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**Re: New Regulation R is Proposed by the SEC and FRB**

Dear Clients and Other Friends:

As required under the Financial Services Regulatory Relief Act of 2006 (signed into law by President Bush on October 13, 2006), the Securities and Exchange Commission ("SEC") and Board of Governors of the Federal Reserve System ("FRB") on December 26, 2006 published joint proposed rules known as "Regulation R" to implement the "broker" exceptions for banks under Section 3(a)(4) of the Securities Exchange Act of 1934. These exceptions have been debated since they were adopted as part of the Gramm-Leach-Bliley Act of 1999 (GLBA).

Regulation R will help define the scope of securities activities that banks may conduct without registering with the SEC as a securities broker. Specifically, Regulation R will implement the statutory exceptions that allow a bank to continue to conduct securities transactions for its customers as part of the bank's trust and fiduciary, custodial and deposit "sweep" functions, and to refer customers to a broker-dealer pursuant to a networking arrangement.

Comments on Regulation R are requested on or before March 26, 2007. As part of the Regulation R proposal, the SEC extended the temporary exemption of banks from the definition of "broker" until July 2, 2007.

**Networking Exception.**

GLB provides an exception from the definition of broker that permits banks to contract with broker-dealers to offer brokerage services, without the bank itself registering as a broker (the "Networking Exception"). The Networking Exception permits the following bank activities:

*"Nominal" Referral Fee.* Under Reg. R, an unregistered bank employee may receive a "nominal one-time cash fee of a fixed dollar amount" for referring a customer to the broker-dealer. A referral fee is "nominal" if it satisfies one of three alternative definitions set forth in the Regulation.

*Bank Bonus Programs are Permissible.* Reg. R allows some securities related bonus compensation that is not deemed to be impermissible "commission" or "incentive"

compensation. The factors to be utilized by the bank in setting its bonus program, however, must include significant factors that are not related to securities transactions at the broker-dealer.

*Higher Referral Fee for Referring Institutional and High Net Worth Customers.* A higher than nominal referral fee for referring institutional and high net worth customers should be permissible. This is because sizable institutions and high net worth individuals are more likely to be able to “fend for themselves” and understand and evaluate the relationship between the bank, its employees and its broker-dealer partner.

The proposal asserts that a bank must act in good faith and establish reasonable policies and procedures to comply with these requirements. Furthermore, the bank and its broker-dealer must include specific provisions in their written agreement that obligate the bank or the broker-dealer to take certain actions. Banks will need to review their compliance procedures and broker-dealer agreements to assure compliance with Reg. R.

### **Trust and Fiduciary Exception.**

GLB contains an exception from the definition of broker that permits a bank to effect transactions in a trustee or fiduciary capacity without registering as a broker. The bank must be “chiefly compensated” for such transactions, consistent with fiduciary principles and standards. These fees are referred to as “relationship compensation” in proposed Reg. R.

Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities only in conjunction with their trust activities.

*“Chiefly Compensated”.* The proposed rules establish alternative tests for banks to determine whether they are “chiefly compensated” on the basis of “relationship compensation.”

The first test is an “account-by-account” test that requires the “relationship-total compensation percentage” for each trust or fiduciary account to be greater than 50%. The second test is a “bank-wide” test that requires the “relationship-total compensation percentage to be at least 70%. It is intended to provide banks with a simpler method of complying with the regulations’ interpretation of “chiefly compensated.”

Under either test, the bank has the flexibility to elect to use a calendar year or the bank’s fiscal year for purposes of complying with the compensation provisions. Also, either test is based on a two-year rolling average of the relevant compensation.

*“Relationship Compensation” Includes 12b-1 Fees.* Reg. R provides that a fee based on a percentage of assets under management (an “AUM fee”) includes, *without limitation*, a 12b-1 fee paid by a mutual fund.

## **Sweep Accounts and Transactions in Money Market Funds**

This exception allows a bank to effect transactions as part of a program for the investment or re-investment of deposit funds into any “no-load” open-end mutual fund that holds itself out as a money market fund.

*Money Market Transactions.* Reg. R includes a new exemption that would permit banks, without registering as a broker, to effect transactions on behalf of a customer in securities issued by a money market fund under certain conditions. This acknowledges that banks have long offered sweeps and other services that invest customer funds in money market funds that do not qualify as “no-load” funds under NASD rules. To qualify for the proposed exemption, the bank would be required to provide the customer, any other bank product or service, which would not require the bank to register as a broker.

## **Safekeeping and Custody**

This proposed exemption allows banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts<sup>1</sup> and IRAs and similar accounts, including HSAs<sup>2</sup>, for which the bank acts as custodian. The exemption also allows banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of custodial accounts.

*Employee Benefit Plan Accounts and Individual Retirement or Similar Accounts are subject to additional regulation including:*

- Employee Compensation Restrictions.
- Advertisement and Sales Literature Restrictions.

*Accommodation Transactions.* In addition to the employee benefit plan/IRA rules for custodial accounts, banks may also accept securities orders for other custodial accounts as an accommodation to the customer, subject to restrictions set forth in the regulation.

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<sup>1</sup> “*Employee benefit plan account*” under Reg. R means a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan or other similar plan, “*including without limitation,*” a 401(a) employer-sponsored plan, a 457 plan, a 403(b) plan, a 414 church plan, governmental or multiemployer plan, a 422 incentive stock option plan, a VEBA, a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan and a supplemental unemployment plan.

<sup>2</sup> “*Individual retirement or similar account*” under Reg. R means an IRA, Roth IRA, HSA, Archer MSA and Coverdell ESA “or similar account.” SIMPLE IRAs and SEP-IRAs are included. Thankfully, as requested by some Reg. B comment letters, the SEC and FRB provided an expansive definition of IRA or similar accounts (as well as “employee benefit plan account” with respect to that definition).

## **Other Exemptions**

Regulation R also includes exemptions from the definition of “broker” for the following activities of banks:

- Mutual fund transactions through NSCC’s Fund/SERV or directly with a transfer agent.
- Noncustodial securities lending services.
- Agency transactions with non-U.S. persons under Regulation S.
- Banks are provided a transitional 18-month exemption to prevent their contracts from being void or voidable under the Exchange Act Section 29(b).
- Banks are provided with a transitional 18-month exemption until the bank’s first fiscal year commencing after June 30, 2008. This provides banks time to make changes to their compliance programs.
- Banks are provided a permanent Exchange Act Section 29(b) exemption if (1) the bank acts in good faith, (2) has established reasonable policies and procedures to comply with Reg. R requirements and (3) a Reg. R violation does not result in significant harm, financial loss or cost to the person seeking to void the contract because of the alleged activity in violation of Reg. R.

## **Proposed Reg. R Requirements Must be Understood and Addressed**

This letter is a brief summary. Many conditions and requirements of proposed Reg. R cannot be set forth in this limited space. One thing is certain, however, banks will have to carefully review their agreements with broker/dealers for legal compliance with Reg. R as well as affected compliance programs.

We welcome your inquiries.

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