FDIC Trust Examination Manual-Reg R

F.1.a.1. Regulation R

Regulation R details the requirements for a bank to qualify for a number of the GLBA exceptions and other administrative exemptions from the definition of "broker," including the trust & fiduciary exception; the custody and safekeeping exemption; the networking exception; and the sweep accounts exception. Other administrative exemptions provided in Regulation R include exemptions for transactions in Regulation S securities, non-custodial securities lending activities, referrals of high net worth/institutional clients under a third-party networking arrangement, as well as certain exemptions from the Exchange Act's Section 3(a)(4)(C)(i) trade execution requirements. These are discussed in greater detail below.

F.1.a.1.a. Trust & Fiduciary Exception

The Trust & Fiduciary exception allows a bank, in its capacity as trustee or fiduciary, to effect securities transactions for the accounts it administers if the following conditions are satisfied:

- Transactions are effected in the bank's trust department or other department that is regularly examined for compliance with fiduciary principles and standards;
- The bank does not publicly solicit brokerage business;
- The bank is "chiefly compensated" for its trust and fiduciary activities on the basis of:
  - An administrative or annual fee; or
  - A percentage of assets under management; or
  - A flat or capped per order processing fee equal to not more than the cost incurred; or
  - A combination of the above; and .
- Trades are effected in compliance with Exchange Act Section 3(a)(4)(C), which requires trades to be effected:
  - By a registered broker-dealer; or
  - Via 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 contrary to fiduciary principles; or
  - In some other manner that the SEC permits.

Fiduciary capacity, for the purposes of Regulation R, is defined by the Office of the Comptroller's Part 9. Fiduciary capacity includes acting as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minors act, or as an investment adviser if the bank receives a fee for its investment advice, or in any capacity in which the bank possesses investment discretion on behalf of another.

The prohibition on solicitation of brokerage business restricts the extent to which a bank can advertise that it effects securities transactions. In its advertisements, a bank may only indicate that it effects securities transactions in connection with its trust and fiduciary services. The fact that a bank effects securities transactions cannot be made more prominent that the material advertising the bank's provision of trust and fiduciary services.

F.1.a.1.a.1 Chiefly Compensated

Regulation R defines what it means to be "chiefly compensated" for trust and fiduciary services on the basis of an annual/administrative fee, a percentage of assets under management, a flat or capped per order processing fee equal to no more than the cost of executive, or a combination of these. Whether a bank satisfies the chiefly compensated requirement depends on the amount of "relationship" compensation in relation to total compensation. Thus, the ratio of relationship compensation, discussed below, to total compensation, either for each trust and fiduciary account or on a bank-wide basis, must equal or exceed a specific percentage. The chiefly compensation ratio calculation is discussed in more detail below.

Chiefly Compensated Test

The chiefly compensated test consists of calculating the ratio of relationship compensation to total compensation for the preceding year and the year preceding that year. The ratio for each year is expressed as a percentage and the percentages for the two years are averaged. Thus, whether a bank satisfies the chiefly compensated test is determined by calculating the moving average of the relationship compensation to total compensation percentages for the two immediately preceding years. Banks may use either a calendar or fiscal year as the basis for the yearly percentages to be calculated. The two year moving average must be computed within 60 days following the end of that year. Since the compliance period begins in the first fiscal year commencing after September 30, 2008, the first calculation of chiefly compensated test will occur by March, 2011, for banks using a calendar year. While the calculation is only required within the two months following the end of the year, banks are encouraged to monitor the percentage throughout the year in order to be able to identify and address any problems that might emerge.

Banks have two options regarding the basis on which the chiefly compensated test is calculated. The test may be determined on an account-by-account basis. Under the account-by-account methodology, the bank would determine the ratio of relationship compensation to total trust and fiduciary compensation attributable to each account for each trust and fiduciary account, except for those accounts that Regulation R requires or allows to be excluded from the test. The bank meets the chiefly compensated test if the chiefly compensated percentage for each account is greater than 50%.

The second option allows a bank to determine compliance with the chiefly compensated test on a bank-wide basis. Under the bank-wide methodology, the bank would calculate a single percentage for each year. The single percentage would include total relationship compensation from all trust and fiduciary accounts required to be included in the computation and the total compensation received by the bank in connection with its provision of trust and fiduciary services. Under this method, the bank satisfies the chiefly compensated test if the percentage is greater than or equal to 70%. Relationship and total compensation are addressed below.

Relationship Compensation

Relationship compensation is any compensation a bank receives that is attributable to a trust or fiduciary account, or to trust and fiduciary activities if calculated on a bank-wide basis, that consists of:

- Annual or administrative fees, including, but not limited to, fees:
  - For personal services, tax preparation, or real estate settlement services; or
  - For disbursing funds from, or for recording receipt of payments to, a trust or fiduciary account; or
  - In connection with securities lending or borrowing transactions; or
  - For custody fees.

  Administrative fees also include various fees in connection with investments in mutual funds. The fees do not have to be paid to the bank by the mutual fund, but can be paid by a third-party, such as the fund's distributor, transfer agent, administrator or an advisor to the fund. Such fees include:
- Fees for personal services;
- Fees for the maintenance of shareholder accounts;
- Fees based on a percentage of assets under management for the following services:
  - Transfer or sub-transfer agent services;
  - Aggregating and processing purchase and redemption orders;
  - Providing account statements to beneficial owners;
  - Processing dividend payments;
  - Providing sub-accounting services;
  - Forwarding communications to beneficial owners; and
  - Receiving, tabulating, and transmitting proxies.

  12b-1 fees are considered relationship compensation since they comprise fees that are based on a percentage of assets under management. The receipt of 12b-1 fees, like the receipt of all compensation related to securities transactions, must be consistent with the fiduciary principles and standards governing the bank's trust and fiduciary accounts.

  Finally, flat or capped per order processing fees that do not exceed the cost incurred in effecting securities transactions qualify as relationship compensation. These fees may include the fee charged by the executing broker-dealer and the addition of the fixed or variable cost incurred by the bank in effecting the transaction. Banks, however, may not include a profit margin to the cost charged to the customer and still have the fees qualify as relationship compensation. Banks, therefore, are expected to document any fixed or variable costs allocated to transactions in order to support that such allocations include only the actual cost incurred by the bank in effecting the transaction.

  It is important to note that relationship compensation is not limited to compensation received by the bank for securities-related transactions, but include all forms of compensation related to the administration of trust and fiduciary accounts, regardless of whether the amounts are paid by the trust or fiduciary account or by a third party.

Total Compensation

The ratio of relationship compensation to total compensation determines whether a bank satsifies the "chiefly compensated" requirement for the Trust & Fiduciary exception from the definition of broker in the Exchange Act. Total compensation encompasses all compensation attributable to a trust or fiduciary account or to the trust and fiduciary business of a bank if the determination is made on a bank-wide basis. However, as discussed below, some forms of compensation are specifically excluded by Regulation R. Total compensation does not include any revenues that

are not derived from the provision of trust or fiduciary services. Examples of compensation that should not be included as either relationship compensation or total compensation are:

- Providing bank-office services to third parties;
- The sale of an office or assets of the trust department;
- Internal credits, such as a credit for deposits of trust funds in the commercial bank; or
- "Soft Dollar" credits.

Excluded Compensation

Regulation R provides for the exclusion of various revenues from both relationship compensation and total compensation. Of particular importance is the exclusion of any compensation that is received in connection with a transaction for which the bank is relying on an exception or exemption other than the Trust & Fiduciary exception. For example, Regulation S provides an exemption for transactions in securities issued in an offshore transaction under SEC Regulation S. A bank purchasing Regulation S securities and relying on the Regulation S exemption could not include compensation from those transactions in calculating the "chiefly compensated" ratio.

Similarly, revenues derived from trust and fiduciary accounts held at a foreign branch are excluded if:

- Held at a non-shell foreign branch; and
- The bank has a reasonable cause to believe that the trust and fiduciary accounts of the foreign branch that are held by or for the benefit of U.S. persons constitute less than 10% of the foreign branch's trust and fiduciary accounts.

A non-shell foreign branch is one that is located outside the U.S.; provides services to residents of the foreign jurisdiction where it is located; and the day-to-day decision-making is not done by an office or branch in the U.S. A bank would have a reasonable cause to believe that an accountholder is not a U.S. person if the person's principal mailing address is outside the U.S. or the foreign branch's records indicate that the accountholder is a non-U.S. person. The exclusion of revenues from accounts held at a foreign branch only applies if the bank utilizes the bank-wide method for calculating the ratio of relationship compensation to total compensation.

Under both the account-by-account and bank-wide methods, compensation from short-term accounts, i.e. those open for less than three months in the relevant year, is not included in total compensation. Compensation from acquired accounts, i.e. accounts that the bank acquired from another entity as part of a merger, consolidation, acquisition, purchase of assets or similar transaction, can be excluded for the first twelve months.

Regulation R also provides for a De Minimis Exclusion where those banks using the account-by-account method can exclude the revenues from the lesser of 1% or 500 accounts in determining compliance with the chiefly compensated requirement. In order to do so, the bank must maintain records demonstrating that the securities transactions by or on behalf of the account were undertaken in the exercise of its trust or fiduciary duties and the bank must not have used the exclusion in the preceding year.

Finally, a transferred account will not cause a bank to fail the chiefly compensated test if the account or its securities are transferred to a registered broker dealer or an

unaffiliated entity that is not required to be registered as a broker within three months following the end of the relevant year.

F.1.a.1.a.2 Trade Execution Requirements

The Trust & Fiduciary exception, as well as the other GLBA/Regulation R exceptions and exemptions, require that securities transactions be executed in accordance with the Exchange Act's execution requirements, which generally require securities transactions to be executed by a registered broker-dealer or in a cross trade. Regulation R, however, provides several exemptions from the Exchange Act's trade execution requirement. Regulation R permits banks to effect certain transactions directly through the NSCC, the issuer's transfer agent, or an insurance company, if certain requirements are met. Regulation R permits transactions in "covered securities" to be effected through the NSCC, directly with the transfer agent, or with an insurance company or separate account that is excluded from the definition of transfer agent in the Exchange Act. A "covered security" is a registered mutual fund or a variable insurance contract funded by a separate account that is registered. The following two requirements must be satisfied:

- The security is not traded on a national securities exchange or through the facilities of a national securities association or an interdealer quotation system; and
- The security is distributed by a registered broker-dealer, or the sales charge is no more than the amount permissible for a security sold by a registered broker-dealer under Investment Company Act of 1940 rules.

Regulation R also provides an exemption whereby transactions in employer securities for employee benefit plans can be effected directly with the transfer agent provided that:

- No commission is charged;
- The transaction is solely for the benefit of an employee benefit plan account;
- The security is obtained directly from:
  - The employer; or
  - An employee benefit plan of the employer.
- The security is transferred only to:
  - The employer; or
  - An employee benefit plan of the employer.

F.1.a.1.b. Custody & Safekeeping Exception

GLBA provides an exception from the definition of broker for banks that provide custody and safekeeping services. GLBA specifically provides that a bank will not be considered a broker if it engages in the following custodial and safekeeping activities:

- Providing safekeeping and custody services to customers with regard to securities, including the exercise of warrants and other rights on behalf of bank customers;
- Facilitating the transfer of funds or securities as a custodian or clearing agent in connection with the clearance and settlement of its customers' transactions in securities;
- Facilitating lending or financing transactions or investing cash in connection with its safekeeping, custody, and securities transfer services;

- Holding securities pledged by a customer to another person or securities subject to repurchase agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided by law, provided that the bank maintains records separately identifying the securities and the customer; or
- 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.

  In addition to the statutory exception, Regulation R provides two exemptions whereby a bank can take orders for the purchase or sale of securities from custody account customers. One exemption allows a bank, as part of its customary banking activities, to accept orders for securities transactions from employee benefit plan accounts, individual retirement accounts, and similar accounts. The second exemption allows a bank to accept orders for securities transactions from custody account customers on an accommodation basis.

  The exemptions discussed below apply to accounts for which the bank acts as a custodian. Regulation R defines an account for which a bank acts as a custodian as an account that is:
- An employee benefit account;
- An individual retirement account or similar account;
- 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 the bank acts as a directed trustee.

  Whether a bank serves as custodian for securities or other assets of an account depends on the services the bank provides to the account, rather than the label used to identify the account. Thus, a bank that acts as an escrow agent or paying agent and that provides custody and safekeeping services to the account is considered an account for which the bank acts as custodian, notwithstanding the fact that the account is not called a custody or safekeeping account.

F.1.a.1.b.1. Exemption for EB, IRA, and Similar Accounts

A bank may accept orders for securities transaction from custody accounts for employee benefit plans, individual retirement plans and similar accounts provided that:

- The bank does not advertise that it accepts orders, except as part of advertising its other custody and safekeeping services;
- No bank employee is compensated based on whether a securities transaction is executed or on the quantity, price, or type of security involved;
- The bank is not a trustee or fiduciary, other than a directed trustee;
- The bank is not acting as a carrying broker; and
- The bank complies with the trade execution requirements in Exchange Act Section 3(a)(4)(C)(i).

Banks may not advertise that custody accounts are securities brokerage accounts or are a substitute for a brokerage account. While the bank cannot be a trustee or fiduciary and still rely on the custody exemption, there is an exception made for banks that serve as directed trustees. A bank that serves as a directed trustee is eligible for the custody exemption provided it complies with the other requirements of the exemption. A directed trustee is a trustee that does not hold any investment discretion over an account.

Within common securities industry usage, the terms "carrying broker" and "clearing broker" are virtually identical and often are used interchangeably. In certain instances, the terms mean a broker that, as part of an arrangement with a second broker (an "introducing" or "corresponding" broker), allows the second broker to be subject to lesser regulatory requirements (e.g. under the net capital provisions of Exchange Act Rule 15c3-1 and the customer protection provisions of Exchange Act Rule 15c3-3). Technically, however, a "carrying broker" is a broker that holds funds and securities on behalf of customers, whether its own customers or customers introduced by another broker-dealer, and a "clearing broker" is a member of a registered clearing agency.
The preamble to the final Regulation R discusses factors that the SEC would consider in determining if a bank were acting as a carrying broker. The SEC indicated that it would consider the existence of shared clients between a broker-dealer and bank and the reason why clients of the broker-dealer have established custody accounts at a bank. The existence of shared customers where the broker-dealer causes its customers to establish custody accounts at a bank could result in a determination that the bank was acting as a carrying broker for the broker-dealer. If, however, the clients of the broker-dealer independently decide to open a custody account at a bank, then the bank would likely not be viewed as acting as a carrying broker for the broker-dealer. Banks may share systems and platforms with a broker-dealer, for example an affiliated broker-dealer with which a common BSA/AML compliance system is used. Other examples of permissible arrangements include legal and compliance functions, accounting and finance functions (such as payroll and expense account reporting), and administrative functions (such as human resources and internal audit). Moreover, banks may perform limited back office functions for a broker-dealer without being deemed as acting as a carrying broker. A broker-dealer cannot delegate to a bank functions that require registration with a self-regulatory organization (SRO) and the broker-dealer must retain control of its property, cash, and securities.
In addition to bank custodians, non-custodial, non-fiduciary third-party administrators and record keepers for employee benefit plans may rely on the EB/IRA custody exemption provided that:

- Both the custodian bank and the third-party administrator/record keeper comply with the requirements of the exemption; and
- The administrator/record keeper does not execute cross trades other than:
  - Crossing or netting open-end mutual funds not traded on an exchange; or
  - Crossing or netting orders for accounts held at the custodian bank that contracted with the third-party administrator/record keeper.

F.1.a.1.b.2. Exemption for Accommodation Trades

For custody accounts that are not maintained by an employee benefit plan, individual retirement accounts, or other similar accounts, a bank may accept orders for securities transactions as an accommodation to the customer provided:

- Any fee charged or received by the bank does not vary based on:
  - Whether the bank accepted the order; or
  - The quantity or price of the securities bought or sold.

- Advertisements do not state that the bank accepts orders for securities transactions;
- Sales literature does not state that the bank accepts orders, except as part of describing other aspects of its custodial and safekeeping services;
- The bank does not provide investment advice or research, make recommendations, or solicit transactions. However, the bank may:
  - Advertise or provide sales literature as allowed in the exemption;
  - Respond to customer inquiries about custody and safekeeping services by providing -
    - Advertisements and sales literature;
    - Prospectus or sales literature prepared by a registered investment company; or
    - Materials based on the above.
- The bank complies with the compensation and trade execution requirements of the EB/IRA exemption.
  The requirement that the bank not provide investment advice or research, make recommendations, or solicit transactions does not prohibit a bank from cross-marketing its trust and fiduciary services to custody account customers. Banks may cross-market investment advisory services to custody customers by:
- Providing non-account specific information via newsletters, websites, etc.;
- Providing examples of research, including stock specific research that the bank provides to other persons for marketing purposes.
  A bank, however, may not provide personalized investment research regarding securities held in a custody account. Lists and menus of securities that can be purchased or sold are not considered investment advice.
  If a customer has both a trust or fiduciary account and a custody account at the bank, the bank may provide investment advice and research to the customer in connection with the trust or fiduciary account. The bank is not responsible for how the trust or fiduciary accountholder uses such advice or research.

F.1.a.1.b.3. Subcustodians

A bank that acts as a subcustodian for an account for which another bank acts as custodian may rely on either the EB/IRA exemption or the Accommodation Trade exemption, depending on the type of account at the custodial bank, provided that:

- Both the subcustodian and the custodian bank comply with the requirements of the respective exemption; and
- The subcustodian does not execute cross trades, other than -
  - Crossing or netting open-end mutual funds not traded on an exchange; or
  - Crossing or netting orders for accounts of the custodian.

F.1.a.1.c. Networking Exception

The networking exception permits non-licensed employees to receive compensation for the referral of a retail customer to a registered broker-dealer without causing the bank to be considered a broker-dealer under the Exchange Act. Regulation R defines "referral" as "an action taken by one or more bank employees to direct a customer of the bank to

a broker-dealer for the purchase or sale of securities for the customer's account." Normally, a non-licensed individual is not allowed to receive incentive compensation in connection with a securities transaction. The networking exception allows non-licensed bank employees to receive a referral fee, which will not be considered incentive compensation, provided that the fee received is a nominal, one-time cash fee of a fixed dollar amount and the payment is not contingent on whether the referral results in a transaction. In addition to limiting referral fees to a nominal amount, the regulation also addresses bank bonus plans and the circumstances under which such plans can include securities-related activities without being considered incentive compensation for purposes of the Exchange Act. Referral fees and bonus programs are discussed in detail below.

F.1.a.1.c.1. Referral Fees

Nominal

Regulation R defines the term nominal referral fee as a payment to a bank employee personally involved in making the referral that does not exceed:

- 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 maximum annual salary established by the bank for the current or prior year for the job family that includes the employee; or
- Twice the actual 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 actual annual salary established by the bank for the current or prior year for the job family that includes the employee; or
- $25

Banks are not limited to using a single definition for determining whether a referral fee is nominal. Banks may use different methodologies for different lines of business or operating units. Banks may also change the methodologies used within a given year. An employee's "job family" means a group of jobs or positions involving similar responsibilities, or requiring similar skills, education, or training, that a bank, ...uses...for purposes of hiring, promotion, and compensation. Examiners should review these job families in order to ensure that they are not being used to evade the "nominal referral fee" requirement.

The $25 definition of "nominal" will be adjusted for inflation beginning on April 1, 2012 and every 5 years thereafter.

Non-Contingent

A fee is non-contingent if it does not depend on whether:

- The referral results in the purchase or sale of a security; or
- The referral results in an account being opened with a broker-dealer; or
- The referral results in multiple transactions.

A referral fee can, however, be contingent on whether the customer:

- Keeps an appointment with the broker-dealer; or
- Meets base-line qualification criteria for referral, such as minimum net worth, etc.

F.1.a.1.c.2. Bonus Programs

Incentive compensation is compensation intended to encourage a bank employee to

refer customers to a broker-dealer or give a bank employee an interest in the success of a securities transaction at a broker dealer. Regulation R provides, however, that incentive compensation does not include a bonus or similar plan that is:

- Paid on a discretionary basis. A bonus plan is discretionary if the amounts paid are not fixed in advanced and employees do not have an enforceable right to the bonus before it is declared by the board;
- Based on multiple factors or variables;
- Include multiple significant factors or variables that are not related to securities transactions at a broker-dealer;
- Referrals by employees are not a factor; and
- Referrals by any other person are not a factor.

Bonus programs can also be based on the overall profitability or revenue of:

- The bank, on a stand-alone or consolidated basis;
- An affiliate or operating unit of a bank, if they do not predominately engage in making referrals to a broker-dealer; or
- A broker-dealer, if:
  - Overall profitability or revenue is only one of multiple factors or variables used to determine compensation;
  - Referrals are not a factor; and
  - Referrals by other employees is not a factor.

In assessing bonus programs for compliance with Regulation R, examiners will consider the following factors:

- Whether the factors and variables of the bonus plan relate to activities actually being conducted;
- The resources being devoted to the activities being conducted; and
- Whether the business lines or activities materially contribute to the amount of bonus payments.

Over time, it is expected that factors and variables related to securities transactions will not predominate the determination of the amount of bonus payments awarded.

F.1.a.1.d. Exemption for Referral of High Net Worth/Institutional Customers

Regulation R provides an additional exemption for referrals by non-licensed bank employees of high net worth (HNW) or institutional customers to a third-party broker-dealer. Unlike referrals of retail customers, payments can be more than nominal in amount and may be contingent in nature. To receive payments under this exemption bank employees must meet the following requirements:

- Not be licensed;
- Be predominately engaged in banking activities other than making referrals to broker-dealers;
- Not be subject to any statutory disqualification; and
- Encounter customers in the ordinary course of the employee's duties.

Regulation R defines a HNW customer as either:

- A natural person who, either individually or jointly with a spouse, has a net worth of at least $5 million, excluding equity in his/her primary residence; or

- Any revocable, living trust, where the settlor is a natural person meeting the $5 million net worth requirement.

  For purposes of determining whether a natural person meets the $5 million net worth test, the assets of a person include: (1) any assets held individually; (2) if the person is acting jointly with his or her spouse, any assets of the person's spouse (whether not such assets are held jointly); and (3) if the person is not acting jointly with his or her spouse, fifty percent of any assets held jointly with such person's spouse and any assets in which such person shares with such person's spouse a community property or similar shared ownership interest.

  Regulation R defines an institutional customer as a corporation, partnership, limited liability company, trust, or other non-natural person with at least:

- $10 million in investments; or
- $20 million in revnues; or
- $15 million in revenues if the referral is for investment banking services.

  The final rule defines "investment banking services" to include, without limitation, 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 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.

  The dollar thresholds detailed above will be adjusted for inflation beginning on April 1, 2012 and every 5 years thereafter.

  When making a referral of a HNW/Institutional customer the bank must disclose the following:

- The name of the broker-dealer; and
- The fact that the bank employee participates in an incentive program where the employee may receive a fee of more than a nominal amount that may be contingent on whether the referral results in a transaction.

  The disclosures must be provided either:

- In writing prior to or at the time of the referral; or
- Orally prior to or at the time of referral, provided that the bank provides the required information in writing within 3 days of the referral.

  Banks may, however, contract with the broker-dealer to provide the required disclosures, provided the agreement is in writing. When provided by the broker-dealer, the disclosures must be provided:

- Prior to or at the time the customer begins the process of opening an account; or
- If the customer already has an account at the broker-dealer, prior to the time the customer places an order.

  The bank must have a reasonable basis for believing that the customer is a HNW or institutional customer at the time of the referral for natural persons or before the referral is paid to the employee for a non-natural person.

  The exemption imposes the following obligations on the broker-dealer with which the bank contracts for third-party brokerage services:

- Determine whether the referring bank employee is subject to a statutory disqualification;
- Have a reasonable basis to believe that the customer referred is a HNW/institutional customer;
- If the referral fee is contingent, perform a suitability analysis of the transaction before execution;
- If the referral fee is non-contingent, determine that the customer:
  - Has the capability to evaluate investment risk and make independent decisions; and
  - Is exercising independent judgment based on individual assessment; or
  - Perform a suitability analysis of all transactions requested by the customer contemporaneously with the referral.

The broker-dealer is required to determine whether the referring employee is subject to a statutory disqualification prior to paying the first referral and once a year thereafter as long as the employee remains eligible to receive such referral fees. The rule requires that, before a higher-than-nominal referral fee is paid to a bank employee under the HNW/institutional customer exemption, the bank provide the broker-dealer the name of the employee and such other identifying information that the broker-dealer may need to determine whether the employee is subject to statutory disqualification. The bank should provide at least annually its broker-dealer partner any changes to the identifying information initially provided.

A bank or broker-dealer would have a “reasonable basis to believe” that a customer is a high net worth customer or institutional customer if, for example, the bank or broker-dealer obtains a signed acknowledgment from the customer (or, in the case of an institutional customer, from an appropriate representative of the customer) that the customer meets the applicable standards to be considered a high net worth customer or an institutional customer, and the bank employee making the referral or the broker-dealer dealing with the referred customer does not have information that would cause them to believe that the information provided by the customer (or representative) is false.

The broker-dealer is required to inform the customer if the customer does not meet the suitability criteria. The broker-dealer must also notify the bank if it determines that the customer is not a HNW or institutional customer and if it determines that a referring employee is subject to a statutory disqualification.

For purposes of the HNW/Institutional Customer exemption the term "referral fee" is defined as a predetermined dollar amount, or a dollar amount determined by a predetermined formula that does not vary based on:

- The revenue generated by or the profitability of the securities transactions of customers; or
- The quantity, price, or identity of the securities transactions conducted over time by the customer; or
- The number of customer referrals made.

A referral fee, however, can be based on a fixed percentage of the revenues received by a broker-dealer for investment banking services provided to the customer.

The exemption provides that a bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of the exemption will not be considered a “broker” under Section 3(a)(4) of 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; provide the customer the required disclosures; or provide the broker-dealer the required information concerning the bank employee receiving the referral fee within the time periods prescribed. 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-dealer the required information, the bank will not lose the exemption from registration in these circumstances. Following any required remedial action, 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.

F.1.a.1.e. Sweep Account Exception/Money Market Fund Exemption

The Sweep Account Exception allows a bank to effect transactions as part of a program for the investment or reinvestment of deposit funds in a no-load money market fund. Regulation R defines a no-load fund as a fund that does not charge an upfront sales load or a deferred sales load, and where total charges against the net assets for sales, sales promotion, personal services or the maintenance of shareholder accounts does not exceed 25 basis points. Under the statutory exception, a bank may also sweep deposit funds on behalf of another bank into a no-load money market fund. Regulation R provides an exemption under which a bank may, on behalf of both bank customers or other banks, invest or reinvest funds in a money market fund that is not a no-load fund, as defined in the regulation.
In order to effect transactions in a money market fund that is not a no-load fund the bank must:

- Provide the customer, directly or indirectly, another product or service that would not cause the bank to register as a broker dealer;
- Provide the customer with a prospectus for the fund not later than at the time the customer authorizes the transactions; and
- Not refer to or characterize the fund as a no-load fund

F.1.a.1.f. Exemption for Transactions in Regulation S Securities

Regulation S is an SEC regulation that governs the conditions under which securities offered to investors outside the U.S. are exempt from registration under the Securities Act of 1933. A Regulation S security is an equity security issued by a public company located in the U.S. to non-U.S. persons in an offshore transaction.
Regulation R exempts a bank effecting transactions in Regulation S securities from the definition of broker to the extent that the bank, acting as an agent:

- Effects a sale of an eligible security to a purchaser who is not in the U.S.; or
- Effects, by or on behalf of a person who is not a U.S. person, a resale of an eligible security after its initial sale with a reasonable belief that the security was sold outside the U.S. to a purchaser who is not in the U.S. or a broker-dealer. If the resale is made

prior to any applicable distribution compliance period under Rule 903(b)(2) or (b)(3) of Regulation S, the resale must comply with Rule 904 of Regulation S; or

- Effects, by or on behalf of a registered broker-dealer, a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside the U.S. to a purchaser who is not in the U.S. If the resale is made prior to any applicable distribution compliance period under Rule 903(b)(2) or (b)(3) of Regulation S, the resale must comply with Rule 904 of Regulation S

An eligible security is a security that:

- Is not being sold from the inventory of the bank or an affiliate of the bank; and
- Is not being underwritten by the bank or an affiliate of the bank on a firm commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank.

A purchaser is a person who purchases an eligible security and who is not a U.S. person.

F.1.a.1.g. Exemption for Securities Lending Transactions

Regulation R provides an exemption from the definition of broker for banks that, as an agent, engage in securities lending transactions or securities lending services. A bank may engage is these activities with or on behalf of persons the bank reasonably believes to be:

- A qualified investor as defined in the Securities Exchange Act of 1934; or
- An employee benefit plan that owns or invests on a discretionary basis not less than $25 million in investments.

A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner and has the right to terminate the transaction and recall the loaned securities on terms agreed by the parties.

Regulation R defines "securities lending services" as:

- Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrowers:
- Receiving, delivering, or directing the receipt or delivery of loaned securities;
- Receiving, delivering, or directing the receipt or delivery of collateral;
- Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending activity;
- Investing, or directing the investment of, cash collateral; or
- Indemnifying the lender of securities with respect to various matters.

F.1.a.2 Other GLBA Exceptions

F.1.a.2.a. Permissible Securities Transactions

Permissible securities transactions are transactions in specific types of securities and

instruments that banks commonly engage in. The types of transactions covered by this exception are:

- Commercial paper, bankers acceptances, or commercial bills;
- Exempted securities, e.g. U.S. government securities;
- Qualified Canadian government obligations; and
- Any standardized credit enhanced debt security issued by a foreign government pursuant to the March 1989 plan of then Secretary of the Treasury Brady, used by such foreign government to retire outstanding commercial bank loans, i.e. Brady bonds.

For purposes of this exception, municipal securities are not treated as exempted securities. Transactions in municipal securities are covered by a separate exception in GLBA.

F.1.a.2.b. Stock Purchase Plans

A bank, acting as transfer agent, may effect transactions in the securities of an issuer as part of any pension, retirement, profit sharing, bonus, thrift, savings, incentive, or other similar benefit plan for the employees of the issuer, or affiliates thereof. The bank, however, may not solicit transactions nor provide investment advice with respect to such securities in connection with the plan.

A bank, acting as transfer agent, may also rely on this exception to effect transactions as part of an issuer's dividend reinvestment plan, if:

- The bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan; and
- The bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the SEC.

Similarly, a bank, acting as transfer agent may effect transactions in the securities of an issuer as part of a plan or program for the purchase or sale of such issuer's share, if:

- The bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan; and
- The bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the SEC.

A bank may deliver written or electronic plan materials to the employees of the issuer, shareholders of the issuers, or members of affinity groups of the issuer, provided the materials are comparable in scope or nature to that permitted by the SEC as of the date of enactment of GLBA or are otherwise permitted by the SEC.

F.1.a.2.c. Private Securities Offerings

A bank may effect sales of a primary offering of securities not involving a public offering, provided that the bank is not affiliated with a broker or dealer and any one private placement offering in which the bank is involved does not exceed 25% of the bank's capital. Private placements of government and municipal securities are not subject to the 25% of capital limitation.

F.1.a.2.d. Municipal Securities

GLBA provides for an exception for a bank acting as a broker in municipal securities transactions.

F.1.a.2.e. Affiliate Transactions

A bank may effect transactions for the account of any affiliate of the bank, provided that the affiliate is neither a registered broker-dealer nor engaged in merchant banking activities. For this exception, affiliate is as defined in the Bank Holding Company Act of 1956. Similarly, the term merchant banking is as described in Section 4(k)(4)(H) of the same act.

F.1.a.2.f. Identified Banking Products

Banks may effect transactions in “identified banking products.” Identified banking products are products that have not traditionally been considered securities and include deposit accounts, certificates of deposit, loans, and loan participations. The loan participation exception, however, is qualified by the requirement that it must be a participation which the bank, or an affiliate of the bank, participates in or owns and that is sold to either qualified investors or persons having the opportunity to review and capability of assessing material information concerning the loan participation. One further requirement governing the sale of loans or loan participations requires that such loans or participations not be deemed securities under the Securities Exchange Act of 1934. Swap agreements, including all credit and equity swaps, other than equity swaps with retail customers, are considered identified banking products.

F.1.a.2.g. De Minimis Transactions

GLBA provides for a de minimis exception for banks that effect up to 500 securities transactions a year. The de minimis exception, however, can not be used for transactions effected by dual employees. It should also be noted that the up to 500 transactions threshold pertains to the total of both broker transactions and dealer riskless principal transactions, so that the combined securities transactions governed by the broker De Minimis and dealer Riskless Principal exceptions must total less than 500 per year.

F.1.b. Registered Dealer

Bank Dealer Exceptions to Registration with the SEC for Certain Securities Activities
Section 202 of the GLBA amended the definition of "dealer" by repealing the Securities Exchange Act exclusion for banks from dealer registration and regulation.
The SEC has issued a final rule concerning the bank dealer exceptions to the Securities Exchange Act of 1934 ("Exchange Act"), as amended in Section 202 of the GLBA. See 68 Federal Register 8686 (February 24, 2003). Also refer to Appendix D, Bank as Dealer. The compliance date of the rule is September 30, 2003. Exchange Act section 3(a)(5) defines a "dealer" as a person that is "engaged in the business of buying and selling securities" for its own account through a broker or otherwise, and exempts persons, whether banks or non-banks, who do not buy or sell securities "as part of a regular business". Banks do not need to register with the SEC and the National Association of Securities Dealers unless they act as dealers and do not qualify under any of the exceptions under Section 202 of GLBA. The SEC has recently issued a Staff Compliance Guide to Bank on Dealer Statutory Exceptions

and Rules, which is available on the SEC Division of Market Regulation's website and in Appendix D of this manual.

GLBA replaced the former uniform bank exception for securities dealer registration under the Exchange Act with four specific exceptions. These statutory exceptions are:

- Investment transactions: permits banks to buy and sell securities for investment purposes for the bank and in its customers' trustee and fiduciary accounts.
- Permissible securities transactions: permits banks to buy and sell exempted securities, certain Canadian government obligations, and Brady bonds.
- Identified banking products: permits banks to buy and sell certain "identified banking products," as defined in Section 206 of GLBA.
- Asset-backed transactions: permits banks through a grantor trust or other separate entity to issue and sell to qualified investors certain asset-backed securities representing obligations predominately originated by a bank, an affiliate of a bank other than a broker-dealer, or a syndicate in which the bank is a member for some types of products.

  The SEC's bank dealer rule addresses certain interpretive issues arising from these statutory exceptions for bank dealer activities. In addition, it addresses certain additional exemptions that involve bank dealer activities that also could be covered as broker activities. These additional exemptions provided under the SEC's bank dealer rule include:

  Riskless principal transactions. This exemption permits banks to engage in a limited number (up to 500) of "riskless principal" transactions per calendar year without registering with the SEC as dealers. A "riskless principal" transaction is one in which, after having received an order to buy from a customer, a bank purchases the security from another person to offset that contemporaneous sale. Alternatively, a riskless principal transaction is one in which after having received an order to sell from a customer, a bank sells the security to another person to offset that contemporaneous purchase.

  - How to count transactions for purposes of this exemption: Transactions with two customers where the bank acts as a riskless principal between them count as one transaction. However, if a bank acts as a riskless principal between one counterparty and multiple counterparties by arranging multiple transactions, each of the transactions on the side that involves the largest number of transactions would count as separate transactions against the annual transaction-limit.
  - How counting will be affected by banks' brokerage activities: The Exchange Act also permits banks to engage in certain "broker" activities without registering with the Commission. At the time the "dealer" provisions become effective, however, the "broker" provisions still will be subject to a Commission order delaying their effectiveness. One of the "broker" exceptions - known as the de minimis exception - permits banks to engage in no more than 500 brokerage transactions per year that are not otherwise exempt without registering with the Commission. When banks utilize this exception after the compliance date is set for the broker rules, banks' riskless principal transactions **and** brokerage transactions effected under the de minimis exception will count toward the same 500-transaction limit. In other words, banks may be able to engage in any combination of brokerage transactions under the de minimis exception and riskless principal transactions under Rule 3a5-1, so long as the total number of these transactions does not exceed 500 per year. Until the broker rules are effective, however, banks may use the entire 500-transaction limit for riskless principal transactions.

  Securities lending transactions. This exemption permits banks to engage in, or effect, securities lending transactions with certain counterparties. A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party under a written securities lending agreement. Through this agreement, the lender retains the economic interests of an owner of the securities. Subject to the terms agreed upon by the parties, including an agreement to loan the securities for a fixed term, the lender also has the right to terminate the transaction and to recall the loaned securities.