowing transactions conducted for a trust or fiduciary account; and for custody services provided to a trust or fiduciary account (whether or not separately charged).

Because securities lending/borrowing fees and custody fees may be charged on an assets-under-management basis, the rule also provides that these fees are relationship compensation when charged in this manner. As with other types of relationship compensation, the fees that a bank receives for effecting securities lending/borrowing transactions for a trust or fiduciary account must be consistent with applicable fiduciary principles.

In addition, the SEC and Fed have included as an example of an annual fee, an annual fee paid for assessing the investment performance of a trust or fiduciary account or for reviewing such an account's compliance with applicable investment guidelines or restrictions. An example of an assets under management fee would be a fee based on the financial performance, such as capital gains or capital appreciation, of trust or fiduciary assets under management.

The regulators believe that the characterization of these fees comports with the manner in which banks generally receive compensation for these services. Several commenters

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noted that banks currently may receive 12b-1 fees, service fees or sub-transfer agent and related fees either directly from a mutual fund or from the fund's distributor, transfer agent, administrator or adviser. In light of these comments, the SEC and Fed eliminated the language in the proposed rules that required that these types of fees be paid by an investment company.

The examples of an administration fee, annual fee and an asset under management fee included in Rule 721(b) are provided only for illustrative purposes. Other types of fees or fees for other types of services could be an administration fee, annual fee or an asset under management fee. In addition, an administration fee, annual fee or assets under management fee attributable to a trust or fiduciary account or a bank's trust or fiduciary business is considered relationship compensation regardless of what entity or person pays the fee, and regardless of whether the fee is related to only securities assets, to a combination of securities and non-securities assets, or to only non-securities assets. These fees are part of the compensation for acting as a trustee or fiduciary.

Some commenters asserted that a bank should be permitted to include within its relationship compensation any per-transaction securities processing fee it charges as a directed trustee or in another fiduciary capacity even if the fee exceeds the bank's costs in processing the transaction. The statute, however, expressly provides that a per-order securities processing fee may be counted towards the statute's chiefly compensated requirement only if the fee is equal to not more than the cost incurred by the bank in connection with executing securities transactions for its trust or fiduciary customers. For this reason, the rules were not modified in the manner requested.

However, the custody exemption is Rule 760 does permit banks that accept securities orders as a directed trustee to do so under that exemption in lieu of the trust and fiduciary exception. In addition, a per order processing fee included in relationship compensation may include the fee charged by the executing broker-dealer as well as any additional fixed or variable costs incurred by the bank in processing the transaction. If a bank includes any such additional fixed or variable costs in the per order processing fees it includes in its relationship compensation, the bank should maintain appropriate policies and procedures governing the allocation of these costs to the orders processed for trust or fiduciary customers. This should help ensure that profits derived from per trade charges are not masked as costs of processing the trades and thereby included in relationship compensation.

Excluded Compensation

If more than one broker exception or exemption is available for a securities transaction effected by a bank for a customer, the bank may choose the exception or exemption on which it relies in effecting the transaction. Rules 721 and 722 explicitly provide that, if a bank effects a securities transaction for a trust or fiduciary customer in accordance with the terms of an exception or exemption other than Rule 721 or Rule 722, the bank may, at its election, exclude the revenues associated with those transactions from the applicable relationship-total compensation calculation in Rule 721 or Rule 722.

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As the rules provide, if a bank elects to exclude the revenues associated with transactions conducted under another exception or exemption, the bank must exclude such revenue from both the bank's relationship compensation and total compensation. Of course, the bank also must comply with the conditions applicable to the other available exception or exemption on which the bank chooses to rely.

Some commenters asserted that a bank should be allowed to include in its relationship compensation all of the revenue from securities transactions conducted for a trust or fiduciary account under another exception or exemption, regardless of whether that revenue otherwise qualifies as relationship compensation. But the SEC and Fed rejected this contention as inconsistent with the terms of the trust and fiduciary exception, which sets forth the types of fees that are included in relationship compensation.

In addition, compensation that is not derived from the provision of trust or fiduciary services should not be included in a bank's relationship or total compensation under either the account-by-account or bank-wide alternative. Such compensation includes, for example, revenue earned by a trust or fiduciary department from providing back-office services to an affiliated or unaffiliated party, On the other hand, the revenue derived from providing fiduciary services to investment companies or companies affiliated with the bank should be included in the relevant chiefly compensated calculation.

Such compensation also includes revenue from the sale of an office or assets of the trust department, or from the provision on a stand-alone basis of other services (such as custody services or the sale of portfolio management software to a third party that independently operates and uses the software in connection with its own business) that do not involve trust or fiduciary services. Further, such compensation also includes internal payments or credits allocated to a bank's trust or fiduciary department or unit from another department or unit of the bank for deposits and other similar services not involving a security. Credits received by a bank from a broker-dealer for brokerage and research services provided by a broker-dealer in accordance with the soft dollar safe harbor in Exchange Act Section 28(e) should also be excluded from the compensation tests.

The SEC and Fed do not believe these credits constitute compensation to the bank for purposes of the exception and rules because these credits must be reasonable in relation to the value of the brokerage and research provided by the broker-dealer in connection with the bank's exercise of investment discretion for its fiduciary accounts.

Trust or Fiduciary Accounts

The rules define a trust or fiduciary account as an account for which the bank acts in a trustee or fiduciary capacity as that term is defined in Exchange Act Section 3(a)(4)(D). This definition is based on the definition of fiduciary capacity in part 9 of the OCC's regulations, which relates to the trust and fiduciary activities of national banks, in effect at the time of enactment of the GLB Act.

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Section 3(a)(4)(D) identifies a number of particular situations where a bank serves in a fiduciary capacity, providing that a bank acts in a fiduciary capacity if, among other situations, the bank has investment discretion on behalf of another. Thus, for example, if a bank has investment discretion over an escrow account on behalf of another, the bank would be acting in a fiduciary capacity with respect to the account. The definition also provides that a bank acts in a fiduciary capacity if it acts in any other similar capacity to those specifically identified. Thus, the scope of the term fiduciary capacity is not fixed in time.

The SEC and Fed recognize that different nomenclature may be used to identify a fiduciary capacity in the relevant governing documents or state laws. For example, the Uniform Probate Code uses the term “personal representative” and similar successor titles in place of the terms “executor” or “administrator” to identify the representative of a decedent.

The trust and fiduciary exception does not require that a bank effecting securities transactions for a customer in a trust or fiduciary capacity do so through a separate trust department or have obtained formal trust powers from its appropriate federal banking agency. However, securities transactions conducted for a trust or fiduciary customer under the exception must be effected in a department of the bank that is regularly examined for compliance with fiduciary principles and standards by the bank’s appropriate federal or state banking supervisor.

A bank effecting transactions for trust or fiduciary customers through a department examined for compliance with trust or fiduciary principles may use other divisions or departments of the bank, or other affiliated or unaffiliated third parties, to handle aspects of these transactions. The bank must continue to act in a trustee or fiduciary capacity with respect to the account and, accordingly, should exercise appropriate diligence in selecting persons to provide services to the bank’s trust or fiduciary customers and in overseeing the services provided in accordance with the bank’s fiduciary obligations.

No party working in conjunction with the bank may rely on the bank’s exception or exemption from broker status. To the extent that any such third party performs activities that would make that entity a broker under Exchange Act Section 3(a)(4), that entity would have to register as a broker notwithstanding any written or unwritten agreement the third party may have with the bank.

The SEC and Fed will rely on the appropriate federal banking agency to determine whether the bank’s activities are conducted in the bank’s trust department or other department regularly examined by examiners for compliance with fiduciary principles.

Other Exemptions

Rule 723(a) permits a bank that uses either the account-by-account or bank-wide compensation test to exclude any trust or fiduciary account that was open for a period of less than 3 months during the relevant year. Rule 723(b) permits a bank to exclude, for purposes of determining its compliance with either compensation test, any trust fiduciary

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account that the bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar transaction by the bank for 12 months after the date the bank acquired the account from the other person.

A bank that elects to use Rule 723(a) or (b) for one or more accounts must exclude both the relationship compensation and total compensation attributable to those accounts for purposes of the applicable compensation test.

Rule 723(c) provides a new exemption under which a bank using the bank-wide approach may exclude for purposes of the chiefly compensated test the trust or fiduciary accounts held at a non-shell foreign branch of the bank, provided that the bank has reasonable cause to believe that the trust or fiduciary accounts of the foreign branch held for the benefit of a U.S. person constitute less than 10 percent of the total trust or fiduciary accounts of the foreign branch. It is expected that few, if any banks, that use the account-by-account approach to the chiefly compensated test will have foreign branches engaged in trust or fiduciary services. Thus, the exemption is limited to banks that use the bank-wide approach.

The rules provides that a bank will be deemed to have reasonable cause to believe that less than 10 percent of the total number of trust or fiduciary accounts of the foreign branch are held by or for the benefit of a U.S. person if the principal mailing address for the accountholder and beneficiary of the account is not in the United States, or the records of the foreign branch indicate that the accountholder and beneficiary of the account is not a U.S. person.

The rule defines a "non-shell foreign branch" of a bank to mean a branch of the bank that is located outside the United States and provides banking services to residents of the foreign jurisdiction in which the branch is located, and for which the decisions relating to day-to-day operations and business of the branch are not made by an office of the bank located in the United States. This definition is designed to exclude branches that are established in certain offshore jurisdictions primarily to provide services to U.S. customers and, for this reason, are managed on a day-to-day basis from the United States.

This exemption provides appropriate relief to banks with respect to foreign branches where the records of the bank indicate that it is not significantly engaged in providing trust or fiduciary services to U.S. customers.

Rule 723(e) permits a bank using the account-by-account approach to exclude, for purposes of the chiefly compensated test, the lesser of (1) 1 percent of the total number of trust or fiduciary accounts held by the bank; or (2) 500 accounts. Under the rule, if a bank has less than 100 trust or fiduciary accounts in the aggregate, the bank may exclude 1 account under the exemption in any given year. But to rely on this exemption with respect to an account, the bank must not have relied on this exemption for such account during the immediately preceding year. In addition, the bank must maintain records demonstrating that the securities transactions conducted by or on behalf of the excluded account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.

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These exclusions reduce administrative burdens and facilitate compliance. A bank, consistent with its fiduciary duties, may need to conduct a higher level of securities transactions for a trust or fiduciary account at certain times, such as shortly after the account is established or acquired from another person or shortly before the account is closed. For example, after a trust or fiduciary account is acquired or established, the bank may need to conduct a number of securities transactions to invest or rebalance the account's holdings in accordance with the terms of the agreement establishing the account or, in cases where the bank has investment discretion, to implement the bank's investment strategy for the account.

The exclusions in Rule 723(a), (b) and (d) are designed to help prevent such short-term fluctuations in the amount of securities transactions conducted for a trust or fiduciary account from distorting, or causing a bank to fail, the relevant compensation test. At the same time, these exclusions promote compliance by requiring that the bank bring the relevant accounts into compliance within a short and prescribed period of time. For this reason, the SEC and Fed do not believe it would be appropriate to expand Rule 723(d) to allow a bank to exclude an account from the chiefly compensated test in consecutive years as requested by some commenters.

Some commenters also asked that the 500 account maximum in Rule 723(d) be raised to avoid discriminating against large banks. The SEC and Fed expect that most banks that have more than 50,000 trust and fiduciary accounts, and thus would be subject to the 500 account cap in Rule 723(d), will operate under the bank-wide test and for this reason have not made the requested change.

Rule 723(c) also provides that a bank that uses the account-by-account approach will not be considered a broker for purposes of Exchange Act Section 3(a)(4) solely because a particular trust or fiduciary account does not meet the chiefly compensated test if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a registered broker-dealer or another unaffiliated entity (such as an unaffiliated bank) that is not required to be registered as a broker-dealer.

Advertising Restrictions

The rules provide that a bank complies with the advertising restriction applicable under either Rule 721 or 722 if advertisements by or on behalf of the bank do not advertise that the bank provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services, and do not advertise the securities brokerage services provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.

An advertisement for these purposes means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or

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billboards, motion pictures, blast e-mail, or telephone directories (other than routine listings).

Other types of material or information that is not distributed through public media, such as mailings or e-mails to a bank's own customers, are not considered an advertisement. In addition, in considering whether an advertisement advertises the securities brokerage services provided to trust or fiduciary customers more prominently than the bank's other trust or fiduciary services, the nature, context and prominence of the information presented, and not simply the length of text or information devoted to a particular subject, should be considered.

Sweep Accounts and Money Market Fund Transactions

Exchange Act Section 3(a)(4)(B)(v) (popularly known as the sweep exception) excepts a bank from the definition of broker to the extent it effects transactions as part of a program for the investment or re-investment of deposit funds into no-load money market funds. The rules define a "money market fund" for purposes of the sweep exception to mean an open-end investment company registered under the Investment Company Act that is regulated as a money market fund pursuant to Rule 2a-7.

In addition, consistent with FINRA rules, the rules provides that a class or series of securities of an investment company will be considered no-load if: (1) the class or series is not subject to a sales charge or a deferred sales charge; and (2) total charges against net assets of the class or series of securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts do not exceed 0.0025 of average net assets annually.

Consistent with FINRA Rule 2830, charges for the following are not be considered charges against net assets of a class or series of an investment company's securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts: (1) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares; (2) Aggregating and processing purchase and redemption orders for investment company shares; (3) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company; (4) Processing dividend payments for the investment company; (5) Providing sub-accounting services to the investment company for shares held beneficially; (6) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or (7) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

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Thus, a bank may effect transactions under the sweep exception and Rule 740 as part of a program to sweep deposit funds of, or collected by, another bank into a no-load money market fund in accordance with the exception and the Rule.

Exemption Regarding Money Market Fund Transactions

Rule 741 permits banks, without registering as a broker, to effect transactions on behalf of a customer in securities issued by a money market fund. To qualify for this exemption, the bank must provide the customer some other product or service, the provision of which would not, in and of itself, require the bank to register as a broker-dealer under Exchange Act Section 15(a).

Examples of other products or services that may be a qualifying "other" product or service include an escrow, trust, fiduciary or custody account, a deposit account or a loan or other extension of credit. The rule also permits a bank to effect transactions under the exemption on behalf of another bank as part of a program for the investment or reinvestment of the deposit funds of, or collected by, the other bank. This is designed to allow banks to provide sweep services to other banks under the exemption, as they may do under the sweep exception itself.

The final exemption continues to allow banks to effect transactions only in securities of a registered money market fund. In addition, the rule continues to provide that, if the class or series of money market fund securities is not no-load (as defined in Rule 740), the bank may not characterize or refer to the class or series of securities as no-load and the bank must provide the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities.

If a bank relies on the exemption to sweep the deposits of another bank into a money market fund that is not no-load, then neither the deposit-holding bank nor the sweeping bank may characterize the fund as a no-load fund, and either the deposit-taking bank or the sweeping bank must provide the customer with a prospectus for the fund within the time prescribed by the rule.

Despite some requests to eliminate it, the prospectus-delivery requirement was retained to ensure that a customer receives notice that its funds are to be invested in a fund that is not no-load before the customer authorizes the transaction. If a customer's funds are invested in a no-load fund and the bank is authorized, under the terms of its agreement with the customer, to alter the specific fund into which the customer's balances are invested, the bank should provide the customer a prospectus for any money market fund that is not a no-load fund prior to the date on which the bank first invests the customer's balances in the fund.

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Safekeeping and Custody

Exchange Act Section 3(a)(4)(B)(viii) provides banks with an exception from the broker definition for certain bank custody and safekeeping activities. This custody and safekeeping exception allows a bank to perform the following activities as part of its customary banking activities without registering as a broker:

- Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;
- Facilitating the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities;
- Effecting securities lending or borrowing transactions with or on behalf of customers as part of the above described custodial services or investing cash collateral pledged in connection with such transactions;
- Holding securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; and serving as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.

Custody Exemption

Rule 760 allows banks to continue to accept securities orders in a custodial capacity and permits bank customers to take advantage of those order-taking services subject to important conditions designed to limit the scope of the activity and provide appropriate investor protections.

Rule 760 and the other final rules do not implement the statutory custody and safekeeping exception. A bank need not rely on the custody exemption in Rule 760 to the extent the bank conducts other custodial activities permitted by Section 3(a)(4)(B)(viii)(I)(aa)-(ee) (for example, exercising warrants or other rights with respect to securities or effecting securities lending or borrowing transactions on behalf of custodial customers) or another of the final rules (Rule 772, which permits banks to effect securities lending or borrowing transactions on behalf of certain non-custodial customers).

In addition, a bank would not have to rely on Rule 760 to the extent the bank holds securities in custody for a customer and provides clearance and settlement services to the account in connection with such securities, but the bank does not accept orders for

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securities transactions for the account or engage in other activities with respect to the account that would require the bank to be registered as a broker.

With regard to the scope and terms of the custody exemption, Rule 760 provides that a bank will not be considered a broker to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities in an employee benefit plan account or an individual retirement account or similar account for which the bank acts as a custodian.

A bank relying on the employee benefit plan and individual retirement and similar account provisions must comply with the advertising and sales literature limitations in paragraphs (a)(2) and (3), the employee compensation limitations in paragraph (c), and the other conditions in the paragraph (d) of the rule.

The provisions in Rule 760(a) for employee benefit plan accounts and individual retirement and similar accounts are designed to reflect the extent and manner in which banks provide order-taking services for these types of accounts. In addition, these provisions take account of the special mention of these accounts in the custody and safekeeping exception and the additional protections to which these accounts typically are subject under the ERISA and the Internal Revenue Code. For these reasons, the rule was not expanded to cover accounts other than employee benefit plan accounts and individual retirement and other similar accounts.

Banks may, however, continue to accept orders from other types of accounts for which the bank acts as a custodian under the accommodation provisions of the rule

Employee compensation restrictions

The employee compensation restrictions in Rule 760(c) apply when a bank, acting in a custodial capacity, accepts a securities order for an employee benefit plan account or an individual retirement account under paragraph (a) of the rule, and when a bank accepts a securities order for another type of custodial account under paragraph (b) of the rule.

Under these restrictions, if a bank accepts securities orders pursuant to Rule 760, then no employee of the bank may receive compensation (including a fee paid pursuant to a 12b-1 plan) from the bank, the executing broker-dealer, or any other person that is based on: (1) whether a securities transaction is executed for the account; or (2) the quantity, price, or identity of the securities purchased or sold by the account. These restrictions are designed to be consistent with banking practices and reduce the financial incentives a bank employee might have to encourage a customer to submit securities orders to the bank and use a custody account as the functional equivalent of a securities brokerage account.

The employee compensation restrictions in Rule 760(c) do not prohibit a bank employee from receiving compensation that is based on whether a customer establishes a custodial account with the bank, or that is based on the total amount of assets in a custodial account at account opening or at any other time. Moreover the rule expressly provides that the

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employee compensation restrictions do not prevent a bank employee from receiving payments under a bonus or similar plan that are permissible under the exception in Rule 700(b)(1) as if a referral had been made by the bank employee, or from receiving any compensation described in Rule 700(b)(2) of the networking rules.

Because the employee compensation restrictions relate to securities transactions conducted in the relevant custody account, they would not prevent a bank employee from receiving a referral fee for referring the customer to a broker- dealer to engage in securities transactions at the broker-dealer that are unrelated to the custody account in accordance with the networking exception or the institutional customer and high net worth customer exemption for networking arrangements.

Thus, for example, the rule does prohibit a bank from directly passing on to an employee a portion or percentage of the 12b-1 fees received by the bank from a custody account's investment in a mutual fund, or a portion of a fee that is charged only when, or that varies based on whether, a securities transaction is executed for the account. A bank employee may receive payments under a bonus or similar plan rule that includes within its allocation pool the revenues generated by one or more custodial accounts if the plan meets the criteria for a discretionary, multi-factor bonus program in Rule 700(b)(1), or the bonus program is based on the overall profitability or revenues of the bank, an affiliate, or operating unit and the program complies with the requirements of the safe harbor in Rule 700(b)(2). If a bank's compensation practices are inconsistent with these limitations, the bank may not rely on the exemption to take securities orders in a custodial capacity

Advertisements and sales literature

Rule 760(a)(2) provides that a bank relying on the exemption may not advertise that it accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts for which the bank acts as custodian, except as part of advertising the other custodial or safekeeping services the bank provides to these accounts.

Rule 760(h)(2) defines an "advertisement" to mean material that is published or used in any electronic or other public media, including any Web site, 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). The bank also cannot advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account.

Moreover, advertisements and sales literature for individual retirement or similar accounts that are issued by or on behalf of the bank may not describe the securities order-taking services provided by the bank to these accounts more prominently than the other aspects of the custody or safekeeping services the bank provides safekeeping and custody services substitute for a securities brokerage account.

The advertising and sales literature restrictions are designed to help prevent a bank from operating a brokerage business out of its custody department and, for this reason, apply to

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all advertisements and sales literature issued by or on behalf of a bank, whether or not a broker-dealer has some compliance responsibility with respect to the advertisement or sales literature. These limitations would not, however, apply to the advertisements or sales literature that a registered broker-dealer may make to inform the public or others about the availability of its brokerage services.

Accommodation for Other Types of Accounts

The rules permit a bank to accept securities orders for other types of custodial accounts only as an accommodation to the customer. The SEC and Fed rejected the idea that they define accommodation. Rather, the bank regulators will develop guidance to assist examiners in reviewing, as part of ongoing risk-focused examination process, the order-taking services provided to these custodial accounts. The guidance will describe the types of procedures a bank should have in place to help ensure that it accepts securities orders for these custodial accounts only as an accommodation to the customer and in a manner consistent with the custody exemption.

As part of these reviews, bank examiners also will consider the form and substance of the relevant accounts, transactions, and activities to prevent evasions of the requirements of the rule. The SEC and Fed believe this approach is appropriate given the disparity in the types, characteristics and uses of other custody accounts, the size and operations of banks that provide these services and the manner in which they do so.

Limitations on bank fees

The rules prohibit a bank that accepts accommodation orders for a custody account from charging or receiving any fee that varies based on whether the bank accepted the order for the transaction or the quantity or price of the securities to be bought or sold. These restrictions do not prevent a bank from charging or receiving a fee that is based on the type of security purchased or sold by the account.

Advertising restrictions

The bank's advertisements may not state that it accepts orders for securities transactions for a custodial account (other than an employee benefit plan or individual retirement account). In addition, the bank's sales literature may state that the bank accepts securities orders for such an account only as part of describing the other custodial or safekeeping services the bank provides to the account, and may not describe the securities order-taking services provided to such an account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account. These restrictions effectuate the purposes of the exemption and are tailored to comply with the customary practices of banks and minimize potential disruptions.

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Investment advice

The rules impose certain restrictions on the ability of a bank to provide investment advice or research concerning securities to an account for which it accepts accommodations orders, make recommendations concerning securities to the account, or otherwise solicits securities transactions from the account.

But the prohibitions do not prevent a bank from cross-marketing its trust, fiduciary or other services to its custody customers. A bank's marketing to custody account customers may include non-account specific information provided in media such as newsletters and websites. In addition, the advice, research, recommendation and solicitation prohibition does not prohibit a bank from providing samples of research, including stock-specific research, to custody customers that the bank provides to other persons for marketing purposes. Thus, banks will continue to be able to cross-market their products and services to their custody customers.

A custody account, however, is not a fiduciary account, and a bank operating under Rule 760(b) with respect to a custodial account may not provide such samples in such a way or with such a frequency as to provide the custody account securities services that only are permissible for a trust or fiduciary customer. The bank, moreover, may not provide personalized investment advice, research or recommendations regarding particular securities to the custodial account for any reason. This would include providing such personalized advice in an effort to convert the account to another type of account, for goodwill or to obtain referrals.

Banks may use menus or other lists to make custodial customers aware of the securities available to them through the custodial account. For example, the restrictions in the rule do not prevent a bank from providing its customers with an online menu of the mutual funds that the customer is able to purchase through the custody account.

The limitations and restrictions in Rule 760(b), including those relating to investment advice and recommendations, relate only to those custodial accounts for which the bank accepts securities orders on an accommodation basis. Thus, for example, these limitations would not apply to an employee benefit plan account or an individual retirement account or a trust or fiduciary account maintained by a customer with a bank even if that customer also maintains a custodial account with the bank.

Rule 760(b)(6) prohibits banks from providing investment advice, research or recommendations concerning securities to, or soliciting securities transactions from, a custody account for which the bank accepts orders under the accommodation trade authority. The rule does not limit the types of research or other services a bank may provide to a customer's trust or fiduciary account. The agencies recognize that a bank may have no control over which account the customer uses to place any orders that result from such research or other services.

The rules provide that, in order to prevent evasions of the custody exemption, the SEC and Fed will consider both the form and substance of the relevant account, transaction,

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and activities (including advertising activities) in considering whether a bank meets the terms of the exemption. For example, they will consider the content, format and frequency of any investment research provided to an accommodation custodial account in considering if such research evades the restrictions in the rule or provides a custody account securities services that only are permissible for a trust or fiduciary customer. Similarly, a bank may not evade the rule's restrictions by providing an accommodation customer that has both a custody account and a trust or fiduciary account with investment advice, recommendations or research that is targeted to the securities held in the customer's custody account. For example, if a customer's custody account has a large position in a particular security and that security is not held in the customer's trust or fiduciary account, a bank may not routinely provide the customer with research focused on that security.

Banks should have and maintain policies and procedures to abide by these limitations and bank examiners will review compliance with these limits in accordance with the risk-based supervisory and examination process, considering both the form and substance of the cross-marketing activities in applying the anti-evasion provisions of the rule.

The restrictions in Rule 760(b)(6) do not prohibit the bank from advertising its custodial services and disseminating sales literature that meets the conditions in the exemption. These restrictions also will not prevent a bank employee from responding to customer inquiries regarding the bank's safekeeping and custody services by providing advertisements or sales literature describing the safekeeping, custody and related services the bank offers, a prospectus prepared by a registered investment company, sales literature prepared by a registered investment company or by the broker-dealer that is the principal underwriter of the registered investment company pertaining to the registered investment company's products, or information based on any of those materials.

The exemption allows a bank's employees to respond to customer inquiries concerning the bank's safekeeping, custodial or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.

Other Conditions Applicable to Order-Taking for All Custody Accounts

The rules provide that a bank that acts as a directed trustee for an account may rely on the custody exception to accept orders for, and effect transactions in, securities for the account. Alternatively, the bank may continue to effect transactions for the account under the rules relating to trust or fiduciary accounts.

If a bank acting as directed trustee relies on the rule to effect transactions for an employee benefit plan account or an individual retirement account, the bank must comply with the conditions in Rule 760(a). If a bank acting as directed trustee relies on the rule to effect transactions for another type of account, the bank must comply with the conditions

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governing accommodation accounts in Rule 760(b). The rule defines a directed trustee as a trustee that does not exercise investment discretion with respect to the account.

Broker execution requirement

Consistent with the requirements of the custody and safekeeping exception, Rule 760(d)(2) requires a bank that accepts orders for a custody account under the rule to comply with Exchange Act Section 3(a)(4)(C) in handling any order for a securities transaction for the account. Under this provision, (i) the bank must direct the trade to a registered broker-dealer for execution, or (ii) the trade must be a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary and is not in contravention of fiduciary principles; or (iii) the trade must be conducted in some other manner permitted under SEC rules.

Carrying broker provisions

Section 3(a)(4)(B)(viii)(II) of the Exchange Act provides that a bank relying on the custody exception may not act as a carrying broker. The Commission's financial responsibility and customer protection rules expand on what it means to carry customer securities. In general, broker-dealers establish carrying arrangements in which other broker-dealers carry their accounts to permit the non-carrying broker-dealer to be subject to lesser financial responsibility requirements under the Exchange Act. A broker-dealer entering into such an agreement with a carrying entity that is not a registered broker-dealer, however, may not take advantage of those lesser requirements.

The agencies have retained this limitation as a condition of the custody exemption without change as it is a term of the statutory custody exception. Banks may look to certain key factors to help distinguish permissible custodial activity from impermissible carrying broker activity. In particular, key factors in considering whether the existence of shared customers between a broker-dealer and a bank may entail impermissible carrying broker activity by the bank are 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 (or one or more broad segments of the broker-dealer's customers) to use the bank's custody accounts instead of maintaining funds and securities in accounts at the broker-dealer, thereby avoiding the broker-dealer's financial and related responsibilities.

The existence of a substantial number of common customers between a broker-dealer and a bank's custody department in the absence of such an arrangement or structure would not cause the bank to act as a carrying broker for the broker-dealer. Similarly, a bank may perform or share systems that perform limited back-office functions on behalf of a broker-dealer without becoming a carrying broker for the broker-dealer.

A broker-dealer, for example, may contract with an unregistered party such as 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-

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dealer remaining responsible for the accuracy and completeness of those confirmations and the broker-dealer aspects of the statements. A bank and an affiliated broker-dealer also may share or coordinate risk management systems such as, for example, those relating to Bank Secrecy Act and anti-money laundering compliance.

Other examples of current permissible coordination arrangements between banks and broker-dealers include legal and compliance functions, accounting and finance functions (such as payroll and expense account reporting), information technology, operations functions (such as disaster recovery services), and administration functions (such as human resources and internal audits). See NASD Notice to Members 05-48 (July 2005).

A broker-dealer, however, may not delegate core functions to a bank or other unregistered entity or functions that would require an individual to pass a qualification examination or register with an SRO. NASD Notice to Members 05-48 (July 2005), “Outsourcing,” provides guidance to member firms regarding the outsourcing activities and functions that, if performed directly by members, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to NASD Rule 3010. 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. This is true even if the broker-dealer is not completely dependent on the bank for all back office functions and execution.

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.

Custodians, Sub-custodians and Administrators/Recordkeepers

As a general matter, the exemption in Rule 760 is available only for an account for which the bank acts as a custodian. The rules define this term to mean an account that is an employee benefit plan account for which the bank acts as a custodian; an individual retirement account or similar account for which the bank acts as a custodian; an account established by a written agreement between the bank and the customer that sets forth the terms that will govern the fees payable to, and rights and obligations of, the bank regarding the safekeeping or custody of securities, or an account for which a bank acts as a directed trustee.

Whether a bank serves as custodian for the securities or other assets of an account depends on the services the bank provides to the account with respect to such securities or assets, not the label used to identify the account or the bank’s services in the agreement between the bank and the customer. Thus, for example, a bank that acts as an escrow agent, fiscal agent or paying agent with respect to an account, and that provides safekeeping or custody services for the securities or other assets in the account, is considered to be a custodian for the account for purpose of the rule regardless of whether the account agreement uses the term “custodian” or any other particular language

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Administrators/recordkeepers and sub-custodians

Rule 760(e) permits a bank that acts as a non-fiduciary and non-custodial administrator or record keeper for an employee benefit plan for which another bank acts as a custodian to accept orders for the account under Rule 760. In addition, the rule permits a bank that acts as a subcustodian for any type of account for which another bank acts as custodian to accept orders for the account under Rule 760. Under these provisions, the administrator/record keeper bank or subcustodian bank, as well as the initial custodian bank for the account, must comply with the provisions of Rule 760 applicable to the type of account involved (i.e. employee benefit plan account, individual retirement account or other types of accounts).

The rule generally prohibits a record keeper/administrator bank or subcustodian bank relying on the exemption from executing a cross-trade or netting orders with or for the relevant account. However, the agencies expanded the exceptions to this general prohibition in light of the comments received. In particular, the rule permits the administrator/record keeper bank or subcustodian bank to cross or net orders for shares of open-end investment companies not traded on an exchange. In addition, the rule permits the administrator/record keeper bank or subcustodian bank to cross orders between or net orders for accounts of the custodian bank that contracted with the administrator/record keeper bank or subcustodian bank for services.

Permitting this additional type of cross-trade and netting activity is consistent with the exceptions to broker execution requirement in Exchange Act Section 3(a)(4)(C) and should allow cost-savings for the customer by eliminating the need for a broker intermediary. At the same time, by prohibiting an administrator/record keeper bank or subcustodian bank operating under the rule from executing cross-trades or netting orders among the accounts of different custodian banks to which it provides services will help prevent banks from establishing a market for securities under the exemption.

These provisions do not apply to a bank that provides custody and order-taking services to the trust or fiduciary accounts of another bank. In these circumstances, the bank providing custodial services is treated as a custodian, and not a subcustodian, for purposes of the rule and may provide order-taking services to the account in accordance with the provisions of Rule 760(a) or (b) applicable to the type of account involved.

Regulation S Transactions

SEC Regulation S provides that offers and sales of securities conducted in accordance with the terms of the regulation will be not be deemed to constitute an offer, offer to sell, sale or offer to buy within the United States for purposes of the securities registration requirements of Section 5 of the Securities Act. Specifically, Rule 903 of Regulation S provides that an offer or sale of securities by the issuer, a distributor, or an affiliate or a person acting on their behalf shall be deemed to occur outside the U.S. within the

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meaning of Rule 901 if the offer or sale is made in an offshore transaction, and no directed selling efforts are made in the U.S. by the issuer, a distributor, affiliate, or person acting on their behalf. Other conditions may also apply depending on the place of incorporation and reporting status of the issuer, and the amount of U.S. market interest in the securities.

Rule 771 of Regulation R exempts banks from the definition of broker under the Exchange Act for certain agency transactions involving Regulation S securities. As with Rule 3a5-2 under the Exchange Act, which the Commission separately is adopting to permit banks to engage in certain Regulation S transactions on a riskless principal basis without being dealers, Rule 771 recognizes that non-U.S. persons located outside the United States generally will not rely on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks, and that those persons may purchase the same securities from foreign banks located outside the U.S. without subjecting the foreign bank to U.S. broker-dealer registration.

The final rule has three parts. The first part permits a bank to effect a sale of an eligible security in compliance with the requirements of Rule 903 of Regulation S to a purchaser 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) of Regulation S, 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, the bank (1) 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 of Regulation S, and (2) if the resale is made prior to any applicable distribution compliance period specified in Rules 903(b)(2) or (b)(3) of Regulation S, the resale must be made in compliance with the requirements of Rule 904 of Regulation S.

The third part of the exemption 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 of Regulation S and, if the resale is made prior to the expiration of any applicable distribution compliance period in Rules 903(b)(2) or (b)(3) of Regulation S, the bank must effect the resale in compliance with the requirements of Rule 904 of Regulation S.

Non-Custodial Securities Lending Transactions

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

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not have custody of the securities or has custody of such securities for less than the entire period of the transaction

The exemption enables 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 currently provide without disruption. Note that 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.

Rule 772 provides that a bank is exempt from the broker definition to the extent that, as agent, it engages in or effects certain securities lending transactions and securities lending services 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: (1) a qualified investor as defined in Exchange Act Section 3(a)(54)(A); or (2) any employee benefit plan that owns and invests, on a discretionary basis, not less than $25 million in investments.

Transactions in Fund Securities and Variable Insurance Products

Rule 775 allows banks to take advantage of certain exceptions and exemptions to the broker definition for transactions involving mutual funds, variable annuity contracts and variable life insurance policies without having to comply with the broker-execution requirement of Exchange Act Section 3(a)(4)(C)(i).

The rule permits banks to effect transactions in open-end mutual funds through the National Securities Clearing Corporation ("NSCC") or the fund's transfer agent, rather than through a broker-dealer. The rule also covers transactions involving variable annuities and variable life insurance policies, as well as transactions involving mutual funds. Applying the exemption to transactions in variable insurance products, as well as to transactions involving mutual funds, will avoid needless disruptions and costs with respect to banks' transactions with customers in which interposing an executing broker-dealer would be inefficient, inconsistent with market practice and unnecessary for investor protection.

To take advantage of the exemption, the security must not be traded on a national securities exchange or traded through the facilities of a national securities association or an interdealer quotation system. In addition, the securities must be distributed by a registered broker-dealer, or the sales charge must be no more than the amount permissible for a security sold by a registered broker-dealer pursuant to any applicable rules of a registered securities association.

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FINRA currently is the only registered securities association. FINRA Rule 2830 limits the sales charges associated with open-end mutual funds. Currently, there are no FINRA rules limiting the sales charges associated with the insurance securities subject to Rule 775. Therefore currently, in all cases, these insurance securities would satisfy the condition under Rule 775(a)(2) that the sales charge be no more than the amount permissible under applicable registered securities association rules.

Finally, the transaction must be effected through the NSCC, or directly with a transfer agent or with an insurance company or a separate account that is excluded from the definition of transfer agent in Exchange Act Section 3(a)(25).

Transactions Involving Company's Securities for its Employee Benefit Plans

In response to concerns, the SEC and Fed adopted an additional exemption in Rule 776 to permit banks that rely on certain exceptions and exemptions to effect certain transactions involving the securities of a company for the company's employee benefit plans and participants without complying with the broker-execution requirements of the Exchange Act.

Rule 776 permits a bank utilizing particular exceptions and exemptions to effect a transaction in the securities of a company to do so directly with a transfer agent acting for the company, subject to conditions, including that no commission may be charged with respect to the transaction and the transaction must be conducted solely for the benefit of an employee benefit plan.

The rule was adopted because requiring banks to send these types of transactions to a broker-dealer for execution at times would preclude plans from engaging in these transactions, would disrupt existing practices and otherwise would introduce cost and complexity to those transactions without materially promoting functional regulation and investor protection.

The same bank typically is the trustee or custodian for the different plans in such transactions and conducts such transactions through cross-trades within the bank. Accordingly, no additional exemption is required for these transactions.

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