

Regulation R: Exceptions for Banks from the Definition of Broker in the Securities Exchange Act of 1934 – A Small Entity Compliance Guide¹
12 CFR 218 and 17 CFR 247

Regulation R implements certain of the broker exceptions for banks from the definition of the term “broker” under Section 3(a)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), as amended by the Gramm-Leach-Bliley Act (“GLBA”). Specifically, Regulation R implements the bank broker exceptions relating to third-party networking arrangements, trust and fiduciary activities, deposit “sweep” activities, and custody and safekeeping activities.

Section 3(a)(4)(B) of the Exchange Act also includes other “broker” exceptions for banks. These exceptions include transactions in exempt securities (such as U.S. government securities); certain stock purchase plans; affiliate transactions; private securities offerings; identified banking products; municipal securities; and a de minimis number of other securities transactions. Although Regulation R does not include provisions related to these statutory exceptions, they remain in force and available to banks.

Regulation R also includes certain exemptions related to foreign securities transactions, securities lending transactions conducted in an agency capacity by a bank that does not have custody of the securities being borrowed or lent, the execution of transactions involving mutual fund shares and variable annuities, and the potential liability of banks under Section 29 of the Exchange Act.

If more than one broker exception or exemption is available to a bank under the statute or rules for a securities transaction, the bank may choose the exception or exemption on which it relies to effect the transaction without registering as a broker-dealer. For example, if a bank effects no more than 500 securities transactions as agent for its customer in a calendar year, the bank may rely on the de minimis exception in section 3(a)(4)(B)(xi) of the Exchange Act in lieu of any other available exception or exemption for such transactions. The bank, of course, must comply with all of the requirements contained in the exception or exemption on which it relies.

A general description of the regulation, by section, follows. Any bank that wants to rely on one of these exceptions or exemptions to the definition of broker should review and understand the terms, limits and conditions to the particular exception or exemption.

Section 218.100 and *Section 247.100* **Definition**

¹ This guide was prepared by the staffs of the Board of Governors of the Federal Reserve System and the U.S. Securities and Exchange Commission as a “small entity compliance guide” under Section 212 of the Small Business Regulatory Enforcement Fairness Act of 1996, as amended. The guide summarizes and explains rules adopted by the Board and the Commission but is not a substitute for any rule itself. Only the rule itself can provide complete and definitive information regarding its requirements.

Defines “Act” for purposes of this part to mean the Securities and Exchange Act of 1934.

Section 218.700 and *Section 247.700* **Defined terms relating to the networking exception from the definition of broker**

The networking exception in Section 3(a)(4)(B)(i) of the Exchange Act permits bank employees that are not registered representatives of a broker-dealer to refer customers to a broker-dealer subject to several conditions. One of these conditions generally prohibits a bank employee that refers a customer to a securities broker-dealer from receiving “incentive compensation” for a securities brokerage transaction other than a “nominal” one-time cash fee for making the referral that is not contingent on whether the referral results in a securities transaction. Rule 700 defines key terms used in the networking exception, including the terms “incentive compensation” and “nominal one-time cash fee of a fixed dollar amount.” Rule 700 includes four different alternatives for satisfying the requirement that a referral fee be “nominal.” These alternatives include a flat \$25 standard (to be adjusted for inflation) and other standards based on the employee’s actual base hourly or annual compensation or the base hourly or annual compensation associated with the employee’s job family. The definition of “incentive compensation” in Rule 700 includes exclusions from that definition for certain types of bank bonus plans.

Section 218.701 and *Section 247.701* **Exemption from the definition of broker for certain institutional referrals**

Rule 701 permits a bank, subject to a variety of conditions, to pay an unregistered employee a higher-than-nominal, contingent fee for the referral of an “institutional customer” or a “high net worth customer” to a broker-dealer. Rule 701 defines certain terms, including “institutional customer” and “high net worth customer,” and sets forth the conditions that apply to a bank making referrals under this section.

Section 218.721 and *Section 247.721* **Defined terms relating to the trust and fiduciary activities exception from the definition of broker**

Section 3(a)(4)(B)(ii) of the Exchange Act permits a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without being registered as a broker. The Exchange Act provides that a bank must be “chiefly compensated” for effecting securities transactions for trust and fiduciary accounts by certain types of fees, which are defined as “relationship compensation” by the rule. Rules 721 and 722 allow banks to use one of two approaches to calculate compliance with the chiefly compensated test: an account-by-account approach or a bank-wide approach. Rule 721 explains how a bank using the account-by-account approach must monitor its compliance with the chiefly compensated test. Rule 721 also provides examples of the type of fees that qualify as “relationship compensation” and provides the conditions a bank must comply with in order to rely on the trust and fiduciary exception, such as restrictions on the bank’s advertisement of its securities activities for its trust and fiduciary accounts.

Section 218.722 and *Section 247.722* **Exemption allowing banks to calculate trust and fiduciary compensation on a bankwide basis**

Rule 722 explains how a bank using the bank-wide approach must monitor compliance with the “chiefly compensated” test in the trust and fiduciary exception. Rule 722 also identifies the other conditions that apply to a bank using this methodology.

Section 218.723 and *Section 247.723* **Exemptions for special accounts, transferred accounts, and a de minimis number of accounts**

Rule 723 permits a bank to exclude certain compensation attributable to a trust or fiduciary account in determining its compliance with the trust and fiduciary exception’s “chiefly compensated” test.

Section 218.740 and *Section 247.740* **Defined terms relating to the sweep accounts exception from the definition of broker**

Exchange Act Section 3(a)(4)(B)(v) excepts a bank from the definition of “broker” to the extent it effects transactions as part of a program for the investment or re-investment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) that holds itself out as a money market fund. Rule 740 defines key terms used in the sweep accounts exception from the definition of “broker,” including “money market fund” and “no-load.”

Section 218.741 and *Section 247.741* **Exemption for banks effecting transactions in money market funds**

Rule 741 permits a bank, subject to certain conditions, to sweep funds in a deposit account into a money market fund that is not a no-load fund. In addition, the Rule permits a bank to invest other customers’ funds into a money market fund if the customer has some other banking relationship with the bank and certain other conditions are met.

Section 218.760 and *Section 247.760* **Exemption from definition of broker for banks accepting orders to effect transactions in securities from or on behalf of custody accounts**

The safekeeping and custody exception in Section 3(a)(4)(B)(viii) of the Exchange Act permits banks to engage in a variety of securities activities in connection with their customary custody and safekeeping activities, such as, for example, clearing and settling securities transactions; exercising warrants and other rights associated with securities held in custody; effecting securities lending or borrowing transactions as part of its custodial services; holding pledged securities on behalf of a customer; and serving as a custodian or providing other related administrative services to certain accounts and benefit plans. Rule 760 of Regulation R permits a bank acting as a custodian (or in certain other capacities specified in the rule) to accept securities orders, subject to certain conditions, for (i) employee benefit plan accounts and individual retirement and similar accounts (“IRAs”) and (ii) other custodial customers as an accommodation to the customers. The applicable conditions are specified in the rule and vary depending on the type of account for which the bank is accepting orders.

A bank does not need to rely on this exception if it does not accept orders from or on behalf of custody accounts.

Section 218.771 and Section 247.771 **Exemption from the definition of *broker* for banks effecting transactions in securities issued pursuant to Regulation S**

Rule 771 permits a bank, subject to certain conditions, to effect transactions in securities issued or sold pursuant to the Securities and Exchange Commission's Regulation S, a safe harbor from registration under the Securities Act of 1933 for certain offshore securities transactions.

Section 218.772 and Section 247.772 **Exemption from the definition of *broker* for banks engaging in securities-lending transactions**

Rule 772 permits a bank to effect securities lending transactions for "qualified investors" and certain employee benefit plans in situations where the bank does not have custody of the securities being borrowed or lent.

Section 218.775 and Section 247.775 **Exemption from the definition of *broker* for banks effecting certain excepted or exempted transactions in investment company securities**

Rule 775 permits a bank to effect transactions in the shares of certain registered mutual funds and certain variable insurance contracts under the statutory trust and fiduciary exception (and the exemption in Rule 722), safekeeping and custody exception (and the exemption in Rule 760) and the exception for transactions in certain stock purchase plans in section 3(a)(4)(B)(iv) without sending the trade to a broker-dealer for execution as would otherwise be required by section 3(a)(4)(C) of the Exchange Act.

Section 218.776 and Section 247.776 **Exemption from the definition of *broker* for banks effecting certain excepted or exempted transactions in a company's securities for its employee benefit plans**

Rule 776 permits a bank, without registering as a broker, to effect certain transactions for an employee benefit plan in the securities of the plan's sponsor.

Section 218.780 and Section 247.780 **Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934**

Rule 780 provides an exemption for banks from potential liability under section 29 of the Exchange Act, subject to certain conditions.

Section 218.781 and Section 247.781 **Exemption from the definition of *broker* for banks for a limited period of time**

Rule 781 provides that a bank must comply with Regulation R and the "broker" exceptions in section 3(a)(4)(B) of the Exchange Act beginning the first day of the bank's first fiscal year that commences after September 30, 2008.

Other Resources

The adopting release for Regulation R can be found at 72 FR 56514 (Oct. 3, 2007), on the Commission's website at <http://www.sec.gov/rules/final/2007/34-56501.pdf>, and on the

U.S. Government Printing Office's website at <http://edocket.access.gpo.gov/2007/pdf/07-4769.pdf>.

Contacting the Commission or the Board

The Commission's Division of Trading and Markets and the Board are pleased to assist small entities with questions regarding Regulation R.

At the Commission, the Office of Interpretation and Guidance responds to questions submitted by email and telephone. You can submit a question by email to tradingandmarkets@sec.gov or you can contact the Office of Interpretation and Guidance at (202) 551-5777.

You can submit a question to the Board on the Board's website at <http://www.federalreserve.gov/feedback.cfm>.