An Overview of Proposed Regulation B

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Catherine McGuire
Chief Counsel
Division of Market Regulation
U.S. Securities and Exchange Commission

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The following presentation highlights and summarizes some of the significant provisions of proposed Regulation B and the Commission's discussion of the proposed regulation. It is not comprehensive. For a detailed explanation of the proposal, interested persons should refer to the Commission's Release No. 34-49879.

Proposed Amendments to Broker Rules

I. Trust and Fiduciary Activities Exception

A. "Trustee" Definitional Exemption

B. Interpretation of "Fiduciary Capacity"

C. "Regularly Examined"

D. "Investment Adviser if the Bank Receives a Fee for its Investment Advice"

E. "Chiefly Compensated" Calculation

F. Indenture Trustee Compensation Exemption

I. Trust and Fiduciary Activities Exception

A. "Trustee" Definitional Exemption

- **As requested by commenters, eliminate the definitional exemption that clarified the applicability of the exception to banks acting as indenture trustees or as trustees for ERISA or IRA accounts**

- **As requested by commenters, do not specifically identify the types of trustee capacities covered by the exception**

I. Trust and Fiduciary Activities Exception

B. Interpretation of "Fiduciary Capacity"

- **Retain interpretation that fiduciary capacities include fiduciary capacities not expressly labeled as such or listed in the statutory definition of "fiduciary capacity," but not agency capacities such as IRA custodian**

- **Do not identify any additional capacities as similar to those specified in the statute**

I. Trust and Fiduciary Activities Exception

C. "Regularly Examined"

"Department that is regularly examined by bank examiners for compliance with fiduciary principles and standards"

- **Increase the flexibility and utility of the examination requirement by:**
  - **Amending interpretation of "all aspects" to clarify that activities associated with effecting securities transactions do not have to be located in a department that is regularly examined for compliance with fiduciary principles and standards but the activity must, when performed in connection with trust and fiduciary services, be so examined**

I. Trust and Fiduciary Activities Exception

D. "Investment Adviser if the Bank Receives a Fee for its Investment Advice"

- **Revise definition to**
  - **Omit "continuous and regular" communication requirement**
  - **Clarify that the bank has a ongoing responsibility to provide advice based upon the customer's individual needs that:**
    - **i. Includes selecting or making recommendations regarding specific securities; and**
    - **ii. If such recommendations are accepted by the customer, the bank is responsible for forwarding the orders for execution**
- **Retain concept that a bank acting as an investment adviser and receiving a fee for its investment advice owes its customer a duty of loyalty, including an affirmative duty to fully and fairly disclose all material facts and conflicts of interest**

I. Trust and Fiduciary Activities Exception

E. "Chiefly Compensated" Calculation

Chiefly Compensated by Relationship Compensation

- **Revise definition of "relationship compensation" to include management fees for non-securities assets**

- **Revise definition of "flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers"**

- **Retain definition of "sales compensation" with amendments to allow account-by-account determinations of fees paid on an aggregate basis, such as 12b-1 fees**

I. Trust and Fiduciary Activities Exception

E. "Chiefly Compensated" Calculation

<u>Two Methods</u>

- **Account-by-Account calculation**
  - **Must have more relationship compensation than sales compensation**
- **Line of Business exemption**
  - **Must have no more than a one to nine ratio of sales compensation to relationship compensation on a line of business or bank-wide basis**
  - **May include as "relationship compensation" management fees for non-securities assets**

(continued)

I. Trust and Fiduciary Activities Exception

E. “Chiefly Compensated” Calculation

<u>Two Methods</u>

- **Line of Business exemption (continued)**
  - **All relationship and sales compensation from any line of business using the exemption must be included in the calculation even if it relates to a transaction or account for which there is another exemption**
  - **Reduce account-by-account review to only:**
    - **i. At account opening (after rules apply); and**
    - **ii. When individual negotiation increases the proportion of sales compensation as compared to relationship compensation**

I. Trust and Fiduciary Activities Exception

E. "Chiefly Compensated" Calculation

NEW Annual Safe Harbor Exemptions (Available for Both Methods)

- **Meet "chiefly compensated" one year = in compliance during all of the next year**
- **Gives banks legal certainty**

I. Trust and Fiduciary Activities Exception

E. "Chiefly Compensated" Calculation

<u>NEW Bank-Wide Exemption Safe Harbor to cure end-of-year failure</u>

- **If annual calculation shows sales compensation exceeds the one to nine ratio of sales compensation to relationship compensation**
  - **Must have no more than a one to seven ratio of sales compensation to relationship compensation**
  - **Available to bank once every 5 years**

I. Trust and Fiduciary Activities Exception

E. “Chiefly Compensated” Calculation

<u>**NEW Account-by-Account Safe Harbor to cure end-of-year failure**</u>

- **If annual calculation fails to show more relationship compensation than sales compensation with respect to a particular account:**
  - **Subject to the limitation that no more than 10% of accounts can fail per year**
  - **Particular account can fail once in 5 years**
  - **Additional safety valve for small number of accounts (the lesser of 500 or 1% of the total number of fiduciary accounts) that fail more than once in a 5-year period**

I. Trust and Fiduciary Activities Exception

E. “Chiefly Compensated” Calculation

<u>Account-by-Account</u>

- **Grandfather exemption for existing living, testamentary, and charitable trust accounts**
  - **Available to banks doing account-by-account calculation**
  - **Exemption continues unless individual negotiation occurs that results in an increase in the proportion of sales compensation as compared to relationship compensation for the account after grandfathered date**
  - **Grandfather date 30 days after publication of Release No. 34-49879 in the Federal Register**

I. Trust and Fiduciary Activities Exception

E. "Chiefly Compensated" Calculation

Allocation Formulas to Calculate Sales Compensation

- **Permit banks to allocate Rule 12b-1 fees to individual accounts by:**
  - **Multiplying number of investment company shares in accounts by net asset value per share, then by the investment company's annual Rule 12b-1 fee rate; or**
  - **Using another method that fairly and consistently measures amount of sales compensation attributable to each account**

- **Permit banks to allocate fees, including revenue sharing, personal service, or maintenance of shareholder accounts, to individual accounts, either by:**
  - **Dividing number of shares in accounts by aggregate number of shares held by bank as trustee or fiduciary and multiplying by dollar amount received by bank; or**
  - **Using another method that fairly and consistently measures amount of sales compensation attributable to each account**

I. Trust and Fiduciary Activities Exception

E. “Chiefly Compensated” Calculation

<u>Timing for Chiefly Compensated Calculation</u>

- **One-year between adoption and compliance date allows banks time to develop compliance systems for “chiefly compensated” calculation**
  - **All banks are in compliance with “chiefly compensated” during first year after compliance date**
  - **2nd year after compliance date, banks’ “chiefly compensated” status is based on prior year**

<u>Example</u>: If rules are final by year-end 2004:

- **Banks develop compliance systems during 2005**
- **Banks are in compliance with “chiefly compensated” during 2006**
- **Banks measure compensation during 2006**
- **Banks chiefly compensated by relationship compensation or within safe harbors or exemptions at end of 2006 are in compliance during 2007**

I. Trust and Fiduciary Activities Exception

F. Indenture Trustee Compensation Exemption

- **Retain separate indenture trustee exemption from “chiefly compensated” that permits investments in no-load money market funds**

- **Add new exemption for investing in money market funds, including funds that are not “no-load,” for certain customers, including trust accounts. The exemption generally would require disclosures of fees to customers other than qualified investors**

- **Revenue received in connection with either of these exemptions would not count towards the account-by-account trustee and fiduciary chiefly compensated comparison**

Proposed Amendments to Broker Rules

II. Networking Exception

A. Definition of "Nominal One-Time Cash Fee of a Fixed Dollar Amount"

B. Accommodation for Non-Cash "Nominal" Referral Fees

C. Other Definitions

D. Other Interpretations

II. Networking Exception

A. Definition of "Nominal One-Time Cash Fee of a Fixed Dollar Amount"

- **Amend the interpretation of "nominal" in the definition to give banks three options for paying referral fees to unregistered employees:**
  1. **The employee's base hourly rate of pay;**
  2. **A flat $25 dollar amount; or**
  3. **An amount based on $15 in 1999 dollars adjusted for inflation**
- **Interpret "one-time" to mean no more than one referral fee per customer referred by an employee, to ensure that a single referral is rewarded with only one payment of incentive compensation**
- **Interpret "fixed dollar amount" as meaning having a set value that does not vary based on factors such as the identity of the broker-dealer to which a customer is referred or the financial status of the customer**

II. Networking Exception

B. Accommodation for Non-Cash "Nominal" Referral Fees

- **In the amended definition of "nominal one-time cash fee of a fixed dollar amount," interpret "cash fee" to permit banks to pay referral fees in "points" rather than in cash, if such fees are paid:**

  1. **In units of value with a readily ascertainable cash equivalent;**

  2. **In amounts such that the total value of each fee is nominal; and**

  3. **Under an incentive program covering a broad range of products that is designed primarily to reward activities unrelated to securities**

II. Networking Exception

C. Other Definitions

- ➢ **Revise the definition of “referral” to eliminate the first securities-related contact limitation**

- ➢ **Define “contingent on whether the referral results in a transaction” to clarify that a referral fee may be contingent upon whether:**

  1. **The employee makes a referral**
  2. **The customer contacts or keeps an appointment with a registered broker-dealer; or**
  3. **The customer has assets, a net worth, or income meeting any minimum requirement that the registered broker-dealer, or the bank, may have established generally for referrals for securities brokerage accounts**

II. Networking Exception

D. Other Interpretations

- **Clarify that “clerical or ministerial functions” are those that do not require licensing, familiarity with the securities industry, or the exercise of judgment concerning securities**

- **Clarify that “qualified pursuant to the rules of a self-regulatory organization” means qualified to effect a securities transaction as a natural person associated with a registered broker-dealer**

Proposed Amendments to Broker Rules

III. Sweep Accounts Exception and Related Exemption

A. Definitions

B. New Exemption for Money Market Fund Transactions for Certain Investors

III. Sweep Accounts Exception and Related Exemption

A. Definitions

- Retain definition of "no-load"
  - Modify definition to refer to the "class or series" of fund shares in which a bank effects transactions
- Interpret "program" to clarify that exception covers arrangements for automatic transfer of funds on a regular, but not necessarily overnight, basis
- Retain definition of "money market fund"

III. Sweep Accounts Exception and Related Exemption

B. New Exemption for Money Market Fund Transactions for Certain Investors

- **Exempt transactions in money market funds for certain bank customers who are qualified investors, and customers for whom a bank acts in a trustee or fiduciary capacity, or in the capacity of escrow agent, collateral agent, depository agent, or paying agent**

- **Transactions do not have to be part of a sweep program**

- **If an investor is not a "qualified investor," and the investor's transactions involve money market fund securities with 12b-1 fees that exceed 25 basis points, the bank must not characterize the funds as "no-load," and must provide a clear and conspicuous notice that:**
  1. **Discloses and separately identifies payments the bank may receive that are sales loads, deferred sales loads, or 12b-1 fees; and**
  2. **Indicates that the customer should carefully review the prospectus for additional information regarding expenses**

Proposed Amendments to Broker Rules

IV. Safekeeping and Custody Exception

A. Interpretation

B. General Bank Custody Exemption

C. Small Bank Custody Exemption

D. Employee Benefit Plans

IV. Safekeeping and Custody Exception

A. Interpretation

- Retain interpretation of safekeeping and custody exception
- Specifically, it does not permit banks to buy or sell securities for custody customers through the bank's omnibus accounts or otherwise take orders for securities and forward them for execution

IV. Safekeeping and Custody Exception

B. General Bank Custody Exemption

- Modify to permit order-taking and receipt of 12b-1 and personal service and maintenance fees for:
  - Existing customers (as of date 30 days after FR publication)
  - Qualified investors (Exchange Act Section 3(a)(54))

(continued)

IV. Safekeeping and Custody Exception

B. General Bank Custody Exemption

- **Other conditions:**
  - **Fee for taking order cannot vary depending on whether bank takes order as shown by fee schedules and charges actually made to similarly situated customers**
  - **Bank employee cannot receive incentive compensation related to the size, value, or completion of any securities transaction effected pursuant to this exemption**
  - **No solicitation**
  - **Response to customer inquiry is limited to providing registration statement for security or sales literature from unaffiliated underwriter or investment company**
  - **Excludes accounts that qualify for trust and fiduciary exception**
  - **Not available if bank uses small bank custody exemption**
  - **Retaining requirement to execute securities transactions in compliance with 3(a)(4)(C)**

IV. Safekeeping and Custody Exception

C. Small Bank Custody Exemption

<u>**Expand Exemption by:**</u>

- **Increasing the asset size limit from $100 million to $500 million**
- **Not affiliated with holding company over $1 billion in assets**
- **Allowing small banks that have trust and fiduciary activity accounts to also use this exemption provided that it does not rely on any other trust and fiduciary exemption**
- **Replacing the three percent annual revenue limit with a $100,000 limit on annual sales compensation**
- **Simplifying the solicitation restrictions to permit small banks to publicly solicit brokerage business as permitted by the trust and fiduciary activities exception**

(continued)

IV. Safekeeping and Custody Exception

C. Small Bank Custody Exemption

<u>Expand Exemption by:</u> (continued)

- **Replacing the prohibition on networking arrangements with third party broker-dealers with a narrower restriction that only prohibits affiliated broker-dealers**

- **Permitting small banks to use dual employees to effect securities transactions, subject to no payment of incentive compensation to dual employees acting in a "banking" capacity (except for networking referral fees)**

(continued)

IV. Safekeeping and Custody Exception

C. Small Bank Custody Exemption

__Expand Exemption by:__ **(continued)**

- **Permitting the use of this exemption for custodial accounts in general, not just tax-deferred accounts**
- **Permitting transactions in all securities, not just mutual funds**
- **Retaining the requirement to execute securities transactions in compliance with Section 3(a)(4)(C)**

IV. Safekeeping and Custody Exception

D. Employee Benefit Plans

- **Permit bank trustees and non-fiduciary administrators to receive asset-based sales charges and service fees from mutual funds to offset plan administration fees, if:**
  - **Bank provides a clear and conspicuous disclosure to the plan sponsor or its designated fiduciary that includes all fees and expenses assessed for services provided to the plan and all compensation received or to be received from a fund complex**
  - **If bank offers the participant-directed brokerage account it does so through a registered broker or dealer**
  - **Bank does not pay any incentive compensation to unregistered persons that differs based on the value of a security or the type of security purchased or sold by an account or a person who exercises control over the assets of such account**
  - **Bank complies with Section 3(a)(4)(C) in executing transactions**

Proposed Amendments to Broker Rules

V. Fund/SERV Exemption for Execution of Investment Company Securities

VI. Regulation S Transactions with Non-U.S. Persons

VII. Affiliate Transactions Exception

VIII. Foreign Broker-Dealers: Rule 15a-6

IX. Savings Associations and Savings Banks

X. Credit Unions

XI. Temporary Extension of Exemption from Section 29 Liability

XII. Timing

XIII. Comments

V. Fund/SERV Exemption for Execution of Investment

- **Expand to include transactions in shares of open-end mutual funds directly with transfer agents acting as agents for these funds, if:**
  - **Transfer agent does not accept fees for the offering of securities; and**
  - **Broker-dealers underwrite the securities; or**
  - **Securities are not sold for sales loads that exceed NASD sales load limits for broker-distributed funds**

VI. Regulation S Transactions with Non-U.S. Persons

NEW Conditional Exemption for Regulation S Securities

- **Bank exempt from both “broker” and “dealer”**
- **As agent or as riskless principal**
- **Eligible security**
- **Sells or resells to a non-U.S. purchaser who is outside of the United States within the meaning of, and in compliance with the requirements of Section 902(k) of Regulation S while Regulation S restrictions apply**

VI. Regulation S Transactions with Non-U.S. Persons

Conditions

- **Securities not sold from inventory of bank or affiliate of bank**
- **If the bank or affiliate of bank participates in firm commitment underwriting of new issue security, then bank will not sell the eligible security to purchaser, unless security acquired from unrelated distribution participant that did not purchase from the bank or affiliate of the bank**

VII. Affiliate Transactions Exception

- **Retain original interpretation of exception**
- **Define term "effects transactions for the account of any affiliate" to mean any securities transaction effected by bank as agent for its affiliate**
  - **Affiliate must be acting as principal**
  - **Affiliate may not:**
    1. **Act as riskless principal for another person;**
    2. **Be a registered broker-dealer; or**
    3. **Be engaged in merchant banking**
  - **The bank obtains the security or securities to complete the transaction from a registered broker or dealer, from a person acting as a broker or dealer or pursuant to another exception or exemption**

VIII. Foreign Broker-Dealers: Rule 15a-6

- **Retain statement that foreign broker-dealers may rely on Exchange Act Rule 15a-6(a)(4)(i) when dealing with a bank to execute trades**

- **Make conforming technical amendments to Rule 15a-6(a)(4)(i)**

IX. Savings Banks and Savings Associations

- **All statutory bank exceptions from the definitions of broker and dealer on the same terms and conditions as banks**
- **Exemptions related to the bank trust and fiduciary exemption**
- **The amended small bank custody exemption**
- **The expanded exemption to permit banks to process trades through Fund/SERV and transfer agents**
- **The securities lending exemptions**
- **The general bank exemption for money market fund transactions with certain customers**
- **Section 29 Exemption**
- **Timing – one year compliance delay exemption**

- **The exemptions not proposed to be extended to thrifts are:**
  - **The employee benefit exemption**
  - **The amended general custody exemption**
  - **The Regulation S exemption**

X. Credit Unions

Propose three exemptions:

- **Broker networking exception**
- **Broker sweep accounts exception**
- **Dealer trustee and fiduciary accounts exception**

XI. Temporary Extension of Exemption from Section 29 Liability

- **Extend temporary exemption from Section 29 liability for 18 months from date exceptions and exemptions are applicable to banks**

XII. Timing

- Propose timing delay until January 1, 2006

XIII. Comments

As our Chairman said at the open meeting addressing these proposals,

> **"To fulfill our primary mandate to protect investors – but at the same time to avoid unnecessary intrusion into the banking business – we need hard data from the industry. We need to know in practical, concrete, dollars-and-cents terms how these proposed rules would affect the banking business – money center banks as well as local banks in small towns, thrifts and credit unions. Theoretical or speculative possibilities will not be terribly useful to us. If we have to choose between investor protection and abstract concerns, the choice will be quite easy. So banks need to run the numbers on this proposal and share those numbers with us."**