Regulation R

What Does It Really Mean

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Cetera Financial Institutions is a marketing name of
Cetera Investment Services LLC, member FINRA/SIPC

Executive Summary

The implementing regulations related to the definition of "broker" in the Securities and Exchange Act of 1934, as amended in the Gramm-Leach-Bliley Act of 1999, are finally here in the form of Regulation R. Regulation R addresses several, but not all of the exceptions available to banks from the need to register as a broker-dealer when involved in certain securities activities. This white paper will address only the networking exception. A key fact to consider is that Regulation R is only one part of the legal and regulatory framework that banks must adhere to in a networking relationship. The networking exception as defined by Congress in the Gramm-Leach-Bliley Act is conditioned on several additional factors most of which address proper identification of the broker-dealer as the entity offering brokerage services.

A key fact to consider is that Regulation R is only one part of the legal and regulatory framework

The History of Regulation R

The history of Regulation R starts with Congress in the wake of the Stock Market Crash of 1929. The Banking Act of 1933, also known as the Glass-Steagall Act, created a specific division between the operation and the regulation of the banking and the securities industries. Shortly thereafter the Securities and Exchange Act of 1934 (Exchange Act) excluded banks from broker-dealer regulations by defining the terms "broker" and "dealer" to exclude banks thereby removing them in many ways from the jurisdiction of the Securities and Exchange Commission (SEC).

Congress passed the Gramm-Leach-Bliley Act (GLB) in 1999 repealing most of the separation provisions of the Glass-Steagall Act. GLB significantly modified Section 3(a)(4) of the Exchange Act, by replacing the broad exclusion of banks from broker-dealer regulation with specific exceptions from the need for banks to register as a broker when engaging in certain securities-related activities.

Two exceptions of broad applicability that are created by the amended definition of broker are the networking exception that allows a broker-dealer to share securities commissions with banks and the trust and fiduciary activities exception that allow trust departments to engage in certain securities-related activities. Fortunately, the amended definition of broker allows broker-dealers, such as Cetera Financial Institutions, to continue to share a percentage of securities commissions with banks. The effect on trust departments is more complex and is outside the scope of this white paper.

The GLB directed the SEC to issue regulations to provide much of the detail necessary for implementation of the functional regulation requirement. The SEC met with tremendous resistance in its efforts to issue regulations. Interim rules were adopted in 2001; extended into 2004 and replaced in 2004 by proposed Regulation B, which never became effective. The Financial Services Regulatory Relief Act of 2006 directed the SEC and the Board of Governors of the Federal Reserve System to jointly issue a single set of rules to facilitate banks' compliance with Section 3(a)(4). Thus, Regulation R was born.

Regulation R provides guidance to supplement Section 3(a)(4) of the Exchange Act, as amended by GLB, with respect to regulatory exceptions for banking activities relating to:

1. third-party networking arrangements;
2. trust and fiduciary activities;
3. sweep activities;
4. safekeeping and custody activities;
5. foreign securities transactions;
6. securities lending transactions conducted in an agency capacity;
7. execution of transactions involving mutual fund shares; and
8. employee benefit plan equity direct purchases.

This white paper will focus on the requirements and guidance provided by GLB and Regulation R specifically for third-party networking arrangements.

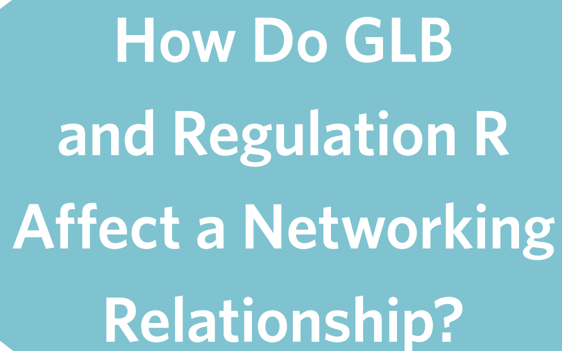
To Whom Does Regulation R Apply?

Regulation R and Section 3(a)(4) of the Exchange Act, as amended by GLB, generally address securities-related activities banks may engage in and how banks may conduct those activities in a manner to avoid meeting the definition of a broker. If a bank's activities exceed the exceptions then the bank would be subject to the registration requirements, as well as the full scope of substantive regulatory requirements, of the Exchange Act. As such Regulation R does not, with one unique variance, apply to broker-dealers. Compliance by banks with Regulation R and the limitations of Section 3(a)(4) of the Exchange Act should be a significant focus of the legal and compliance advisors of affected banks.

Regulation R relies upon the definition of a "bank" in Section 3(a)(6) of the Exchange Act. This definition of a bank was amended by the Financial Services Regulatory Relief Act of 2006 to add federal savings associations and FDIC-insured state savings associations, but did not include credit unions. Thus, for purposes of compliance with Regulation R, all banks and savings associations must comply, but credit unions will need to continue to rely upon the SEC's Chubb No-Action Letter and the NCUA's Letter 150 for guidance when entering into networking relationships.

What is the Compliance Date for Regulation R?

Regulation R was effective on December 3, 2007. Fortunately, the mandatory compliance date for Regulation R and the push out rules of GLB was the first day of the bank's first fiscal year starting after September 30, 2008. Therefore, a bank whose fiscal year coincides with the calendar year had a mandatory compliance date of January 1, 2009.



Fortunately, GLB in amending the definition of broker in the Exchange Act preserved the long standing ability of banks to enter into networking arrangements with broker-dealers. It is extremely important to bear in mind that Regulation R is only one part of the full regulatory picture.

GLB's amendment of the definition of broker provides the majority of guidance relative to the proper structure and operation of a networking arrangement. In creating the networking exception set out in Section 3(a)(4) of the Exchange Act, GLB set forth the following requirements for networking arrangements:

THIRD-PARTY BROKERAGE ARRANGEMENTS

The bank enters into a contractual or other written arrangement with a broker or dealer registered under this title under which the broker or dealer offers brokerage services on or off the premises of the bank if:

1. such broker or dealer is clearly identified as the person performing the brokerage services;
2. the broker or dealer performs brokerage services in an area that is clearly marked and, to the extent practicable, physically separate from the routine deposit-taking activities of the bank;
3. any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement clearly indicate that the brokerage services are being provided by the broker or dealer and not by the bank;
4. any materials used by the bank to advertise or promote generally the availability of brokerage services under the arrangement are in compliance with the federal securities laws before distribution;
5. bank employees (other than associated persons of a broker or dealer who are qualified pursuant to the rules of a self-regulatory organization) perform only clerical or ministerial functions in connection with brokerage transactions including scheduling appointments with the associated persons of a broker or dealer, except that bank employees may forward customer funds or securities and may describe in general terms the types of investment vehicles available from the bank and the broker or dealer under the arrangement;
6. bank employees do not receive incentive compensation for any brokerage transaction unless such employees are associated persons of a broker or dealer and are qualified pursuant to the rules of a self-regulatory organization, except that the bank employees may receive compensation for the referral of any customer if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction;
7. such services are provided by the broker or dealer on a basis in which all customers that receive any services are fully disclosed to the broker or dealer;
8. the bank does not carry a securities account of the customer except as permitted under clause (2) or (8) of this subparagraph; and the bank, broker, or dealer informs each customer that the brokerage services are provided by the broker or dealer and not by the bank and that the securities are not deposits or other obligations of the bank, are not guaranteed by the bank, and are not insured by the FDIC.

It is important to be aware that six of the eight conditions require that the investing public be clearly informed that the broker-dealer sells securities and not the bank. Cetera Financial Institutions has built all of these

conditions into its advertising guidelines. Thus, making sure that all marketing and advertising material follows the Cetera Financial Institutions advertising guidelines is an excellent means for the bank's marketing and compliance personnel to monitor compliance by the bank with this important part of the Exchange Act.

The networking exception contained in GLB does not address the type or amount of compensation that a bank may receive from the broker-dealer under a networking arrangement. The exception does, however, indicate that a bank may not pay its unregistered employees incentive compensation for any brokerage-related activities. Certain exclusions to this general rule have been carved out. GLB permits an unregistered bank employee to receive a nominal one-time cash fee of a fixed-dollar amount for a referral to the broker-dealer if payment of the referral fee is not contingent on whether the referral results in a transaction. In addition, Regulation R in clarifying the definition of prohibited "incentive compensation" clears the way for certain types of bonus plans, as long as those plans are paid on a discretionary basis and based on multiple factors or variables.

Referral Fees

Regulation R provides extensive detail in defining what Congress meant in GLB when allowing unregistered bank employees to receive compensation for the referral of a customer if the compensation is a nominal one-time cash fee of a fixed-dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction.

Nominal

Regulation R creates a new definition of what would constitute a "nominal" fee for referrals and permits the fee to be calculated in one of three main ways:

1. The first and simplest option within the definition of nominal is a one-time cash payment for each referral of up to $25, as adjusted from time to time.
2. The second option would be a referral fee that is based upon the employee's actual pay and may be up to twice the employee's actual hourly wage, or 1/1,000th of the employee's actual annual base salary.
3. The third option allows for a "job family" of employees to receive the same referral fee. The regulation allows for the payment of a referral fee not to exceed twice the average of the minimum and maximum hourly wage or 1/1,000th of the average of the minimum and maximum annual base salary established by the bank for the current or prior year for the job family that includes the employee.

Regulation R also defines a job family to be a group of jobs or positions involving similar responsibilities or skills, education or training and also stipulates that these must be groupings used in the ordinary course of business within the bank and not created simply for purposes of paying referral fees.

One Time

Regulation R holds firm to the concept of a one-time fee. However, in situations in which more than one person is involved in the referral, all employees who personally participated in the referral may receive a one-time cash fee for the referral. In addition, it appears that a referral fee may be paid for each referral made, including separate referrals of the same individual or entity.

Cash Fee

The regulation clearly states that the fee must be paid in cash. This will be a significant change for some bank's referral programs. A bank may not pay referral fees in non-cash forms, such as vacation packages, stock grants, lottery tickets, personal time off, annual leave or consumer goods. However, the timing of the referral fee is flexible. In other words, the referral payment doesn't have to be made immediately, but can be paid on a quarterly or other periodic basis.

Fixed Dollar Amount

While Regulation R allows a bank some flexibility in determining the amount of the fee, the fee must be fixed before the referral is made and may not be contingent or vary on any subjective criteria, such as the number of referrals made within a set period of time. In other words, tiered or staggered programs or referral contests which result in an additional benefit will not be permitted under the new rule.

Qualified Referrals

The statutory networking exception states that the payment of the referral fee may not be contingent on the whether the referral results in a transaction. Regulation R, however, recognizes that the payment of the fee may be for qualified referrals, in that the referral payment may be contingent on whether a customer contacts or keeps an appointment with a registered representative or meets any baseline criteria preset by the bank such as minimum assets or net worth or any citizenship or residency requirements.

Exception for Institutional and High-Net-Worth Individuals

Regulation R allows an unregistered bank employee to receive a greater than nominal referral fee for referring a high-net-worth or institutional customer under certain conditions. While the understanding of how to properly structure a referral fee program for institutional and high-net-worth individuals is important, it is necessary to first understand what can be paid as a referral fee to determine whether a given bank will adequately benefit from the additional flexibility for referrals of institutional and high-net-worth individuals.

Referral Fee Limitation

Regulation R does place limits on the amount of the referral fees a bank employee may receive for institutional or high-net-worth individuals. These limitations are designed to reduce the potential "salesman's stake" of the bank employee in securities transactions conducted at the broker-dealer. The regulation indicates that 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:

1. the revenue generated by, or the profitability of, securities transactions conducted by the customer with the broker-dealer;
2. the quantity, price, or identity of securities purchased or sold over time by the customer with the broker-dealer; or
3. the number of customer referrals made.

For these purposes, "predetermined" means established or fixed before the referral is made. 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.

The result of the limitations is that the amount of the referral fee must be established by the bank without reference to any economic benefit that may be received by the bank. Additionally the referral fee must be established without reference to whether the customer will affect any transaction or transactions in any particular product there by limiting the ability to guess at the economic benefit of the referral. Put more directly, the bank will need to set the referral fee before it will know what, if any, economic benefit will be received by the bank from the referral. This suggests that most banks will be quite conservative in setting referral fees for institutional or high-net-worth individuals. It is also likely that given this economic limitation and the significant complexity, described below, of facilitating the institutional and high net worth exceptions that banks may use the more common and predictable definition of nominal for all referral activity.

Customer Qualification

In order to have more flexibility in the referral fee amount the customer must qualify as a high-net-worth or institutional customer. A high-net-worth customer is defined as a natural person, who, either individually or jointly with their spouse, has at least $5 million in net worth, excluding the primary residence and associated liabilities. This would include any revocable, inter vivo or living trust accounts the settler of which is a natural person.

An institutional customer is defined as a non-natural person (i.e., corporation, limited liability company, trust, etc.) with at least $10 million in investments or $20 million in revenues.

Disclosure

In order for the bank to qualify for the higher referral fee, the bank must provide to the institutional or high-net-worth customer written disclosure that clearly and conspicuously discloses the name of the broker-dealer and that the bank employee making the referral is participating in an incentive program under which they may be paid more than a nominal amount. In addition, the disclosure must indicate that the fee may be contingent on whether the referral results in a transaction with the broker-dealer.

This disclosure may be provided by the bank in writing prior to or at the time of the referral. Or, alternatively, the disclosure can be provided verbally to the customer and the bank must then follow up in writing within three business days of the referral. The rules also allow for the broker-dealer to provide the written disclosure to the customer prior to or at the time the customer begins the process of opening an account at the broker-dealer or prior to the time the customer places an order for a securities transaction with the broker-dealer if stated in the networking contract between the parties.

Suitability Analysis

In addition, if the referral fee is contingent on whether the referral results in a transaction, the broker-dealer must perform a suitability analysis on each transaction, before the securities transaction is conducted. The requirement of suitability pre-review by the broker-dealer based upon the bank's referral program is extremely disruptive and an amazing example of jurisdictional gymnastics. If the referral fee is not contingent on a resulting transaction, but before the referral fee is paid by the bank, the broker-dealer must either perform a suitability analysis or determine that the customer has the capability to evaluate the investment risk and is exercising independent judgment in making the investment decisions. The suitability requirement poses an interesting challenge. Not only does it require significant communication and cooperation between the bank and the broker-dealer, but it opens the door for regulatory interpretation of jurisdictional responsibility.

Bank Employee Qualifications

The referring employee, in order to receive a larger than nominal referral fee, must meet certain qualifications. Specifically, the employee must be predominantly engaged in banking activities and have encountered the institutional or high-net-worth customer in the ordinary course of their assigned duties for the bank. The bank employee may not be registered with FINRA or subject to a statutory disqualification under the Exchange Act. The onus is on the broker-dealer to verify that the bank employee qualifies for the larger than nominal referral fee; but the rule requires the bank to provide this information to the broker-dealer at least annually.

Incentive Compensation

Section 700(b)(1) of Regulation R creates an exception to the general prohibition in GLB regarding incentive compensation. It adopts a definition of incentive compensation that recognizes that discretionary bonus plans based upon multiple significant factors or variables are not likely to give unregistered bank employees an undue promotional interest or salesman's stake in the brokerage services offered by the broker-dealer. This definition factors in general business practices and attempts to accommodate existing types of bank bonus plans.

Discretionary Basis

A bonus or similar plan will be considered discretionary if the amount an employee may receive under the plan is not fixed in advance and the employee does not have an enforceable right to payments under the plan until the amounts are established and declared by the bank. In addition, Regulation R recognizes that the structure of most bonus plans include the use of targets, goals or metrics that must be met in order for any bonus to be paid. The regulation specifically allows the use of such metrics to be included in any bonus or similar plan, provided the plan is otherwise a discretionary plan.

Multiple Factors or Variables

Regulation R requires there to be multiple factors or variables in a bonus plan to fit within the exception to GLB. Each multiple factor or variable of the plan must be significant; may not be related to a securities transaction; may not include referrals; and may not include reference to referrals made by others.

Each factor or variable will be considered significant if it plays a material role in determining an employee's compensation under the bonus plan (i.e., the amount of the employee's bonus could be reduced or increased by a material amount based on the non-securities factor or variable.) In considering if a bonus program contains sufficient banking or other factors unrelated to securities transactions, the agencies will consider, among other things:

1. whether such factors or variables relate to banking or other non-broker-dealer business actually being conducted by the bank or its employees;
2. the resources devoted by the bank to such business; and
3. whether such business materially contributes to the payments made under the plan over time.

The exception is designed to accommodate discretionary bank bonus programs based on general measures of the business or performance of a bank or division of the bank, not on referrals; allowing for some factor based on securities activity as well as multiple significant factors that are unrelated to securities activity. The regulation explicitly notes that using the number of referrals as a factor is prohibited.

Safe Harbor

The final rule retains a safe harbor designed to avoid having to analyze the minute details of a particular bonus program to determine if the plan meets the requirements for exception. The safe harbor will apply in circumstances where the general structure of the program clearly reduces the potential for sales practice concerns.

The provision allows a bonus or similar plan based upon any measure of the overall profitability or revenue of the bank, any affiliate or operating unit of the bank (other than a broker-dealer) as long as:

1. such measure of overall profitability or revenue is only one of multiple factors or variables used to determine the compensation;
2. the factors or variables used to determine the compensation include multiple significant factors or variables that are not related to the profitability or revenue of the broker-dealer;
3. a referral made by the employee is not a factor or variable in determining the compensation under the plan; and
4. the employee's compensation under the plan is not determined by reference to referrals made by any other person.

The rationale of the safe harbor being that any potential connection between the revenue received as a result of a referral and the payments made under the plan would be tenuous and largely speculative thereby effectively addressing any undue promotional interests of an employee. Bonus plans based on a bank's earnings per share or stock price would be directly related to the overall profitability or revenue and would therefore be allowed under the safe harbor.

Other plans that don't fit solidly within this safe harbor exception will be reviewed and analyzed under the multi-factor, discretionary criteria. This would also apply to those plans based in any way on the revenue or profitability of the unit or branch or the division that includes an affiliated broker-dealer. Fee income to the bank derived from the broker-dealers activities either on a gross or net basis would appear to be includable in the measure of overall profitability or revenue of the bank along with other significant bank related factors or variables.

Enforcement

Over the years there have been many varied and creative campaigns devised to provide incentives to unregistered bank employees. It would appear that programs that pay a higher dollar amount for reaching a certain threshold number of referrals; qualifying (or not qualifying) for an incentive bonus by having a set number of referrals; contests between branches or groups of bank employees to see who can produce the most referrals as elements of a bonus plan would no longer be allowed.

The banking agencies have indicated that they expect to review bank bonus plans in the context of the networking exception as part of their bank examinations. If bonus plans evolve over time to include payments predominantly related to securities transactions, the agency's expectations are that those plans will be modified in accordance with the new guidelines.

Finally, as indicated above, Regulation R and the GLB amendments to the Exchange Act principally govern the activities of banks, not the brokerage firm. Therefore, it is the legal, compliance and business decision of the bank regarding the referral and bonus programs. Cetera Financial Institutions

can provide guidance and information, but ultimately it will be the bank's responsibility to properly structure any referral program or bonus compensation plan for unregistered bank employees.

What Can We Expect In the Future?

The banking regulators (Federal Reserve, OCC, FDIC, and OTS) are required by GLB to promulgate recordkeeping rules for banks that will operate under the broker exceptions in Section 3(a)(4) of the Exchange Act. These rules, which are to be developed in consultation with the SEC, will establish recordkeeping requirements to enable banks to demonstrate and facilitate compliance with the terms of the statutory exception and the final rules.

The Federal Reserve and the SEC in their communications have indicated they expect to continue their dialogue with FINRA concerning potential modification to FINRA's Conduct Rule 3040. Conduct Rule 3040 currently creates a significant barrier to a registered representative's ability to participate in securities transactions that are not effected through the employing broker-dealer. With the adoption of Regulation R, Conduct Rule 3040 and its approach to protecting purchasers of securities remains a significant turf battle between the banking and the securities regulators.

Any future additions or changes to Regulation R necessary to implement GLB's requirements must be adopted jointly by the SEC and the Federal Reserve. Expectations are that the need for joint activity will make additions and changes to Regulation R difficult and time consuming, and as such, infrequent.

Requests for interpretation guidance also require the SEC and the Federal Reserve to issue this guidance jointly. This is also expected to result in a time consuming and as such infrequent approach to interpretive guidance. In the event of an enforcement action the SEC and Federal Reserve are not only required to work jointly, but also to include the federal banking agency for the bank in question. This is a significant level of complexity that could lead to a higher level of confusion and a lack of predictability.

Conclusion

Regulation R, and the more important amendments to the definition of broker in the Exchange Act, are in large part consistent with the Interagency Statement on the Retail Sale of Non-Deposit Investment Products issues by the federal banking regulators in 1994. Regulation R adopts a similar but more structured approach to most referral fees. In the area of institutional or high-net-worth customers Regulation R opens the door to more flexibility in the amount of the referral fee but creates a very complex set of limitations and requirements that may make it impractical to use this additional flexibility. The treatment of bank employee bonus programs in Regulation R provides clarity for a useful management tool which is now available to banks.

All banks currently in or considering a brokerage networking relationship should take the pending effective date of Regulation R as a reminder to review their networking relationship to ensure that not only are the requirements of Regulation R addressed but more importantly that the guidance provided by Congress in creating the networking exception to the definition of "broker" in the Exchange Act is being closely followed. It is possible that bank and securities examiners, both at the federal and state level, will use the effective date of Regulation R to increase scrutiny of the way in which networking relationships, particularly elements related to customer confusion, are conducted.

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