Federal Register

Wednesday,
October 3, 2007

# Part III

# Federal Reserve System

# Securities and Exchange Commission

**12 CFR Part 218 and 17 CFR Parts 240 and 247**

**Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks and Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules; Final Rules**

**FEDERAL RESERVE SYSTEM**

**12 CFR Part 218**

**[Regulation R; Docket No. R–1274]**

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 240 and 247**

**[Release No. 34–56501; File No. S7–22–06]**

**RIN 3235–AJ74**

## Definitions of Terms and Exemptions Relating to the ''Broker'' Exceptions for Banks

**AGENCIES:** Board of Governors of the Federal Reserve System (''Board'') and Securities and Exchange Commission (''SEC'' or ''Commission'') (collectively, the Agencies).

**ACTION:** Final rule.

**SUMMARY:** The Board and the Commission jointly are adopting a single set of final rules that implement certain of the 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''). The rules define terms used in these statutory exceptions and include certain related exemptions. In developing these rules, the Agencies have consulted with, and sought the concurrence of, the Office of the Comptroller of the Currency (''OCC''), the Federal Deposit Insurance Corporation (''FDIC'') and the Office of Thrift Supervision (''OTS''), and have taken into consideration all comments received on the proposed rules issued in December 2006. The rules are intended, among other things, to facilitate banks' compliance with the Exchange Act and the GLBA.

**DATES:** *Effective dates:* The addition of parts 12 CFR 218 and 17 CFR 247 is effective September 28, 2007. Regulations at 12 CFR 218.781 and 17 CFR 247.781 (collectively ''Rule 781'') are effective on September 28, 2007. Regulations at 12 CFR 218.100 through 218.780 and 17 CFR 247.100 through 247.780 are effective December 3, 2007. Amendments affecting Part 240 of Title 17 are effective December 3, 2007.

*Compliance date:* Banks are exempt from complying with the rules and the ''broker'' exceptions in Section 3(a)(4)(B) of the Exchange Act until the first day of their first fiscal year that commences after September 30, 2008.

**FOR FURTHER INFORMATION CONTACT:**

*BOARD:* Kieran J. Fallon, Assistant General Counsel, (202) 452–5270, Andrea Tokheim, Counsel, (202) 452–2300, or Brian Knestout, Attorney, (202) 452–2249, Legal Division, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Users of Telecommunication Device for Deaf (TDD) only, call (202) 263–4869.

*SEC:* Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel, Joshua Kans, Senior Special Counsel, John J. Fahey, Branch Chief, or Elizabeth MacDonald, Special Counsel, at (202) 551–5550, Office of the Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:**

**Table of Contents**

I. Introduction
A. Background
B. Overview of Comments
C. Final Rules and Related Matters
II. Networking Arrangements
A. Overview of Proposed Rules and Comments
B. Rule 700: Definition of Terms Used in Networking Exception
1. Definition of ''Nominal One-Time Cash Fee of a Fixed Dollar Amount''
2. Definition of ''Referral''
3. Definition of ''Contingent on Whether the Referral Results in a Transaction''
4. Definition of ''Incentive Compensation''
a. Exception for Discretionary, Multi-Factor Bonus Plans
b. Safe Harbor for Plans Based on Overall Profitability or Revenue
C. Rule 701: Exemption for Referrals Involving Institutional Customers and High Net Worth Customers
1. Definitions of ''Institutional Customer'' and ''High Net Worth Customer''
2. Determining that a Customer Meets the Relevant Thresholds
3. Conditions Relating to Disclosures
4. Suitability or Sophistication Analysis by Broker-Dealer
5. Conditions Relating to Bank Employees
6. Good Faith Compliance and Corrections by Banks
7. Referral Fees Permitted Under the Exemption
8. Permissible Bonus Compensation Not Restricted
III. Trust and Fiduciary Activities
A. Trust and Fiduciary Exception and Proposed Rules
B. Joint Final Rules
1. ''Chiefly Compensated'' Test and Bank-Wide Exemption Based on Two-Year Rolling Averages
2. ''Relationship Compensation''
3. Excluded Compensation
4. Trust or Fiduciary Accounts
5. Exemptions for Special Accounts, Foreign Branches, Transferred Accounts, and a De Minimis Number of Accounts
6. Advertising Restrictions
IV. Sweep Accounts and Transactions in Money Market Funds
A. Rule 740: Definition of Terms Used in Sweep Exception
B. Exemption Regarding Money Market Fund Transactions
V. Safekeeping and Custody
A. Background
B. Rule 760: Custody Exemption
1. Order-Taking for Employee Benefit Plan Accounts and Individual Retirement or Similar Accounts
a. Employee Compensation Restrictions
b. Advertisements and Sales Literature
c. Other Conditions
2. Order-Taking as an Accommodation for Other Types of Accounts
a. Accommodation Basis
b. Employee Compensation Restrictions
c. Limitations on Bank Fees
d. Advertising and Sales Literature Restrictions
e. Investment Advice or Recommendations
3. Other Conditions Applicable to Order-Taking for All Custody Accounts
a. Directed Trustees
b. Broker Execution Requirement
c. Carrying Broker Provisions
4. Custodians, Subcustodians, and Administrators/Recordkeepers
a. ''Account for Which a Bank Acts as a Custodian''
b. Administrators/Recordkeepers and Subcustodians
5. Evasions
VI. Other Exemptions
A. Exemption for Regulation S Transactions With Non-U.S. Persons and Broker-Dealers
B. Exemption for Non-Custodial Securities Lending Transactions
C. Exemption for Banks Effecting Certain Excepted or Exempted Transactions in Investment Company Securities and Variable Insurance Products
D. Exemption for Certain Transactions involving a Company's Securities for Its Employee Benefit Plans and Participants
E. Temporary and Permanent Exemption for Contracts Entered Into by Banks From Being Considered Void or Voidable
F. Extension of Time and Transition Period
VII. Finding That the Exemptions Are Appropriate and in the Public Interest and Consistent With the Protection of Investors
VIII. Withdrawal of Proposed Regulation B and Removal of Exchange Act Rules 3a4–2–3a4–6, and 3b–17
IX. Administrative Law Matters
A. Paperwork Reduction Act Analysis
B. Consideration of Benefits and Costs
C. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation
D. Consideration of Impact on the Economy
E. Regulatory Flexibility Analysis
F. Plain Language
X. Statutory Authority
XI. Text of Rules and Rule Amendment

## I. Introduction

### *A. Background*

The GLBA amended several federal statutes governing the activities and supervision of banks, bank holding

companies, and their affiliates.[1] Among other things, it lowered barriers between the banking and securities industries erected by the Banking Act of 1933 (''Glass-Steagall Act'').[2] It also altered the way in which the supervisory responsibilities over the banking, securities, and insurance industries are allocated among financial regulators. Among other things, the GLBA repealed most of the separation of investment and commercial banking imposed by the Glass-Steagall Act. The GLBA also revised the provisions of the Exchange Act that had completely excluded banks from broker-dealer registration requirements.

In enacting the GLBA, Congress adopted functional regulation for bank securities activities, with certain exceptions from Commission oversight for specified securities activities. With respect to the definition of ''broker,'' the GLBA amended the Exchange Act to provide eleven specific exceptions for banks.[3] Each of these exceptions permits a bank to act as a broker or agent in securities transactions that meet specific statutory conditions.

In particular, Section 3(a)(4)(B) of the Exchange Act as amended by the GLBA provides conditional exceptions from the definition of broker for banks that engage in certain securities activities in connection with third-party brokerage arrangements;[4] trust and fiduciary activities;[5] permissible securities transactions;[6] certain stock purchase plans;[7] sweep accounts;[8] affiliate transactions;[9] private securities offerings;[10] safekeeping and custody activities;[11] identified banking products;[12] municipal securities;[13] and a de minimis number of other securities transactions.[14]

In October 2006, the Financial Services Regulatory Relief Act of 2006 (''Regulatory Relief Act'') became effective.[15] Among other things, the Regulatory Relief Act requires that the SEC and the Board jointly adopt a single set of rules to implement the bank broker exceptions in Section 3(a)(4) of the Exchange Act.[16] In addition, it required that the Agencies issue a single set of proposed rules to implement these exceptions not later than 180 days after enactment of the Regulatory Relief Act (April 11, 2007).

In December 2006, the Agencies jointly issued, and requested public comment on, a single set of proposed rules to implement the broker exceptions for banks relating to third-party networking arrangements, trust and fiduciary activities, sweep activities, and safekeeping and custody activities.[17] The proposed rules included certain exemptions related to these activities, as well as exemptions related to foreign securities transactions, securities lending transactions conducted in an agency capacity, the execution of transactions involving mutual fund shares, and the potential liability of banks under Section 29 of the Exchange Act. In developing the proposed rules, the Agencies considered, among other things, the language and legislative history of the ''broker'' exceptions for banks adopted in the GLBA, the rules previously issued or proposed by the Commission relating to these exceptions, and the comments received in connection with those prior rulemakings.

The Agencies requested comment on all aspects of the proposed rules. In addition, the Agencies requested comment on whether it would be useful or appropriate for the Agencies to adopt rules implementing the other bank ''broker'' exceptions in Section 3(a)(4)(B) of the Exchange Act that were not addressed in the proposal.

*B. Overview of Comments*

The Agencies received comments from 58 organizations and individuals on the proposed rules. Commenters included 22 trade associations, 20 banking organizations, 7 other organizations in the financial services industry, 3 community and nonprofit groups, two credit unions, one state government, one self-regulatory organization, one association of state securities administrators, and one individual. Many commenters supported the proposed rules as a general matter. For example, commenters asserted that the proposed rules would provide banks considerable flexibility in providing securities services to their customers, would avoid disrupting bank activities and customer relationships, or were a significant improvement over earlier proposals.[18] In addition, many commenters supported the general approaches (including related exemptions) taken by the proposed rules to implement the networking, trust and fiduciary, sweep, and safekeeping and custody exceptions. Several commenters, however, contended that the proposed rules did not adequately protect investors, and particularly retail investors.[19] Some of these commenters argued that that the Agencies should withdraw the proposed rules and issue new rules based on those issued in 2001[20] or 2004.[21]

Most commenters also recommended that the Agencies modify specific provisions of the proposed rules to, among other things, reduce administrative burden, better protect bank customers or investors, or clarify the scope or effect of the rules. The comments received on the proposed rules are discussed in greater detail in the following sections of this **SUPPLEMENTARY INFORMATION.**

*C. Final Rules and Related Matters*

After carefully considering the comments, the Agencies have adopted

[1] Pub. L. No. 106–102, 113 Stat. 1338 (1999).

[2] Pub. L. No. 73–66, ch. 89, 48 Stat. 162 (1933) (as codified in various Sections of 12 U.S.C.).

[3] 15 U.S.C. 78c(a)(4).

[4] Exchange Act Section 3(a)(4)(B)(i). This exception permits banks to enter into third-party brokerage, or ''networking'' arrangements with brokers under specific conditions.

[5] Exchange Act Section 3(a)(4)(B)(ii). This exception permits banks to effect transactions as trustees or fiduciaries for securities customers under specific conditions.

[6] Exchange Act Section 3(a)(4)(B)(iii). This exception permits banks to buy and sell commercial paper, bankers' acceptances, commercial bills, exempted securities, certain Canadian government obligations, and Brady bonds.

[7] Exchange Act Section 3(a)(4)(B)(iv). This exception permits banks, as part of their transfer agency activities, to effect transactions for certain issuer plans.

[8] Exchange Act Section 3(a)(4)(B)(v). This exception permits banks to sweep funds into no-load money market funds.

[9] Exchange Act Section 3(a)(4)(B)(vi). This exception permits banks to effect transactions for affiliates, other than broker-dealers.

[10] Exchange Act Section 3(a)(4)(B)(vii). This exception permits certain banks to effect transactions in certain privately placed securities, under certain conditions.

[11] Exchange Act Section 3(a)(4)(B)(viii). This exception permits banks to engage in certain enumerated safekeeping or custody activities, including stock lending as custodian.

[12] Exchange Act Section 3(a)(4)(B)(ix). This exception permits banks to buy and sell certain ''identified banking products,'' as defined in Section 206 of the GLBA.

[13] Exchange Act Section 3(a)(4)(B)(x). This exception permits banks to effect transactions in municipal securities.

[14] Exchange Act Section 3(a)(4)(B)(xi). This exception permits banks to effect up to 500 transactions in securities in any calendar year in addition to transactions referred to in the other exceptions.

[15] Public Law No. 109–351, 120 Stat. 1966 (2006).

[16] *See* Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act.

[17] *See* 71 FR 77522, December 26, 2006.

[18] *See, e.g.*, Citigroup Letter, Independent Community Bankers Ass'n (''ICBA'') Letter, American Bankers Ass'n (''ABA'') Letter, JPMorgan Chase & Co. (''JP Morgan'') Letter, Financial Services Roundtable (''Roundtable'') Letter.

[19] *See, e.g.*, Massachusetts Securities Division Letter, Pace Investors Rights Project (''Pace Project'') Letter, Boyd Financial Letter.

[20] Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001).

[21] Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004). *See, e.g.*, North American Securities Administrators Association (''NASAA'') Letter.

final rules to implement the broker exceptions for banks relating to third-party networking arrangements, trust and fiduciary activities, sweep activities, and custody and safekeeping activities.[22] The Board and SEC have consulted extensively with, and sought the concurrence of, the OCC, FDIC and OTS in developing these final rules.

Like the proposal, the final rules include certain exemptions related to these activities, as well as exemptions related to foreign securities transactions, securities lending transactions conducted in an agency capacity, the execution of transactions other than through a broker-dealer, the potential liability of banks under Section 29 of the Exchange Act, and the date on which the GLB Act's ''broker'' exceptions for banks will go into effect.

As discussed in the following sections, the Agencies have modified the rules in numerous respects in light of the comments received. These changes include, among other things, modifications to the examples of ''relationship compensation'' in Rule 721 to clarify the scope of the term for purposes of the rules relating to trust and fiduciary activities; the custody exemption in Rule 760 to permit banks acting as a directed trustee to accept orders under the exemption; and Rule 781 to extend the compliance date for a bank until the first day of its first fiscal year commencing after September 30, 2008. The Agencies also have adopted new exemptions relating to trust or fiduciary accounts held in a foreign branch of a bank,[23] and to permit a bank to effect, under certain conditions and without using a broker-dealer, transactions in a fiduciary or custodial capacity for an employee benefit plan in the stock of the plan's sponsor.[24]

The final rules are designed to accommodate the business practices of banks and protect investors. 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 the bank effects a transaction in a security sold in an offshore transaction for a custody account that is permissible under either the Regulation S exemption in Rule 771 or the custody exemption in Rule 760, the bank may choose which exemption to rely on and comply with in effecting the transaction. Similarly, if a bank effects no more than 500 securities transactions as agent for its customers 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.[25]

Section 401 of the Regulatory Relief Act amended the definition of ''bank'' in Section 3(a)(6) of the Exchange Act to include any Federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, as used in the final rules, the term ''bank'' includes any savings association that qualifies as a ''bank'' under Section 3(a)(6) of the Exchange Act, as amended.[26]

Identical sets of the final rules are being adopted by the Board and SEC and will be published by the Board in Title 12 of the Code of Federal Regulations and by the SEC in Title 17 of the Code of Federal Regulations.[27] Pursuant to the Regulatory Relief Act, this single set of final rules supersedes any and all other proposed or final rules issued by the Commission on or after the date of enactment of the GLBA with regard to the definition of ''broker'' under Section 3(a)(4) of the Exchange Act.[28]

Any additions or changes to these rules that may be appropriate to implement Section 3(a)(4)(B) of the Exchange Act will be adopted jointly by the SEC and Board in accordance with the consultation provisions in Section 101(b) of the Regulatory Relief Act. In addition, if any rules (including exemptions) are proposed or adopted in the future related to the other bank ''broker'' exceptions in Section 3(a)(4)(B) of the Exchange Act that are not addressed in the final rules now being adopted by the SEC and the Board, they would be proposed and adopted jointly by the SEC and Board.[29]

As required by the GLBA, the Board, OCC, FDIC, and OTS (collectively, the Banking Agencies) will develop, and request public comment on, recordkeeping rules for banks that operate under the ''broker'' exceptions in Section 3(a)(4) of the Exchange Act.[30] These rules, which will be developed in consultation with the SEC, will establish recordkeeping requirements to enable banks to demonstrate compliance with the terms of the statutory exceptions and the final rules and will be designed to facilitate compliance with the statutory exceptions and the rules.

Several commenters urged the Agencies also to cooperate in providing interpretations or guidance (such as staff no-action letters) concerning the final rules or the broker exceptions for banks in Section 3(a)(4)(B) of the Exchange Act or in taking enforcement action to enforce compliance with these rules or exceptions.[31] In addition, a number of commenters urged the Agencies to work

[22] Commenters generally did not request that the Agencies adopt rules to implement the other broker exceptions for banks at this time or stated that no additional guidance was needed at this time with respect to these exceptions. *See* ABA Letter.

[23] *See* Rule 723(c).

[24] *See* Rule 776.

[25] An employee of a bank that operates in accordance with the exceptions in Section 3(a)(4)(B) of the Exchange Act and, where applicable, the rules is not required to register as a ''broker'' to the extent that the employee's activities are covered by the relevant exception or rule.

[26] Several commenters asked the Agencies, or the Commission independently, to adopt rules that would extend to federal or state-chartered credit unions some or all of the ''broker'' exceptions or exemptions provided banks under Section 3(a)(4)(B) of the Exchange Act or the final rules. *See, e.g.*, Credit Union Nat'l Ass'n Letter, Nat'l Ass'n of Credit Union Service Organizations Letter, Nat'l Ass'n of Fed. Credit Unions Letter, Navy Fed. Credit Union Letter, and XCU Corp. Letter. While the GLBA's ''bank'' exceptions do not by their terms apply to credit unions, these requests are under consideration by the Commission, which is the agency with authority to address these matters. The Commission notes the existence of SEC staff positions with regard to networking relationships between a credit union and a broker-dealer and is not addressing this issue at this time. *See, e.g.*, Chubb Securities Corp., 1993 SEC No-Act. LEXIS 1204 (Nov. 24, 1993).

[27] The final rules adopted by the Board and the SEC within their respective titles of the Code of Federal Regulation (12 CFR part 218 for the Board and 17 CFR part 247 for the SEC) are identically numbered from § ___.100 to § ___.781. For ease of reference, the single set of final rules adopted by each Agency are referred to in this release as Rule ___, excluding title and part designations. A similar format is used to refer to the single set of proposed rules issued by the Agencies.

[28] Pub. L. No. 109–351, § 101(a)(3), 120 Stat. 1966, 1968 (2006).

[29] A few commenters requested that the Commission delegate authority to act on future exemptive requests from banks to the Director of its Division of Market Regulation. *See* America Community Bankers Ass'n (''ACB'') Letter, Roma Bank Letter. Because particular banks may have individual situations that may be appropriate for additional relief, the Commission delegated authority to the Director of the Division of Market Regulation to consider, on a case-by-case basis, individual requests for exemptive relief from banks. To facilitate the processing of these requests, the Commission delegated this exemptive authority within its Rules of Organization and Program Management in Rule 30–3(a)(70) (17 CFR 200.30–3(a)(70)). The Commission continues to expect the staff to submit novel and complex requests for exemptions to the Commission.

[30] *See* 12 U.S.C. 1828(t)(1).

[31] *See, e.g.*, ABA Letter, Clearing House Ass'n Letter, Citigroup Letter, The PNC Financial Services Group, Inc. (''PNC'') Letter. One commenter, however, expressed concern that coordination among the Agencies might result in slower responses to requests for guidance. See American Bar Ass'n Section of Business Law Letter (''Business Law Section Letter'').

with the Financial Industry Regulatory Authority (''FINRA'') [32] to modify promptly its Rule 3040 as it applies to persons that are employees of both a bank and a broker-dealer (so-called ''dual employees'').[33]

In light of the joint nature of the final rules and the Agencies' joint rule-writing authority for the bank broker exceptions in Section 3(a)(4)(B),[34] the Agencies will jointly issue any interpretations and responses to requests for no-action letters or other interpretive guidance concerning the scope or terms of the exceptions and rules, and will consult and, to the extent appropriate, coordinate with each other and the appropriate federal banking agency for a bank concerning any formal enforcement actions proposed to be taken against a bank for violations of the exceptions or rules.

The Agencies already consult with and coordinate with each other and the other federal banking agencies in a variety of areas, and the Agencies and the other federal banking agencies are in the process of supplementing their existing policies and procedures to facilitate coordination with respect to the broker exceptions and rules. Banks or others that seek an interpretation of, or a no-action letter or other staff guidance concerning, the rules or the exceptions should submit their request to both Agencies. The Agencies also expect to continue their dialogue with FINRA concerning potential modifications to that authority's Rule 3040.

## II. Networking Arrangements

The third-party brokerage exception (''networking exception'') in Section 3(a)(4)(B)(i) of the Exchange Act permits a bank to avoid being considered a broker if, under certain conditions, it enters into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers.[35] The networking exception does not address the type or amount of compensation that a bank may receive from its broker-dealer partner under a networking arrangement. However, the networking exception provides that a bank may not pay its unregistered employees [36] incentive compensation for brokerage transactions. Nevertheless, the statutory exception does permit a bank employee to receive a ''nominal one-time cash fee of a fixed dollar amount'' for referring bank customers to the broker-dealer if payment of the referral fee is not ''contingent on whether the referral results in a transaction.'' [37] Congress included this general prohibition on, and limited exception to, incentive compensation to reduce concerns regarding the securities sales practice of unregistered bank employees.

### *A. Overview of Proposed Rules and Comments*

Proposed Rule 700 defined certain key terms related to referral fees and incentive compensation used in the networking exception. For example, the proposed rule provided that a referral fee would be considered ''nominal'' if it met any of four standards included in the rule. The proposed rule also defined when a referral fee would be ''contingent on whether a referral results in a transaction,'' what constitutes ''incentive compensation,'' and what types of bank bonus plans would not be considered incentive compensation under the networking exception. Proposed Rule 701 included an exemption that permitted bank employees, subject to certain conditions, to receive higher-than-nominal, contingent referral fees for referring institutional customers and high net worth customers to a broker-dealer.

Many commenters supported the general approach of Proposed Rules 700 and 701, including the range of alternatives provided for determining if a referral fee is nominal and the adoption of an exemption for referrals involving high net worth or institutional customers.[38] Some commenters, however. suggested that the proposed rules would harm investors by giving bank employees undue incentives to direct unsophisticated customers into potentially unsuitable investment products.[39]

### *B. Rule 700: Definition of Terms Used in Networking Exception*

#### 1. Definition of ''Nominal One-Time Cash Fee of a Fixed Dollar Amount''

Proposed Rule 700 defined the term ''nominal one-time cash fee of a fixed dollar amount'' to mean a cash payment for a referral in an amount that meets any one of four alternative standards: the first based on twice the average hourly base wage established by the bank for the employee's job family; the second based on 1/1000th of the average annual base salary established by the bank for the employee's job family; the third based on twice the employee's actual base hourly wage; and the fourth based on a specified dollar amount ($25), indexed for inflation.[40]

Many commenters generally supported the flexibility that this range of alternatives would afford in determining whether a referral fee is ''nominal.'' [41] Some commenters expressed concern that the proposed rule placed greater limits on permissible payments under networking arrangements than exist currently under applicable federal banking agency guidance or questioned the need for a definition of ''nominal'' to be established by rule at all.[42] A few commenters contended that the specific dollar amount in the proposed rule ($25) was too low.[43] A number of commenters, however, believed that the alternatives would result in the payment of fees that are higher than nominal and would create incentives for bank employees to make securities referrals even when not appropriate for the customer. These commenters questioned, for example, whether twice an employee's hourly wage was truly nominal and whether the Agencies had sufficient basis for selecting that measure of ''nominal.'' [44]

[32] On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD's Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority Inc., or FINRA, in connection with the consolidation of member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Release No. 56146 (July 26, 2007). FINRA's Rules currently consist of the rules adopted by the NASD and effective on the date of the consolidation (which include NASD Rule 3040), as well as certain rules of the NYSE that FINRA has incorporated into its own rules.

[33] *See, e.g.*, ABA Letter, Clearing House Ass'n Letter, Harris Bank Letter, HSBC Bank, N.A. (''HSBC Bank'') Letter, HSBC Securities (USA) Inc. (''HSBC Securities'') Letter, Roundtable Letter. These commenters asserted that it was important for the requested modifications to FINRA's Rule 3040 to be made prior to the date on which banks would first have to comply with the new ''broker'' exceptions in the GLBA.

[34] *Rapaport* v. *U.S. Department of Treasury*, 59 F. 3d 212, 216–217 (D.C. Cir. 1995), *cert. denied* 116 S.Ct. 775 (1996).

[35] 15 U.S.C. 78c(a)(4)(B)(i).

[36] An unregistered bank employee is an employee that is not registered or approved, or otherwise required to be registered or approved, in accordance with the qualification standards established by the rules of any self-regulatory organization.

[37] 15 U.S.C. 78c(a)(4)(B)(i)(VI).

[38] *See, e.g.* ABA Letter, Roundtable Letter, Citigroup Letter, Union Bank of California (''Union Bank'') Letter.

[39] *See, e.g.*, Pace Project Letter.

[40] Proposed Rule 700(c).

[41] *See, e.g.*, Roundtable Letter, ACB Letter.

[42] *See, e.g.*, Bank Insurance & Securities Ass'n (''BISA'') Letter, Wisconsin Bankers Ass'n (''WBA'') Letter.

[43] *See, e.g.*, Clearing House Ass'n Letter and ICBA Letter.

[44] *See, e.g.*, Boyd Financial Letter, NASAA Letter, Pace Project Letter, and University of Cincinnati Corp. Law Ctr. Letter.

After carefully reviewing the comments, the Agencies have determined to adopt the ''nominal'' definition substantially as proposed. Including a definition of ''nominal'' in the rule will provide banks with certainty as to the Agencies'' interpretation of that standard and should facilitate compliance. The Agencies believe that each of the alternatives for defining ''nominal'' is consistent with the statutory networking exception, which provides that a bank employee may receive compensation for each referral if the compensation for that referral is ''nominal'' and meets the other requirements of the statute. Under each of the alternatives established, the amount of compensation a bank employee may receive for each referral will be small in relation to the employee's overall compensation and therefore unlikely to create undue incentives for the bank employee to engage in activities, such as ''pre-selling'' specific securities to the customer involved in violation of the networking exception,[45] which would raise sales practice concerns. As discussed below, the multiple alternatives are designed to provide flexibility for banks of all sizes and locations to use different business models and to take into account economic differences around the country and among their employees in assessing how best to structure their program(s) for paying ''nominal'' cash referral fees under the networking exception. The alternatives also were designed to allow for roughly equivalent treatment of bank employees at different base or hourly compensation levels within a bank.

Rule 700(c) provides that a referral fee paid to any bank employee will be considered ''nominal'' if it does not exceed $25.[46] This dollar amount will be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect any changes in the value of the Employment Cost Index For Wages and Salaries, Private Industry Workers (or any successor index thereto), as published by the Bureau of Labor Statistics, from December 31, 2006.[47] The Agencies selected this index because it is a widely used and broad indicator of increases in the wages of private industry workers, which includes bank employees. Available data indicate that the $25 amount is consistent with the level of referral fees generally paid to tellers and other bank employees engaged in making referrals of retail customers under existing Banking Agency guidance, which also includes a ''nominal'' standard.[48]

As under the proposal, a referral fee also will be considered ''nominal'' under Rule 700(c) if the payment does not exceed (1) twice the employee's actual base hourly wage; (2) 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 (3) 1/1000th 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.[49]

In developing these alternatives to the fixed $25 fee, the Agencies considered data on the average hourly wages of bank tellers, which are the class of bank employees most typically engaged in making referrals of retail customers. These data indicate that the national mean hourly wage in 2005 for tellers was $10.59.[50] Accordingly, the $25 amount is slightly more than twice the national mean hourly wage for tellers in 2005, and slightly more than 1/1000th of the annualized salary of an employee that makes $12.50 per hour (or $25 every two hours) based on a 40 hour work week.[51] Thus, the alternatives based on twice the employee's hourly base wage or 1/1000th of the employee's base annual salary, at current pay rates, are designed to allow bank employees to receive referral fees that are roughly equivalent to those that may be received by bank tellers under the flat dollar option.

The options based on the employee's job family use these same measurements but allow comparisons to the average of the minimum and maximum hourly base wage or base salary of the employee's job family. These options are designed to reduce administrative burden while also ensuring that referral fees remain nominal in amount. To provide comparability between the alternative based on an employee's actual compensation and those based on the compensation established for the employee's job family, the Agencies have modified the final rule to provide that a referral fee also will be considered nominal if it does not exceed 1/1000th of the employee's actual base annual salary.[52] Under the final rules, a bank may use a different ''nominal'' methodology in its different business lines or operating units and may alter the methodology it uses within a given year.

One commenter suggested that the term ''job family'' was ambiguous and could allow banks to include all employees in a single job family, which would result in payments to employees with salaries at the lower end of the job family that may be well in excess of twice their hourly wage.[53] Rule 700 defines a ''job family'' as a group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank, or a separate unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation.[54] The requirements that a job family include jobs or positions with similar responsibilities, or that require similar skills, education and training, and be used by the bank in the ordinary course of its business for hiring, promotion and compensation purposes are designed to prevent a bank from establishing special job family classifications to evade the ''nominal'' standard. A bank may not deviate from its ordinary classification of jobs for purposes of determining whether a referral fee is nominal under this standard, and the Banking Agencies will monitor the job family classifications used by banks for ''nominal'' determination as part of the risk-focused examination process. Depending on a bank's internal employee classification system, examples of a job family may include tellers, loan officers, or branch managers. The Agencies note, moreover, that other provisions of the networking exception also provide significant protection to customers. For example, the networking exception provides that unregistered bank employees may perform only clerical or ministerial functions in connection with brokerage transactions.[55] Accordingly, bank employees referring a customer to a broker-dealer under the exception may not provide investment advice concerning securities or make specific

[45] *See* Exchange Act Section 3(a)(4)(B)(i)(V).

[46] Rule 700(c)(3).

[47] Each adjustment would be rounded to the nearest multiple of $1. Rule 700(f).

[48] *See* ABA Securities Ass'n., 2003/2004 National Survey of Bank Retail Investment Services, Vol. I, at 60 (survey data demonstrate that 20 percent of banks pay retail referral fees of $20 or more); Banking Agencies' Interagency Statement on Retail Sales of Nondeposit Investment Products (Feb. 15, 1994).

[49] Rule 700(c)(1) and (2).

[50] Occupational Employment and Wages, May 2005, (Tellers), U.S. Department of Labor, Bureau of Statistics.

[51] Specifically, twice the hourly wage for an employee who earns an annual base salary of $25,000 (1,000 × $25) would be $24.04, based on a 40 hour per week (or 1080 hours per year) work schedule.

[52] Rule 700(c)(2).

[53] *See* Pace Project Letter.

[54] Proposed Rule 700(d).

[55] *See* 15 U.S.C. 78c(a)(4)(B)(i)(V).

securities recommendations to the customer.[56]

A few commenters suggested that, by defining ''nominal'' by reference to hourly wages and annual base salary, the rule treats unfairly employees who receive a considerable portion of their compensation through bonuses tied to sales of non-securities products.[57] Because the five alternatives included in the final rule are based on a set dollar amount or the hourly wage or annual base salary established by a bank for the employee or the employee's job family, the alternatives help ensure that a referral fee will be nominal in relation to the employee's compensation in the year it is paid. Bonuses, however, typically are discretionary, vary significantly from year-to-year and, as noted by commenters, may constitute a significant portion of the compensation of certain types of bank employees in particular years. Permitting referral fees to be based in part on the size of a bonus paid in a previous year (or projected to be paid in the current year) could allow bank employees to receive a referral fee that is not nominal in relation to the employee's compensation, or the average compensation paid to employees within the relevant job family, in the year in which the fee is paid and, thus, could increase the potential for sales practice concerns.

Commenters also asserted that more than one employee should be able to receive a fee for a single referral and also requested clarification as to whether officers and directors of a bank may receive referral fees under the exception.[58] The Agencies believe that the networking exception permits a bank employee who personally participated in a referral to receive a referral fee for the referral.[59] Accordingly, the Agencies have modified Rule 700(c) to clarify this position. Thus, for example, a supervisory employee may receive a separate, nominal one-time cash fee for a referral made by another individual supervised by the employee only if the supervisory employee personally participated in the referral. A supervisory employee may not, however, receive a referral fee merely for supervising the employee making the referral or administering the referral process. An officer or director of a bank who makes or personally participates in making a referral may receive a nominal fee for the referral as a bank employee.

The proposed rule permitted a nominal referral fee to be paid only in cash. Many commenters requested that banks be given the flexibility to pay referral fees in non-cash forms.[60] The terms of the networking exception, however, provide for a ''nominal, one-time cash fee of a fixed dollar amount''[61] and, accordingly, the final rule continues to require that referral fees paid under the exception be paid in cash. A bank, therefore, may not pay referral fees in non-cash forms, such as vacation packages, stock grants, annual leave, or consumer goods. The final rules do not, however, prevent a bank from paying an employee on a quarterly or more frequent periodic basis the total amount of nominal, fixed cash fees the employee earned during the period. For example, if a bank employee is entitled to receive a $25 referral fee for each securities referral and the employee makes three qualifying referrals in a given quarter, the bank may pay the employee $75 at the end of the quarter instead of three individual payments of $25. A bank also may use a ''points'' system to keep track of the number of qualifying securities referrals made by the employee during a quarterly or more frequent period and the total amount of nominal, fixed cash fees that the employee is entitled to receive at the end of the period. In all cases, however, points must translate into cash payments on a uniform basis and the cash amount that an employee will receive for a qualifying securities referral (*e.g.*, twice the employee's actual base hourly wage) must be fixed before the referral is made and may not be contingent or vary based on whether an employee makes a specified number or type of securities referrals during a quarterly or more frequent period.[62]

2. Definition of ''Referral''

The statutory networking exception permits bank employees to receive a nominal one-time cash fee of a fixed dollar amount for the ''referral'' of a customer to a broker-dealer. Rule 700(e) defines a 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.[63] For purposes of the networking exception and Rules 700 and 701, the term ''customer'' includes both existing and potential customers of the bank.

As proposed, a bank employee may receive a referral fee under the networking exception and Rule 700 for each referral made to a broker-dealer, including separate referrals of the same individual or entity. In addition, nothing in the statutory networking exception or the final rules limits or restricts the ability of a bank employee to refer customers to other departments or divisions of the bank itself, including, for example, the bank's trust, fiduciary or custodial department. Likewise, the networking exception and the rules do not apply to referrals of retail, institutional or high net worth customers to a broker-dealer or other third party solely for transactions not involving securities, such as loans, futures contracts (other than a security future), foreign currency, or over-the-counter commodities, or solely for transactions in securities (such as U.S. Government obligations) that would not require the other party to register under section 15 of the Exchange Act.[64]

3. Definition of ''Contingent on Whether the Referral Results in a Transaction''

Under the statutory networking exception, a nominal fee paid to an unregistered bank employee for referring a customer to a broker-dealer may not be contingent on whether the referral results in a transaction. This limitation is designed to allow banks to reward bank employees for introducing customers to a broker-dealer without giving unregistered bank employees a direct financial interest in any resulting securities transaction at the broker-dealer.

The final rule, like the proposed rule, provides that a referral fee will be considered ''contingent on whether the referral results in a transaction'' if payment of the fee is dependent on

[56] A bank employee, however, may describe in general terms the types of investment vehicles available from the bank and the broker-dealer under the arrangement. *See id.*

[57] *See, e.g.*, ABA Letter, BISA Letter, Clearing House Ass'n Letter, Harris Bank Letter, Roundtable Letter, PNC Letter, U.S. Trust Company, N.A. (''U.S. Trust'') Letter, and WBA Letter.

[58] *See, e.g.*, Consumer Bankers Ass'n (''CBA'') Letter, BISA Letter.

[59] *See* Section 3(a)(4)(B)(i)(VI) of the Exchange Act (permitting ''the bank employee [to] receive compensation for the referral of any customer'' in accordance with the exception).

[60] *See, e.g.*, ABA Letter, BISA Letter, Clearing House Ass'n Letter, and JP Morgan Letter.

[61] *See* Exchange Act Section 3(a)(4)(B)(i)(VI).

[62] The exception and the final rules also do not prohibit a bank from providing its employees non-cash items, such as pizza or coffee mugs, in connection with programs to familiarize bank employees with new types of investment vehicles offered by the bank or the broker-dealer through the arrangement, provided that the programs or items given to employees do not reward or compensate an employee for making a referral to a broker-dealer. Thus, for example, a ''pizza party'' that is made available only to those employees that have made one or more referrals to a broker-dealer would not be permissible.

[63] Rule 700(e).

[64] A bank that acts as a government securities broker (as defined in Section 3(a)(43) of the Exchange Act) is not exempt from and must comply with the notification and other applicable requirements of section 15C of the Exchange Act.

whether the referral results in a purchase or sale of a security; whether an account is opened with a broker-dealer; whether the referral results in a transaction involving a particular type of security; or whether the referral results in multiple securities transactions.[65] The final rule expressly provides that a referral fee may be contingent on whether a customer (1) contacts or keeps an appointment with a broker-dealer as a result of the referral; or (2) meets any objective, base-line qualification criteria established by the bank or broker-dealer for customer referrals, including such criteria as minimum assets, net worth, income, or marginal federal or state income tax rate, or any requirement for citizenship or residency that the broker-dealer, or the bank, may have established generally for referrals for securities brokerage accounts.[66] A bank or broker-dealer may establish and use different objective, base-line qualification criteria (including citizenship or residency requirements) for different classes of customers or for different business lines, divisions or units of the bank or broker-dealer.

Commenters generally supported these permissible contingencies. Some commenters contended that the rule also should allow payment of a nominal referral fee to be contingent on other events, such as the opening of an account at the broker-dealer or on the opening of an account that may be used to conduct only securities transactions that the bank itself could effect without registering as a broker under the exceptions for banks in Sections 3(a)(4)(B) of the Exchange Act.[67] Opening a securities account at the broker-dealer, however, is a necessary first step to executing securities transactions and one that a customer is unlikely to take unless the customer anticipates engaging in securities transactions with the broker-dealer. In light of this close link between opening an account and executing securities transactions, the Agencies have not modified the rule as requested and the final rule continues to provide that payment of a referral fee may not be contingent on whether the customer opens an account (other than the types of accounts described in Part B.2 *supra*.) at the broker-dealer. Other contingencies not specified in the rule may be permissible if they are not based on whether the referral results in a securities transaction at the broker-dealer.

In addition, the ''broker'' exceptions in Sections 3(a)(4)(B) of the Exchange Act are available only to banks. Accordingly, a referral to a broker-dealer for a securities transaction within the scope of section 15 of the Exchange Act still involves a ''broker'' transaction at the broker-dealer even if a bank could conduct the transaction itself without registering as a broker, and a referral fee may not be contingent on the occurrence of such a transaction (or the opening of an account to engage in such transactions).[68]

4. Definition of ''Incentive Compensation''

The networking exception prohibits an unregistered employee of a bank that refers a customer to a broker-dealer under the exception from receiving ''incentive compensation'' for the referral or any securities transaction conducted by the customer at the broker-dealer other than a nominal, non-contingent referral fee. To provide banks and their employees additional guidance in this area, Proposed Rule 700(b) defined ''incentive compensation'' as compensation that is intended to encourage a bank employee to refer potential customers to a broker-dealer or give a bank employee an interest in the success of a securities transaction at a broker-dealer.

The proposed rule also excluded certain types of bonus compensation from the definition of ''incentive compensation.'' Proposed Rule 700(b)(1) excluded compensation paid by a bank under a bonus or similar plan if such compensation is paid on a discretionary basis; based on multiple factors or variables; such factors or variables include significant factors or variables that are not related to securities transactions at the broker-dealer; and a referral made by the employee or any other person is not a factor or variable in determining the employee's compensation under the plan.

In addition, Proposed Rule 700(b)(2) provided that the definition of incentive compensation did not prevent a bank from compensating its employees on the basis of any measure of the overall profitability of (1) the bank, either on a stand-alone or consolidated basis; (2) any of the bank's affiliates (other than a broker-dealer) or operating units; or (3) a broker-dealer if such profitability is only one of multiple factors or variables used to determine the compensation of the officer, director, or employee and those factors or variables include significant factors or variables that are not related to the profitability of the broker-dealer. The Agencies specifically requested comment on whether existing bank bonus programs would fit, or could easily be adjusted to fit, within these proposed exclusions.

Many commenters indicated that the proposed bonus provisions worked well and would not interfere with bank bonus plans generally. One commenter, however, opposed the proposed bonus provisions arguing that permitting bonuses to be based even in part on revenues generated by activity conducted at a broker-dealer would encourage bank employees to make referrals regardless of the appropriateness of the referral in order to increase their compensation under the bonus plan.[69] In addition, a number of commenters requested that the Agencies either confirm that bonus programs structured in particular ways identified by the commenter would not fall within the definition of ''incentive compensation'' or modify the terms of the exclusions to encompass plans with these features. For example, several commenters asked the Agencies to confirm that the rules would not prohibit a bank from basing an employee's bonus on the assets, revenues or profits brought to the bank and its partner broker-dealer by that employee. Other commenters asked that the Agencies provide that all ''traditional'' bank bonus programs are protected under the rule.

A number of commenters also raised specific issues with one or more aspects of the exception in Rule 700(b)(1) for discretionary, multi-factor bonus plans or the safe harbor in Rule 700(b)(2) for plans based on overall profitability. For example, some commenters requested clarification of the ''discretionary'' requirement in paragraph (b)(1) and asserted that a bonus plan should be considered ''discretionary'' if employees do not have an enforceable right to compensation under the plan until it is paid.[70] One commenter also argued that Proposed Rule 700(b)(1) should not prohibit the number of referrals made by an employee from playing a role in the employee's compensation under a bonus plan.[71]

Several commenters also asserted that the safe harbor in paragraph (b)(2) should be clarified or expanded to cover

[65] Rule 700(a).

[66] Rule 700(a).

[67] *See, e.g.*, BISA Letter, Clearing House Ass'n Letter, and U.S. Trust Letter.

[68] For similar reasons, a referral to a broker-dealer for such a transaction is a ''referral'' for purposes of the networking exception and Rule 700.

[69] *See* NASAA Letter.

[70] *See, e.g.*, U.S. Trust Letter and Union Bank Letter.

[71] *See* TD Banknorth, N.A. (''TD Banknorth'') Letter.

bonus programs based on any measure of the financial performance, and not just the ''overall profitability,'' of a bank, affiliate, operating unit or broker-dealer.[72] Commenters indicated that bank bonus programs may be based on a wide variety of measures or metrics related to the operations or performance of the bank, an affiliate or operating unit.[73] Some commenters also requested that the safe harbor be revised to clarify that a bonus program may be based on the overall profitability of an operating unit of an affiliate of a bank (other than a broker-dealer), or be expanded to allow bonus programs to be based on the financial performance of a branch, division, or geographical or operational unit of a broker-dealer.[74]

The purpose of the exception and exclusion in paragraph (b) is to recognize that certain types of bonus plans are not likely to give unregistered bank employees a promotional interest in the brokerage services offered by the broker-dealers with which the bank networks and to avoid affecting bonus plans of banks generally. As described below, the Agencies have made several revisions to the exception and exclusion to help clarify the types of bonus plans that fall outside of the scope of ''incentive compensation'' and to ensure that excepted or excluded plans are not likely to give bank employees an impermissible promotional interest in the broker-dealer's activities. These exceptions and exclusions are crafted to accommodate existing types of bank bonus programs in general. Nevertheless, a plan's longevity or the number of banks that utilize similar plans are not factors in determining whether a plan constitutes ''incentive compensation'' under this definition. Accordingly, banks that have networking arrangements with a broker-dealer should review their existing bonus programs in light of the standards set forth in the rule to evaluate whether they may constitute impermissible incentive compensation.

a. Exception for Discretionary, Multi-Factor Bonus Plans

Under Rule 700(b)(1) of the final rules, compensation paid by a bank under a bonus or similar plan is specifically excepted from ''incentive compensation'' if it is paid on a discretionary basis and based on multiple factors or variables, provided that (1) those factors or variables include multiple, significant factors or variables that are not related to securities transactions at the broker-dealer; (2) a referral made by the employee is not a factor or variable in determining the employee's compensation under the plan; and (3) the employee's compensation under the plan is not determined by reference to referrals made by any other person.[75] The Agencies have modified the rule to make clear that, to be excluded under Rule 700(b)(1), a multi-factor plan must include *multiple*, significant factors or variables that are not related to securities transactions at the broker-dealer.[76] The proposed rule already required that there be ''significant factors or variables'' and the addition of ''multiple'' highlights the plural nature of these terms.

Each factor or variable unrelated to securities transactions at the broker-dealer will be considered ''significant'' for purpose of Rule 700(b) if it plays a material role in determining an employee's compensation under the bonus or similar 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. This clarification will give banks greater certainty and will allow them to more readily identify the types of factors or variables not related to securities transactions that must be included within a discretionary, multi-factor bonus plan under paragraph (b)(1) of the Rule. Thus, under paragraph (b)(1), a bank's bonus program may take account of the full range of banking, securities or other business of one or more customers brought to the bank and its partner broker-dealer by an employee so long as the bonus is paid on a discretionary basis, the banking and other factors or variables not related to securities transactions at the broker-dealer are significant factors or variables under the bonus program, and a referral or number of referrals made by the employee or others is not a factor or variable under the program. In this way, the rule is designed to accommodate discretionary bank bonus programs that are based on general measures of the business or performance of a bank or a particular customer, branch or other unit of the bank, that are *not* based on referrals made by one or more bank employees and that include some inputs based on securities transactions at a broker-dealer as well as multiple significant factors or variables that are unrelated to securities transactions at the broker-dealer.

A bank may not establish or maintain one or more ''sham'' non-securities factors or variables in its bonus or similar plan for the purpose of evading the restrictions in Rule 700(b) and the Banking Agencies will continue to review the bonus and similar plans of banks participating in networking arrangements as part of the risk-focused supervisory process. In considering if a bonus program at a bank contains sufficient banking or other factors unrelated to securities transactions at a broker-dealer, the agencies will consider, among other things, whether such factors or variables relate to banking or other non-broker-dealer business(es) actually being conducted by the bank or its employees, the resources devoted by the bank to such business(es), and whether such business(es) materially contributes to the payments made under the plan over time. It is not expected that the actual payments made under a bank's bonus or similar plan would, over time, be based predominantly on securities transactions conducted at a broker-dealer. If such a situation were to occur, the bank would be expected to make appropriate modifications to its bonus or similar plan going forward.

A bonus or similar plan will be considered ''discretionary'' under the final rule 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 amount of any payments are established and declared by the bank. A plan may, however, include targets or metrics that must be met in order for any bonus to be paid, provided the plan is otherwise a ''discretionary'' plan.

The Agencies have not modified the rule to allow a bonus plan to be based on the fact of a referral or the number of referrals made by one or more bank employees. The Agencies believe that doing so would allow a direct linkage between a referral and an employee's bonus compensation and be contrary to the purposes of the exception.

b. Safe Harbor for Plans Based on Overall Profitability or Revenue

The safe harbor provisions of Rule 700(b)(2) are designed to allow banks to avoid having to analyze whether a particular bonus program meets the

[72] *See, e.g.*, ABA Letter, Clearing House Ass'n Letter.

[73] *See, e.g.*, Clearing House Ass'n Letter, Harris Bank Letter, U.S. Trust Letter.

[74] *See, e.g.*, ABA Letter, Clearing House Ass'n Letter, HSBC Bank Letter, PNC Letter, and Union Bank Letter.

[75] Rule 700(b)(1). The requirement that an employee's compensation not be based on a ''referral'' made by the employee or another person means that the employee's compensation under the bonus or similar plan may not vary based on the fact that the employee or other person made a referral to a broker-dealer or the number of securities referrals made by the employee or other person to a broker-dealer.

[76] A similar change has been made to the corresponding language in Rule 700(b)(2).

requirements of the exception in paragraph (b)(1) in circumstances where the general structure of the program clearly reduces the potential for sales practice concerns in connection with a referral to a broker-dealer. The Agencies have made several changes to the safe harbor to address the issues raised by commenters and to ensure that the safe harbor achieves its purpose. In particular, the Agencies have modified paragraph (b)(2) of the rule to cover any bonus or similar plan that is based on the overall profitability or revenue of:

(i) The bank, either on a stand-alone or consolidated basis;

(ii) Any affiliate of the bank (other than a broker-dealer), or any operating unit of the bank or an affiliate (other than a broker-dealer), if the affiliate or operating unit does not over time predominately engage in the business of making referrals to a broker-dealer; or

(iii) A broker-dealer if:

(A) Such measure of overall profitability or revenue is only one of multiple factors or variables used to determine the compensation of the officer, director or employee;

(B) The factors or variables used to determine the compensation of the officer, director or employee include multiple significant factors or variables that are not related to the profitability or revenue of the broker-dealer;

(C) A referral made by the employee is not a factor or variable in determining the employee's compensation under the plan; and

(D) The employee's compensation under the plan is not determined by reference to referrals made by any other person.

When a bonus program is based on the overall profitability of a bank, an affiliate of a bank (other than a broker-dealer), or an operating unit of the bank or an affiliate (other than a broker-dealer), any relationship between a referral made by an employee and the amount of payments that the employee may receive under the plan are likely to be attenuated. In these circumstances, for example, any potential connection between the revenue received by a bank from its partner broker-dealer as a result of a referral and the payments made to the referring bank employee under the plan likely would be tenuous and largely speculative given the number of other employees, business and actions that contribute to the overall profitability of the bank, affiliate or most operating units. The Agencies believe this attenuation effectively addresses any potential that payments under the plan would give an employee an undue promotional interest in any securities transactions that may occur at the broker-dealer as a result of a referral. A bonus plan based on the overall *revenue* of a bank or qualifying affiliate or operating unit would be similarly attenuated and, for this reason, the Agencies have modified the safe harbor to cover plans based on either the ''overall profitability or revenue'' of a bank or a qualifying affiliate or operating unit. This would include plans based on an entity's earnings per share or stock price, both of which are directly related to the entity's overall profitability or revenue. Because other, more granular measures of the financial performance of a bank, affiliate or operating unit could create an unduly close connection between the employee's expected payment under the bonus plan and referrals made to the broker-dealer or the securities transactions that result from those referrals, the rules provide for plans structured in more granular ways to be analyzed under the multi-factor, discretionary criteria in Rule 700(b)(1).

The potential connection between a referral made by a bank employee and the payments made to the employee under a bonus plan may be particularly strong if payments under the plan are based on the profitability or revenue of (i) the partner broker-dealer itself or a specific branch or operating unit of the broker-dealer (such as the branch or operating unit responsible for handling customers referred by the bank), or (ii) an operating unit of the bank or a non-broker-dealer affiliate that is predominantly engaged over time in referring customers to the broker-dealer. To address the potential for improper incentives in these situations, the Agencies have modified Rule 700(b)(2)(iii) to allow a bonus program to be based on the overall profitability or revenue of a broker-dealer only if the program meets the conditions specified in (A)–(D) above. These conditions are similar to those that would apply to a discretionary bonus or similar plan under paragraph (b)(1) and are designed to ensure that the profitability or revenue of the broker-dealer is only one of multiple significant factors or variables in determining the employee's compensation and that a referral or number of referrals made by the employee is not a factor or variable under the program.[77] Like the proposal, the safe harbor in paragraph (b)(2) is not available to bonus plans based on the profitability or revenue of a particular branch, division or operating unit of the partner broker-dealer.

In addition, the Agencies have modified paragraph (b)(2)(ii) of the rule to exclude bonus plans based on the profitability or revenue of an operating unit of a bank or non-broker-dealer affiliate that over time predominantly engages in the business of making referrals to a broker-dealer. This exclusion is intended to prevent a bank from basing a bonus plan on the overall profitability or revenue of a bank unit that is focused solely or predominately on making referrals to a broker-dealer. This restriction, however, is not intended to prevent a bonus plan from being based on the overall profitability or revenue of a bank unit, such as a call center, that in fact markets, sells or supports a range of bank products in addition to making referrals to a broker-dealer and which is not, over time, predominantly engaged in the business of making referrals to a broker-dealer.

*C. Rule 701: Exemption for Referrals Involving Institutional Customers and High Net Worth Customers*

The proposed rules included an exemption that would permit a bank, subject to certain conditions, to pay an employee a contingent referral fee of more than a nominal amount for referring an ''institutional customer'' or ''high net worth customer'' to a broker-dealer with which the bank has a contractual or other written networking arrangement.[78] Among the conditions included in the proposed rule were conditions that—

- Established the financial thresholds at which a customer would be considered an ''institutional customer'' or ''high net worth customer'';
- Limited the types of bank employees that may receive a higher-than-nominal referral fee under the exemption and the manner in which these fees may be structured;[79]
- Required the bank to provide certain disclosures to the customer regarding the referral arrangement;[80] and
- Required that the agreement between the bank and the broker-dealer include certain provisions, including a provision obligating the broker-dealer to perform a suitability analysis of certain securities transactions that may result from the referral or a sophistication analysis of the customer referred.[81]

Many commenters supported providing an exemption for referrals

[77] As with a multi-factor bonus plan under paragraph (b)(1) of the Rule, a non-securities factor or variable will be considered ''significant'' under paragraph (b)(2)(iii) if it plays a material role in determining an employee's compensation under the bonus or similar plan.

[78] Proposed Rule 701.

[79] *See* Proposed Rule 701(a)(1) and (d)(4).

[80] *See id.* at 701(a)(2)(i).

[81] *See id.* at 701(a)(3)(ii).

involving sophisticated individuals and entities.[82] These commenters, for example, asserted that the exemption was appropriate in light of the required sophistication of the customer involved.[83] Other commenters, however, argued that providing an exemption to the ''nominal'' requirement would not be in the interest of investors or the public. These commenters asserted that the exemption as proposed would allow bank employees to have a significant salesman's stake in securities transactions and encourage bank employees to act as finders or salespeople for a broker-dealer.[84]

Many commenters, including a number that supported the exemption, also asked that the Agencies modify the exemption to, among other things, lower or alter the thresholds at which a person would be considered an ''institutional customer'' or ''high net worth customer'' under the rule; eliminate the provisions of the rule requiring the broker-dealer to perform a suitability or sophistication analysis in connection with a referral; or eliminate the limitations on the manner in which a higher-than-nominal referral fee may be structured. In addition, many commenters requested that the Agencies modify the rule in several respects to reduce administrative burden and complexity. For example, several commenters asked that the Agencies provide a bank and its partner broker-dealer greater flexibility to assign between themselves the responsibility for fulfilling the disclosure and other obligations included in the rule.

After carefully considering the comments, the Agencies have decided to retain the exemption. The Agencies continue to believe that it is appropriate to provide an exemption from the nominal and contingency limitations in the networking exception for referrals that both involve institutions and individuals that meet certain financial criteria and that occur under other conditions designed for investor protection. When provided appropriate information, such institutions and individuals are more likely to be able to understand and evaluate the relationship between a bank and its employees and the bank's broker-dealer partner and the impact of that relationship on any resulting securities transaction with the broker-dealer. The conditions in the final exemption are designed to help ensure that, among other things, institutional and high net worth customers, as defined in the rule, receive appropriate investor protections and information that enables the customer to understand the financial interest of the bank employee so the customer can make informed choices. Moreover, as the exemption itself provides, a bank operating under the exemption also must comply with the terms and conditions in the statutory networking exception (other than the compensation restrictions in Section 3(a)(4)(B)(i)(VI) of the Exchange Act's networking exception), including the terms and conditions that require the disclosure of the uninsured nature of securities and that limit the role that a bank employee may have in a brokerage transaction.[85] These conditions provide additional protections to institutional and high net worth customers that may be referred to a broker-dealer under Rule 701.

The Agencies have modified the final rule in several respects to, among other things, provide banks and broker-dealers greater flexibility in complying with the rule's disclosure requirements and to make the exemption more workable in practice. In light of the protections retained in the rule, the Agencies also have modified the thresholds at which a non-natural person will be considered an ''institutional customer'' for purposes of the rule. These modifications are discussed further below.

Banks that pay their employees only nominal, non-contingent fees in accordance with Rule 700 for referring customers—including institutional or high net worth customers—to a broker-dealer do not need to rely on, or comply with, the exemption provided in Rule 701. As under the proposal, the final rule requires that the written agreement between a bank operating under the exemption and its partner broker-dealer include terms that obligate the broker-dealer to take certain actions. Banks and broker-dealers are expected to comply with the terms of their written networking arrangements. If a bank or broker-dealer does not comply with the terms of the agreement, however, the bank would not become a ''broker'' under Section 3(a)(4) of the Exchange Act or lose its ability to operate under the proposed exemption.

1. Definitions of ''Institutional Customer'' and ''High Net Worth Customer''

Proposed Rule 701(d)(2) defined an ''institutional customer'' to mean any corporation, partnership, limited liability company, trust, or other non-natural person that has at least $10 million in investments *or* $40 million in assets. Under the proposal, a non-natural person also would qualify as an ''institutional customer'' with respect to a referral if the customer has $25 million in assets *and* the bank employee refers the customer to the broker-dealer for investment banking services. Proposed Rule 701(d)(1) defined a ''high net worth customer'' to mean any natural person who, either individually or jointly with his or her spouse, has at least $5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse. Proposed Rule 701 also included provisions governing the allocation of assets held by a natural person jointly with his or her spouse and provided for the dollar thresholds in the rule to be adjusted for inflation every five years.

A number of commenters argued that the proposed dollar thresholds for both types of customers were too high in light of the nature of the transactions involved and the other requirements of the exemption.[86] Commenters asserted that customers with lower levels of net worth, assets or investments are sophisticated enough to understand and evaluate the implications of a higher-than-nominal or contingent referral fee. Commenters suggested a wide variety of alternative thresholds, with many recommending that the Agencies use an existing standard established under the federal securities laws for assessing a customer's investment sophistication. For example, commenters recommended that the Agencies use the ''accredited investor'' definition in the Commission's Regulation D, or the definition of that term proposed for use in connection with investments in certain private investment vehicles, for purposes of defining an institutional or high net worth customer;[87] treat all corporate and non-natural persons as an institutional customer; consider all persons advised by a bank or a registered investment adviser to be sophisticated; or lower the asset threshold for municipalities or

[82] *See, e.g.*, BISA Letter, CBA Letter, Citigroup Letter, ICBA Letter, Roundtable Letter, Securities Industry and Futures Markets Ass'n (''SIFMA'') Letter, State Street Corp. Letter, U.S. Trust Letter, Union Bank Letter.

[83] *See* CBA Letter.

[84] *See, e.g.*, Massachusetts Securities Division Letter, NASAA Letter.

[85] *See* Exchange Act Section 3(a)(4)(B)(i)(V) and (IX).

[86] *See, e.g.*, HSBC Bank Letter, U.S. Trust Letter, SIFMA Letter, Roundtable Letter.

[87] *See* 17 CFR 230.501(a)(3), (5) and (6); Securities Act Rel. No. 33–8766, 72 FR 400, Jan. 4, 2007.

charitable organizations.[88] Several commenters also asked that the Agencies allow banks to use a business customer's revenues for purposes of determining if the customer is an institutional customer.

After carefully reviewing the comments, the Agencies have modified the definition of an ''institutional customer'' in the final rule to mean any corporation, partnership, limited liability company, trust, or other non-natural person that has, or is controlled by a non-natural person that has, at least: (i) $10 million in investments; or (ii) $20 million in revenues; or (iii) $15 million in revenues if the bank employee refers the customer to the broker-dealer for investment banking services.[89] When converted to an equivalent asset number, the $20 million and $15 million revenue thresholds in the final rule are somewhat lower than $40 million and $25 million asset thresholds in the proposed rule.[90] The Agencies believe that these lower thresholds are appropriate for corporate and other non-natural customers in light of the other protections retained in the final rule, including the provisions requiring a suitability or sophistication determination, and the greater internal and external resources that business entities typically have as compared to individuals. The Agencies have modified the thresholds to be based on revenues (rather than assets) to eliminate the potential for borrowings to influence the status of a corporate customer and to promote the equivalent treatment of non-financial companies and financial companies. In addition, the Agencies have amended the rule to provide that a company controlled by an institutional customer will itself be considered an institutional customer. A company controlled by another company should generally have access to the resources and sophistication of the controlling company.

The lower revenue threshold for referrals involving investment banking services is designed to facilitate access to the capital markets by smaller companies. Like the proposal, 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.[91] 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. These examples are not exhaustive and are provided solely for illustrative purposes.[92]

The final rule continues to define a ''high net worth customer'' as a natural person who, either individually or with his or her spouse, has at least $5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse. In response to comments,[93] the Agencies have modified this definition to include any revocable, inter vivos or living trust the settlor of which is a natural person who, either individually or jointly with his or her spouse, meets the $5 million in net worth test.[94] This change is designed to reflect the fact that otherwise sophisticated individuals may hold assets through such trusts for estate planning or other purposes.

The Agencies believe that customers that meet the net worth, investment and revenue thresholds included in the final rule should have the ability to understand and evaluate the financial interest of the bank employee making a referral to a broker-dealer under the exemption. In developing these thresholds, the Agencies took into account the limited nature of activities covered by the exemption (*i.e.*, a referral by a bank employee to a broker-dealer). The Agencies have not modified the rule, as requested by some commenters, to treat any person advised by a bank or a registered investment adviser as an institutional or high net worth customer. The existence of such an advisory relationship generally is not, by itself, sufficient to establish the financial sophistication of an individual or corporate entity for purposes of the other similar standards in or developed under the federal securities laws.[95]

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 or 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. These rules are designed to ensure that the full amount of jointly owned assets are not considered in cases where one spouse acts independently of the other in contacting a broker-dealer.[96] The Agencies have re-formatted these allocation provisions in the final rule to make them easier to understand and promote compliance.

As in the proposal, the dollar threshold for both institutional customers and high net worth customers will be adjusted for inflation on April 1, 2012, and every five years thereafter, to reflect changes in the value of the Personal Consumption Expenditures Chain-Type Price Index, as published by the Department of Commerce, from December 21, 2006. The Agencies selected this index because it is a widely used and broad indicator of inflation in the U.S. economy.

### *2. Determining That a Customer Meets the Relevant Thresholds*

The proposal required the bank to determine that the customer being

[88] *See, e.g.*, ABA Letter, Clearing House Ass'n Letter, State Street Corp. Letter.

[89] Rule 701(d)(2).

[90] To develop comparable asset and revenue thresholds for an institutional customer, the Agencies used a dataset composed of all publicly traded, U.S.-incorporated, non-financial companies with a market capitalization of greater than $0 and for which asset and sales data were available in the 2005 CompuStat Universe of North American companies published by Standard & Poor's Corporation. For more information on the CompuStat Universe, *see http://www2.standardandpoors.com/spf/pdf/products/Compustat2006.pdf.* A company with $40 million in assets and a company with $25 million in assets would rank at approximately the 27.5th percentile and the 21.9th percentile, respectively, of all companies within this dataset when ranked according to assets. When the companies within this dataset are ranked according to sales, the companies at approximately the 27.5th percentile and the 21.9th percentile have approximately $27.7 million and $15.7 million in sales.

[91] *See* Rule 701(d)(3).

[92] When used in this rule, the term ''include, without limitation'' means a non-exhaustive list. This usage is not intended to suggest that the term ''including'' as used in the Exchange Act and the rules under that Act means an exhaustive list. The use of the term ''including, but not limited to'' in Exchange Act Rules 10b–10 and 15b7–1 is also not intended to create a negative implication regarding the use of ''including'' without the term ''but not limited to'' in other Exchange Act rules. *See* Exchange Act Release No. 49879, 69 FR 39682 (June 30, 2004), at footnote 76.

[93] *See* ABA Letter, PNC Letter, Roundtable Letter.

[94] Rule 701(d)(1)(i)(B).

[95] *See, e.g.*, 15 U.S.C. 80a–2(a)(51), 78c(a)(54); 17 CFR 230.501(a).

[96] One commenter asserted that the Agencies should allow a person to include assets that the person holds jointly with someone other than a spouse, such as a relative or domestic partner, for purposes of calculating whether the person meets the net worth threshold. *See* Roundtable Letter. The Agencies have not modified the rule in this manner to keep the scope of individuals whose assets may be considered in determining whether a natural person has the appropriate level of financial sophistication consistent with the standards used in determining whether a natural person is an accredited investor under the Commission's Regulation D. *See* 17 CFR 230.501(a).

referred met the standards to be a high net worth or institutional customer either (i) before the referral fee was paid to the bank employee, in the case of a non-natural person, or (ii) prior to or at the time of the referral, in the case of a natural person.[97] In making these determinations for a natural person, the proposed rule allowed the bank to rely on a signed acknowledgment from the person that he or she met the standards to be a high net worth customer.[98] The proposed rule also required that the written agreement between the bank and the broker-dealer provide for the broker-dealer to (i) determine that the customer being referred met the standards to be a high net worth customer or institutional customer before the referral fee was paid,[99] and (ii) promptly inform the bank if the broker-dealer determined that a customer referred under the exemption did *not* meet the applicable standard.[100]

Commenters argued that either the bank or the broker-dealer, but not both, should be required to make these customer eligibility determinations and that the bank and the broker-dealer should be permitted to allocate responsibility for these determinations between themselves.[101] In addition, several commenters contended that a bank should be allowed to make the eligibility determinations for both high net worth customers and institutional customers before the referral fee is paid or before a securities transaction is effected at the broker-dealer.[102] A few commenters also asserted that banks and broker-dealers should be permitted to rely on a signed acknowledgement from either an institutional or high net worth customer.[103]

The status of the referred customer as a high net worth or institutional customer is a fundamental aspect of the exemption and the final rule continues to provide for both the bank and the broker-dealer to determine that the customer meets the necessary qualification criteria to provide added assurance that these criteria are met.[104] In addition, less information typically is in the public domain concerning the financial resources of an individual than of a corporation or other business entity and, accordingly, there is a greater likelihood that a bank employee—without further investigation—will be able to preliminarily identify corporate or other business customers that are likely to satisfy the rule's eligibility criteria than in the case of individuals. For these reasons, the final rule continues to provide for the bank to determine that a natural person is a high net worth customer before a referral is made and before the employee potentially develops an expectation of a higher-than-nominal fee.

The Agencies, however, have modified the final rule to make it more flexible while retaining its underlying purpose by providing that a bank or a broker-dealer satisfies its customer eligibility requirements if the bank or broker-dealer ''has a reasonable basis to believe that the customer'' is an institutional customer or high net worth customer before the time specified in the rule.[105] 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, respectively, and the bank employee making the referral or the broker-dealer employee dealing with the referred customer does not have information that would cause the employee to believe that the information provided by the customer (or representative) is false.

3. Conditions Relating to Disclosures

The proposed exemption required that the bank provide a high net worth customer or institutional customer being referred to the bank's broker-dealer partner certain written disclosures about the bank employee's potential interest in the referral prior to or at the time of the referral.[106] Commenters generally believed that providing these types of disclosures to a high net worth or institutional customer would help ensure that the customer received appropriate information concerning the relationship between the bank and the broker-dealer,[107] although a few questioned whether sophisticated customers required any disclosures at all or suggested that more simplified disclosures be permitted.[108] A number of commenters also asserted that the requirement that the bank provide these disclosures ''prior to or at the time of the referral'' was impractical or burdensome.[109] Commenters instead asserted that the rule should allow the disclosures to be provided before the referral fee is paid or before a securities transaction is effected at the broker-dealer, or allow the bank and the broker-dealer to determine which entity would make the disclosures.[110]

The final rule continues to require that a high net worth or institutional customer referred to a broker-dealer under the exception receive disclosures that clearly and conspicuously disclose (i) the name of the broker-dealer; and (ii) that the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker-dealer and that payment of this fee may be contingent on whether the referral results in a transaction with the broker-dealer.[111] This requirement ensures that high net worth or institutional customers receive notice of the financial interest the referring employee may have in the transaction so they can make informed choices.

In light of the comments, the Agencies have modified the provisions of the rule governing how and when these disclosures must be provided to make the rule more workable and less burdensome while also requiring that customers receive the information in time to make informed choices. Specifically, the final rule provides two options for providing the required

[97] Proposed Rule 701(a)(2)(ii).

[98] Proposed Rule 701(a)(2)(ii)(B)(2).

[99] Proposed Rule 701(a)(3)(i).

[100] Proposed Rule 701(a)(3)(iii)(A).

[101] *See, e.g.*, BISA Letter, Clearing House Ass'n Letter, Citigroup Letter, and SIFMA Letter. Some commenters, for example, suggested that requiring bank employees to make these determinations might require the employee to go beyond the limited role a bank employee is permitted to play in a brokerage transaction under the statute. *See, e.g.*, BISA Letter, ABA Letter.

[102] *See, e.g.*, ABA Letter, BISA Letter, Clearing House Ass'n Letter, HSBC Bank Letter, and PNC Letter.

[103] *See, e.g.*, Citigroup Letter, SIFMA Letter.

[104] *See* Rule 701(a)(2)(ii) and (3)(ii)(B). The final rule also continues to provide for the written agreement between the bank and the broker-dealer to require the broker-dealer to inform the bank if the broker-dealer determines that a referred customer does not meet the relevant eligibility thresholds. *See* Rule 701(a)(3)(v)(A).

[105] Rule 701(a)(2)(ii).

[106] Proposed Rule 701(a)(2)(i).

[107] *See, e.g.*, ABA Letter, JP Morgan Letter, Roundtable Letter, BISA Letter.

[108] *See, e.g.*, Bank of America Corp. (''BofA'') Letter and WBA Letter.

[109] For example, some commenters noted that some referrals may occur only by telephone or asserted that it may be unclear to an employee when a referral actually occurs.

[110] *See, e.g.*, ABA Letter, BISA Letter, Clearing House Ass'n Letter, HSBC Bank Letter, and WBA Letter. In addition, some commenters contended that banks should be required to provide similar conflict-of-interest disclosures to customers referred to a broker-dealer under the statutory networking exception. *See, e.g.*, Boyd Financial Letter, Pace Project Letter, University of Cincinnati Corp. Law Center Letter. The statutory networking exception itself sets certain disclosures that the bank or broker-dealer must provide a customer in situations where the bank employee making the referral may receive only a ''nominal'' referral fee. 15 U.S.C. 78c(a)(4)(i)(IX).

[111] Rule 701(b).

disclosures. Under the first option, as under the proposal, the bank must provide the high net worth or institutional customer the disclosures *in writing* prior to or at the time of the referral.[112] The second option allows the bank to provide the disclosure to the customer *orally* prior to or at the time of the referral. However, if the bank provides the customer the required disclosures only orally, then either (i) the bank must provide the disclosure to the customer in writing within 3 business days of the date of the referral; or (ii) the broker-dealer must be obligated, under the terms of its written agreement with the bank, to provide the disclosures in writing to the customer.[113] If the broker-dealer is responsible for providing the written disclosures, then it must provide the disclosures to the customer prior to or at the time the customer begins the process of opening an account at the broker-dealer (if the customer does not already have an account with the broker-dealer) or prior to the time the customer places an order for a securities transaction with the broker-dealer as a result of the referral (if the customer already has an account at the broker-dealer).[114] In this way, the rule provides a mechanism for customers to receive the disclosures in writing when they initially are provided only orally. Whether provided orally or in writing, the required disclosures will be considered to have been made in a clear and conspicuous manner if they are provided in a manner designed to call attention to the nature and significance of the information.

4. Suitability or Sophistication Analysis by Broker-Dealer

The proposed exemption required that the written agreement between the bank and the broker-dealer provide for the broker-dealer to perform a suitability or sophistication analysis of a securities transaction or the customer being referred, respectively. The type and timing of the analysis needed to be conducted by the broker-dealer depended on whether the referral fee was contingent on the completion of a securities transaction at the broker-dealer.[115] The proposed rule also required that the written agreement between the bank and its partner broker-dealer obligate the broker-dealer to inform the bank if it determined that a customer referred under the exemption, or a transaction to be conducted by the customer, did not meet the relevant suitability or sophistication standard.[116]

Several commenters objected to this suitability/sophistication requirement arguing that the broker-dealer should be required to conduct a suitability/sophistication analysis only when such an analysis would otherwise be required under the rules of the broker-dealer's self-regulatory organization (''SRO'') (*i.e.*, in those cases where the broker-dealer makes a recommendation to the customer concerning securities).[117] Commenters also argued that the suitability/sophistication requirement was unworkable or unnecessary given that the transaction may involve only a referral (without a securities transaction occurring) of a sophisticated customer.[118] In addition, some commenters expressed concern that the proposed standards would increase the potential liability of broker-dealers or delay the ability of a broker-dealer to respond to a customer's instructions.

After carefully considering the comments, the Agencies have retained the requirement that the parties' written agreement provide for the broker-dealer to perform a suitability analysis when a referral fee is contingent on a transaction and a suitability or sophistication analysis for other referrals. These requirements provide additional investor protections in those circumstances where the bank employee making the referral may receive a higher-than-nominal referral fee. The suitability and sophistication standards included in the final rule are based on the standards that broker-dealers currently must apply and use under applicable SRO rules and, thus, should be familiar to those broker-dealers that partner with banks operating under the exemption.[119] In addition, the exemption gives a broker-dealer the flexibility to perform a suitability analysis, if one is otherwise required by the rule, in connection with all referrals made under the exemption if the broker-dealer determines that such an approach is appropriate for business, compliance or other reasons.

Specifically, for contingent referral fees payable under the exemption, the written agreement between the bank and the broker-dealer must provide for the broker-dealer to conduct a suitability analysis of each securities transaction that triggers any portion of the contingency fee in accordance with the rules of the broker-dealer's applicable SRO as if the broker-dealer had recommended the securities transaction.[120] This analysis must be performed by the broker-dealer before each securities transaction on which the referral fee is contingent is conducted.

For non-contingent referral fees payable under the exemption, the written agreement must provide for the broker-dealer to conduct, before the referral fee is paid, either (1) a sophistication analysis of the customer being referred; or (2) a suitability analysis with respect to all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the broker-dealer's applicable SRO as if the broker-dealer had recommended the securities transaction.[121] Under the sophistication analysis option, the broker-dealer must determine that the customer has the capability to evaluate investment risk and make independent decisions, and determine that the customer is exercising independent judgment based on the customer's own independent assessment of the opportunities and risks presented by a potential investment, market factors, and other investment considerations.[122] This sophistication analysis is based on

[112] Rule 700(a)(2)(i).

[113] Rule 701(a)(2)(i) and (a)(3)(i).

[114] Rule 701(a)(3)(i). As a general matter, a customer begins the account-opening process when the customer fills out the appropriate forms provided by the broker-dealer to establish an account.

[115] Proposed Rule 701(a)(3)(ii).

[116] Proposed Rule 701(a)(3)(iii)(C).

[117] *See, e.g.*, ABA Letter, Clearing House Ass'n Letter, Citigroup Letter, and PNC Letter. *See also* FINRA Rule 2310 and FINRA IM–2310–3 (discussing suitability obligations of member broker-dealers). One commenter also asserted that any expansion of a broker-dealer's suitability obligations should be processed and approved through the normal market regulation and SRO process. *See* SIFMA Letter.

[118] *See, e.g.*, Clearing House Ass'n Letter, SIFMA Letter. Commenters also asserted that a broker-dealer may not be able to perform the proposed ''sophistication'' analysis if the customer does not open an account or refuses to provide the broker-dealer the information necessary to perform the analysis.

[119] One commenter expressed concern that the suitability/sophistication requirements of the rule may discourage low-cost, execution-only brokers from establishing relationships with banks under the exemption. *See* Business Law Section Letter. The Agencies are mindful of the need to keep appropriate investment options, including low-cost options, available to investors. However, given the cost structure of low-cost brokers, the Agencies expect that few such brokers would participate in referral arrangements under the exemption that provides for higher-than-nominal referral fees. Broker-dealers that do not wish to become obligated to perform the suitability/sophistication analyses required by the rule also may continue to establish and maintain networking arrangements pursuant to the statutory networking exception.

[120] Rule 701(a)(3)(ii)(A). Because the exemption provides for a broker-dealer to conduct its suitability analysis in accordance with the rules of its applicable SRO, the broker-dealer may follow and take advantage of any applicable SRO rules or interpretations that allow the broker-dealer to make an alternative suitability evaluation. See, *e.g.*, FINRA IM–2310–3 (discussing a member's suitability obligations with respect to certain institutional investors).

[121] Rule 701(a)(3)(iii)(B).

[122] Rule 701(a)(3)(ii)(B)(*1*).

elements of FINRA IM–2310–3 (Suitability Obligations to Institutional Customers).

The Agencies have modified the final rule to provide for the broker-dealer to notify the customer, rather than the bank, if the broker-dealer determines that a high net worth or institutional customer, or a securities transaction to be conducted by such a customer, does not meet the applicable sophistication or suitability standard.[123] Providing such notification to the customer should assist the customer in deciding whether or not to conduct the transaction.

5. Conditions Relating to Bank Employees

Paragraph (b)(1) of the Proposed Rule included certain limitations on the types of bank employees that may receive a higher-than-nominal referral fee under the rule. In particular, the Proposed Rule provided that the bank employee: be predominantly engaged in banking activities, other than making referrals to a broker-dealer; encounter the high net worth or institutional customer in the ordinary course of the employee's assigned business for the bank; not be qualified or required to be qualified under the rules of a SRO; and not be subject to statutory disqualification under Section 3(a)(39) of the Exchange Act (other than subparagraph (E) of that Section) (''statutory disqualification'').[124]

The proposed exemption also included other provisions related to the SRO and statutory disqualification conditions. First, it required that the written agreement between the bank and the broker-dealer must provide for the bank *and* the broker-dealer to affirmatively determine, before a referral fee is paid to a bank employee under the exemption, that the employee is not subject to statutory disqualification.[125] Second, it required that the bank provide the broker-dealer the name of the employee and such other identifying information that may be necessary for the broker-dealer to determine whether the bank employee is subject to statutory disqualification or associated with a broker-dealer.[126] And third, it required that the parties' written agreement obligate the broker-dealer to promptly inform the bank if it determined the bank employee was subject to statutory disqualification.[127]

The final rule retains these provisions with the following modifications.[128] In response to comments,[129] the Agencies have modified the SRO condition in paragraph (a)(1)(A) of the Rule to provide that the employee receiving the referral fee must not be ''registered or approved, or otherwise required to be registered or approved, in accordance with the qualification standards established by the rules of any self-regulatory organization.'' The Agencies have modified the related language in paragraph (a)(2)(iii) of the rule in a similar manner.

Several commenters argued that the requirement that a bank employee encounter the high net worth or institutional customer ''in the ordinary course of the bank employee's assigned duties'' was unnecessary and ambiguous.[130] The Agencies have retained the requirement to help ensure that a bank employee making a referral under the rule does so as part of the employee's duties as a bank employee and not as a sales representative of the broker-dealer. However, the Agencies recognize that in the ordinary course of his or her assigned duties for the bank, a bank employee may encounter customers or potential customers outside the employee's regular business hours or at locations outside of the bank, such as at social or civic functions or gatherings.

A number of commenters contended that the bank and the broker-dealer should not both be required to verify that the bank employee is not subject to statutory disqualification and suggested that the bank and broker-dealer be permitted to allocate this responsibility between themselves.[131] The Agencies have modified the rule to provide for these determinations to be made by the broker-dealer under the terms of the parties' written agreement.[132] The Agencies believe that broker-dealers are better suited to make this determination given their familiarity with the Exchange Act's statutory disqualification standards, provided that they receive the necessary information concerning the employee from the bank. A broker-dealer fulfills its responsibilities under paragraph (a)(3)(ii)(A) of Rule 701 if the broker-dealer determines that a bank employee is not subject to statutory disqualification before the employee first receives a referral fee under Rule 701 and at least once each year thereafter as long as the employee remains eligible to receive referral fees under the rule.

As a means designed to ensure that the broker-dealer has the appropriate information to make these determinations, the rule continues to require that, before a higher-than-nominal referral fee is paid to a bank employee under the 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.[133] Once the information for a particular employee is conveyed to the broker-dealer, the bank should provide at least annually its broker-dealer partner any changes to the identifying information initially provided under paragraph (a)(2)(iii) of Rule 701 for an employee who continues to make referrals and receive referral fees under the exemption so that the broker-dealer may perform its periodic review of the employee's qualifications under paragraph (a)(3)(ii)(A).

6. Good Faith Compliance and Corrections by Banks

As in the proposal, the final 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. Similarly, to promote compliance with the terms of the

[123] Rule 701(a)(3)(iv).

[124] *See* Proposed Rule 701(a)(1).

[125] Proposed Rule 701(a)(3)(i)(A).

[126] Proposed Rule 701(a)(2)(iii).

[127] Proposed Rule 701(a)(3)(iii)(B).

[128] *See* Rule 701(a)(1), (a)(2)(iii), (a)(3)(ii)(A), and (a)(3)(v)(B).

[129] *See* Business Law Section Letter.

[130] *See, e.g.*, ABA Letter, BISA Letter, Clearing House Ass'n Letter, Comerica Bank Letter, and U.S. Trust Letter. For example, some asserted that bank employees may be expected to identify and develop client relationships at social or other events and expressed concern that the language might prevent a bank employee from receiving a referral fee for institutional or high net worth customers encountered in these ways.

[131] *See, e.g.*, ABA Letter, BISA Letter, Clearing House Ass'n Letter, Citigroup Letter, PNC Letter, and SIFMA Letter.

[132] Rule 701(a)(3)(ii)(A).

[133] Rule 700(a)(2)(iii).

exemption, 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 under the statutory networking exception and Rule 700.[134]

A few commenters suggested that the Agencies strike the requirement that the bank seek to reclaim the higher-than-nominal portion of a referral fee. The Agencies have retained this requirement as it helps provide employees an incentive to comply with the rule.[135]

7. Referral Fees Permitted Under the Exemption

Proposed Rule 701 placed certain limits on how a higher-than-nominal referral fee paid under the exemption may be structured.[136] Some commenters argued that these restrictions are unnecessary in light of the other protections included in the exemption, or that the rule should allow a higher-than-nominal referral fee to be based on a percentage of any type of securities transaction conducted at a broker-dealer (rather than just investment banking transactions).[137] On the other hand, one commenter asserted that, by allowing a referral fee to be based on the total amount of assets maintained in an account with the broker-dealer, the rule would provide an incentive for bank employees to provide ongoing investment advice to customers.[138]

The final rule continues to place limits on the types of referral fees a bank employee may receive under the exemption. These limitations are designed to reduce the potential ''salesman's stake'' of the bank employee in securities transactions conducted at the broker-dealer. Specifically, the exemption provides that a referral fee paid under the exemption may be a dollar amount based on a fixed percentage of the revenues received by the broker-dealer for investment banking services provided to the customer.[139] Alternatively, 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.[140] 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.

As the exemption provides, these restrictions do not prevent a referral fee from being paid in multiple installments or from being based on a fixed percentage of the total dollar amount of assets placed in an account with the broker-dealer. Additionally, these restrictions do not prevent a referral fee from being based on a fixed percentage of the total dollar amount of assets (including securities and non-securities assets) maintained by the customer with the broker-dealer. Fees structured in this manner and consistent with the limitations in paragraph (d)(4)(i) of the Rule do not provide a bank employee an incentive to recommend the purchase or sale of particular securities. In fact, the bank employee would have no special incentive to recommend the purchase of any security, as the addition of cash or other non-security instruments to the account would count equally towards the employee's compensation as any addition of securities to the account.

8. Permissible Bonus Compensation Not Restricted

The exemption for high net worth and institutional customers expressly provides that nothing in the exemption prevents or prohibits a bank from paying, or a bank employee from receiving, any type of compensation under a bonus or similar plan that would not be considered incentive compensation under paragraph (b)(1), or that is described in paragraph (b)(2), of Rule 700 (implementing the networking exception).[141] As explained above, these types of bonus arrangements do not tend to create the kind of financial incentives for bank employees that the statute was designed to address.

## III. Trust and Fiduciary Activities

### *A. Trust and Fiduciary Exception and Proposed Rules*

Section 3(a)(4)(B)(ii) of the Exchange Act (the ''trust and fiduciary exception'') permits a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without being registered as a broker.[142] A bank must effect such transactions in its trust department, or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.[143] In addition the bank must be ''chiefly compensated'' for such transactions, consistent with fiduciary principles and standards, on the basis of: (1) An administration or annual fee; (2) a percentage of assets under management; (3) a flat or capped per order processing fee that does not exceed the cost the bank incurs in executing such securities transactions; or (4) any combination of such fees.[144]

Banks relying on this exception may not publicly solicit brokerage business, other than by advertising that they effect transactions in securities in conjunction with advertising their other trust activities.[145] In addition, a bank that effects a transaction in the United States of a publicly traded security under the exception must execute the transaction in accordance with Exchange Act Section 3(a)(4)(C).[146] This Section requires that the bank direct the trade to a registered broker-dealer for execution, effect the trade through 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 in contravention of fiduciary principles established under applicable federal or state law, or effect the trade in some other manner that the Commission permits.[147] The trust and fiduciary exception recognizes the

[134] Rule 701(a)(2)(iv).

[135] One commenter requested that the rule provide a similar safe harbor for broker-dealers. *See* SIFMA Letter. Any obligations of a broker-dealer that arise by reason of Rule 701 run only to its bank partner under the terms of their agreement and the Agencies believe the issue of contractual liability between the parties is best addressed by the parties themselves. As stated in the proposal, the Commission anticipates that it may be necessary for either FINRA or the Commission to propose a rule that would require broker-dealers to comply with the written agreements entered into pursuant to Rule 701.

[136] Proposed Rule 701(d)(4).

[137] *See, e.g.,* Clearing House Ass'n Letter and JPMorgan Letter.

[138] *See* NASAA Letter.

[139] Rule 701(d)(4)(ii).

[140] Rule 701(d)(4)(i). A referral fee paid under the exemption may be contingent on whether the customer opens an account with the broker-dealer or executes one or more transactions in the account during the initial phases of the account.

[141] Rule 701(c).

[142] 15 U.S.C. 78c(a)(4)(B)(ii).

[143] *Id.*

[144] 15 U.S.C. 78c(a)(4)(B)(ii)(I).

[145] 15 U.S.C. 78c(a)(4)(B)(ii)(II).

[146] 15 U.S.C. 78c(a)(4)(C).

[147] 15 U.S.C. 78c(a)(4)(C)(i)–(iii). As discussed *infra* at Part VI.C, the Agencies have adopted Rule 775 that permits banks, subject to certain conditions, to effect trades in securities issued by an open-end company and certain variable insurance contracts without sending the trade to a registered broker-dealer. Trades effected by a bank in accordance with Rule 775 are conducted in accordance with Section 3(a)(4)(C) of the Exchange Act.

traditional securities role banks have performed for trust and fiduciary customers and includes conditions to help ensure that a bank does not operate a securities broker in the trust department.

The proposed rules provided that a bank would meet the ''chiefly compensated'' condition in the trust and fiduciary exception if the bank's relationship compensation attributable to each trust or fiduciary account exceeded 50 percent of the total compensation attributable to the relevant account.[148] The proposed rules also included an exemption that would permit a bank to use a bank-wide approach to the ''chiefly compensated'' condition as an alternative to the account-by-account approach. A bank using this proposed alternative would be able to use the aggregate relationship and total compensation that the bank received from its trust and fiduciary business as a whole to monitor its compliance with the chiefly compensated test. The proposed rule allowed a bank to use this bank-wide alternative if, among other things, the bank's aggregate relationship compensation attributable to its trust or fiduciary business as a whole equaled or exceeded 70 percent of the total compensation attributable to its trust or fiduciary business. This bank-wide alternative was designed to simplify compliance, alleviate concerns about inadvertent noncompliance, and reduce the costs and disruptions banks likely would incur under the account-by-account approach.

The proposal defined the term ''relationship compensation'' to mean the types of trust and fiduciary compensation specifically identified in the trust and fiduciary exception. The proposed rules also provided examples of fees that would be considered an administration fee or a fee based on a percentage of assets under management for these purposes. For example, the proposed rules provided that fees paid by an investment company pursuant to a plan under 17 CFR 270.12b–1 (''12b–1 fees'') or for personal service or the maintenance of shareholder accounts (''service fees'') would be considered relationship compensation under the rules. The proposed rules also implemented the statute's advertising restriction and provided certain other conditional exemptions.

[148] Proposed Rule 721.

*B. Joint Final Rules*

1. ''Chiefly Compensated'' Test and Bank-Wide Exemption Based on Two-Year Rolling Averages

A majority of commenters supported the general approach taken in the proposed rules implementing the trust and fiduciary exception, including the proposed bank-wide alternative for the chiefly compensated test. For example, a number of commenters stated that the proposed bank-wide approach would provide banks an improved, workable and flexible method of complying with the statutory exception.[149] Some commenters, however, opposed either the account-by-account or bank-wide alternative to the ''chiefly compensated'' requirement. For example, some commenters argued that the account-by-account approach was inconsistent with the terms and purposes of the trust and fiduciary exception.[150] Another commenter argued that an account-by-account approach to the chiefly compensated test is the only way to help ensure that a bank does not operate a brokerage business out of its trust or fiduciary departments and, for this reason, recommended that the Agencies eliminate the bank-wide alternative.[151] Some commenters also requested that the Agencies lower the 70 percent relationship compensation/total compensation percentage required by the bank-wide exemption to 60 percent or 50 percent to make it more consistent with the percentage required by the account-by-account approach.[152]

After carefully considering the comments, the Agencies have retained the two alternative approaches in substantially the same form as proposed. Specifically, Rule 721 provides that a bank meets the ''chiefly compensated'' condition in the trust and fiduciary exception if the ''relationship-total compensation percentage'' for each trust or fiduciary account of the bank is greater than 50 percent.[153] The ''relationship-total compensation percentage'' for a trust or fiduciary account is calculated by (1) Dividing the relationship compensation attributable to the account during each of the immediately preceding two years by the total compensation attributable to the account during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.[154]

The final rules (Rule 722) also allow a bank to use a bank-wide approach to the ''chiefly compensated'' condition as an alternative to the account-by-account approach. To use this bank-wide methodology, the bank must meet two conditions. First, the ''aggregate relationship-total compensation percentage'' for the bank's trust and fiduciary business as a whole must be at least 70 percent.[155] The ''aggregate relationship-total compensation percentage'' of a bank operating under the bank-wide approach is calculated in a similar manner as the ''relationship-total compensation percentage'' of an account under the account-by-account, except that the calculations would be based on the aggregate relationship compensation and total compensation received by the bank from its trust and fiduciary business as a whole during each of the two immediately preceding years. In other words, the percentage would be determined by (1) Dividing the relationship compensation attributable to the bank's trust and fiduciary business as a whole during each of the immediately preceding two years by the total compensation attributable to the bank's trust and fiduciary business as a whole during the relevant year; (2) translating the quotient obtained for each of the two years into a percentage; and (3) then averaging the percentages obtained for each of the two immediately preceding years.[156] Second, the bank must comply with the conditions in the trust and fiduciary exception (other than the compensation test in Section 3(a)(4)(B)(ii)(I)) [157] and comply with Section 3(a)(4)(C) (relating to trade execution) of the Exchange Act.[158]

The Agencies believe that providing banks these two alternatives is consistent with the purposes of the trust and fiduciary exception. In this regard, the availability of these two alternatives is designed to avoid disrupting the trust and fiduciary operations of banks. The

[149] *See, e.g.*, ABA Letter, Roundtable Letter, U.S. Trust Letter, WBA Letter.

[150] *See, e.g.*, Clearing House Ass'n Letter.

[151] *See* NASAA Letter.

[152] *See* ACB Letter, CBA Letter.

[153] Rule 721(a)(1).

[154] The rule provides for this process to be accomplished by calculating the ''yearly compensation percentage'' and the ''relationship-total compensation percentage'' for the account. *See* Rule 721(a)(2) and (3).

[155] Rule 722(a)(2).

[156] The rule provides for this process to be accomplished by calculating the ''yearly bank-wide compensation percentage'' and the ''aggregate relationship-total compensation percentage'' for the bank's trust and fiduciary business as a whole. *See* Rule 722(b) and (c).

[157] The Agencies have modified the bank-wide exemption to clarify that these conditions include the advertising restrictions contained in the trust and fiduciary exception as implemented by Rule 721(b). *See* Rule 722(a)(1).

[158] Rule 722(a)(1).

compensation tests in both the account-by-account and bank-wide approaches are designed to ensure that a bank's trust department is not unduly dependent on the types of securities-related compensation not permitted by the statute. The 70 percent compensation threshold in the bank-wide exemption is higher than that required under the account-by-account approach in order to compensate for the loss of particularity when the chiefly compensated test is implemented and monitored on a bank-wide basis, rather than on an account-by-account basis. The Agencies note that several commenters also asserted that the proposed aggregate relationship compensation-total compensation percentage required by the bank-wide alternative (70 percent) would not disrupt the trust and fiduciary operations or customer relationships of banks in light of the proposal's definition of ''relationship compensation.''

Some commenters asked that the Agencies modify how the bank-wide exemption could be applied in several ways. For example, some asserted that a bank should be allowed to apply the 70 percent compensation threshold separately to each individual fiduciary business line, operating unit or geographic region of the bank, rather than only on an aggregate bank-wide basis. Others asked that the Agencies allow a bank to use an aggregate compensation approach only for some trust or fiduciary business lines and use the account-by-account approach for the bank's trust or fiduciary accounts in its remaining business lines.[159] In addition, some asked that a bank be permitted to monitor compliance with the 70 percent compensation test on a combined basis with its affiliated entities engaged in trust or fiduciary activities (such as an affiliated bank or a subsidiary or affiliate registered as an investment adviser).[160] Some commenters also asked the Agencies to modify the bank-wide approach to provide for a bank's relationship compensation-total compensation percentage to be calculated based on the compensation attributable to all of the bank's trust and fiduciary accounts rather than the compensation from the bank's ''trust and fiduciary business.'' [161]

The Agencies believe that the bank-wide alternative as structured provides banks appropriate and adequate flexibility in conducting their trust and fiduciary operations while meeting the statute's goals. The bank-wide approach is designed to reflect both the relationship compensation and total compensation received by a bank through the conduct of its full range of trust or fiduciary services, and, thus, allow banks to avoid tracking their trust or fiduciary revenue back to one or more specific accounts. At the same time, the use of two uniform methodologies (account-by-account or bank-wide) should facilitate the review of bank compliance during the bank supervisory process and aid the development of software and related systems by banks and their service providers for compliance purposes. Furthermore, because the broker exceptions for a bank in Section 3(a)(4)(B), including the trust and fiduciary exception, apply to each bank individually and are not available to a nonbank entity, including a nonbank subsidiary or affiliate of a bank, the Agencies have not modified the rules to allow a bank to monitor its compliance with the compensation limit in Rule 721 on a combined basis with one or more affiliated banks, subsidiaries or affiliates. The Agencies also do not believe that requiring banks to monitor their compliance with the 70 percent compensation test on a bank-wide basis, rather than on an individual business line or operating unit basis, will impose significant additional burdens on banks.[162]

A 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 of either the account-by-account or bank-wide approach.[163] In addition, whether a bank decides to use the account-by-account approach or the bank-wide approach, the bank's compliance with the relevant compensation restriction is based on a two-year rolling average of the compensation attributable to the trust or fiduciary account or the bank's trust or fiduciary business, respectively. This two-year averaging is designed to allow for short-term fluctuations that otherwise could lead a bank to fall out of compliance with the exception or exemption from year-to-year.

Some commenters asked that the Agencies clarify when a bank must commence monitoring its compliance with the two-year rolling compensation test. As discussed *infra* in Part VI.F, a bank must comply with the exceptions in Section 3(a)(4)(B) of the Exchange Act and the final rules starting the first day of the bank's first fiscal year commencing after September 30, 2008. Thus, a bank that operates on a calendar-year basis must start monitoring its compliance with the compensation requirements on either an account-by-account or bank-wide basis beginning January 1, 2009, and would first have to meet the applicable compensation restriction after the conclusion of 2010 (based on the average of the bank's year-end compensation ratios for 2009 and 2010).[164] To allow banks sufficient time to obtain and verify the relevant compensation data, the Agencies have modified both the account-by-account approach and the bank-wide approach to provide banks up to 60 days after the end of a year to calculate their compliance with the relevant compensation restriction.[165] While the rules provide for a bank's compliance with the compensation tests to be determined based solely on calculations as of year-end, banks are encouraged to monitor their trust and fiduciary compensation on a regular basis as appropriate to identify and address potential compliance issues before the end of the relevant two-year period.

2. ''Relationship Compensation''

Both the account-by-account and bank-wide approaches are based on the ratio of the relationship compensation attributable to a trust or fiduciary account or a bank's trust and fiduciary business to the total compensation attributable to the account or business. The proposal defined the term ''relationship compensation'' to mean the types of trust and fiduciary compensation identified in the statute: an administration fee; an annual fee (payable on a monthly, quarterly or other basis); a fee based on a percentage

[159] *See* Clearing House Ass'n Letter.

[160] *See* Citigroup Letter, Clearing House Ass'n Letter, Mellon Bank, N.A. (''Mellon'') Letter, PNC Letter, ABA Letter.

[161] *See, e.g.*, ABA Letter, Joint ABA/ABASA/Clearing House Ass'n Letter of July 16, 2007, BISA Letter, Clearing House Ass'n Letter, Comerica Bank Letter.

[162] The Agencies note, for example, that a bank that operates under the bank-wide approach may use different systems across its trust or fiduciary business lines, units or regions to monitor its compensation within those business lines, units or regions, provided that such information is then aggregated on a bank-wide basis as provided in Rule 722.

[163] Proposed Rule 721(a)(6).

[164] This same schedule also would apply to a bank that operates on an October 1st to September 30th fiscal year, but that elects to use the calendar year for purposes of monitoring its compliance with the chiefly compensated test. The Agencies believe the delay and phased-in nature of the compensation tests should provide banks as a general matter sufficient notice and time to address potential compensation issues across the full range of their trust and fiduciary accounts, including personal and charitable accounts and estates. *See* Business Law Section Letter.

[165] *See* Rule 721(a)(3)(ii) and Rule 722(c)(2).

of assets under management; a flat or capped per order processing fee that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or any combination of these fees.[166] The proposed rules also provided examples of fees that would be considered an administration fee or a fee based on a percentage of assets under management for these purposes. For example, the proposed rules provided that 12b–1 fees,[167] service fees,[168] and fees for certain sub-transfer agent, sub-accounting or related services [169] paid by an investment company on the basis of assets under management would be considered relationship compensation under the rules.

The Agencies received numerous comments on the definition of relationship compensation. A number of commenters supported the definition including, in particular, the examples recognizing 12b–1 and service fees as relationship compensation. For example, some commenters stated that treating these fees as relationship compensation is consistent with the terms and purposes of the trust and fiduciary exception and ''critical'' to ensuring that the rules do not disrupt the trust and fiduciary operations and customer relationships of banks.[170] Other commenters, however, argued that all 12b–1 fees, or the portion of such fees paid for distribution expenses, should be excluded from relationship compensation.[171] These commenters asserted that treating 12b–1 fees as relationship compensation would allow banks to have a ''salesman's stake'' in their customers'' securities transactions in contravention of the purposes of the statute, result in the disparate treatment of banks and registered investment advisers, and create confusion as to how 12b–1 fees should be treated under other aspects of the federal securities laws and rules of the NASD (now FINRA).

In addition, many commenters asked that the Agencies clarify whether additional types of fees not mentioned in the proposed rules would qualify as relationship compensation. For example, commenters asked the Agencies to confirm that fees separately charged a trust or fiduciary customer for custodial services and fees charged or earned in connection with securities lending and borrowing transactions conducted for a trust or fiduciary customer are relationship compensation.

After carefully considering the comments, the Agencies have retained, consistent with the statute, the definition of relationship compensation as any compensation that a bank receives that is attributable to a trust or fiduciary account and that consists of (1) an administration fee, (2) an annual fee (payable on a monthly, quarterly or other basis), (3) a fee based on a percentage of assets under management (an ''AUM fee''), (4) a flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or (5) any combination of these fees.[172]

The final rules also continue to list all 12b–1 fees that are paid on the basis of assets under management and attributable to a trust or fiduciary account (under the account-by-account test) or the bank's trust and fiduciary business as a whole (under the bank-wide test) as examples of AUM fees that are relationship compensation. The Agencies believe that treating 12b–1 fees in this manner is consistent with both the language and purposes of the trust and fiduciary exception. When paid on the basis of a percentage of assets under management these fees fall within the types of fees expressly permitted by the trust and fiduciary exception. 12b–1 fees that are paid on the basis of assets under management also are distinguishable from the types of non-relationship compensation, such as front-end or back-end sales loads [173] or per-order transaction fees that exceed a bank's costs, that are limited by the statute's chiefly compensated test.

Treating 12b–1 fees in this manner also will avoid significant disruptions to the trust and fiduciary operations of banks and, when viewed in light of other provisions and protections, is consistent with investor protection. Many bank trust and fiduciary departments, particularly those that act as a corporate trustee or as a trustee or fiduciary for employee benefit plans, receive a significant portion of their trust and fiduciary compensation through payments made under a 12b–1 plan.

Importantly, as provided in the trust and fiduciary exception, all 12b–1 fees received by a bank must be consistent with the fiduciary principles and standards governing the bank-customer relationship,[174] and the bank's compliance with these principles and standards will continue to be regularly examined by bank examiners during the bank supervisory and examination process. In addition, the treatment of 12b–1 fees that are paid on the basis of assets under management and service fees as ''relationship compensation'' for purposes of the trust and fiduciary exception and related rules does not affect the treatment of such fees under other provisions of the federal securities laws, the federal banking laws, applicable trust or fiduciary principles and standards, or the rules of an SRO. Thus, for example, the treatment of 12b–1 fees that are paid on the basis of assets under management and service fees as relationship compensation for purposes of these rules does not alter or affect the

[166] Proposed Rule 721(a)(4).

[167] Proposed Rule 721(a)(4)(iii)(A).

[168] Proposed Rule 721(a)(4)(iii)(B).

[169] *See* Proposed Rule 721(a)(4)(i) and (iii)(C). Specifically, these fees, which are hereinafter referred to as ''sub-transfer agent and related fees'' are paid for (1) providing transfer agent or sub-transfer agent services for the beneficial owners of investment company shares; (2) aggregating and processing purchase and redemption orders for investment company shares; (3) providing the beneficial owners with account statements showing their purchases, sales, and positions in the investment company; (4) processing dividend payments to the account for the investment company; (5) providing sub-accounting services to the investment company for shares held beneficially in the account; (6) forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or (7) receiving, tabulating, and transmitting proxies executed by the beneficial owners of investment company shares in the account.

[170] *See* Joint ABA/ABASA/Clearing House Ass'n Letter of June 7, 2007.

[171] *See* NASD Letter, NASAA Letter.

[172] Rule 721(a)(4). For banks operating under the bank-wide alternative, fees of these types are relationship compensation if they are attributable to the bank's trust or fiduciary business as a whole. *See* Rule 722(c)(1).

[173] A front-end sales charge is a charge that is used to finance sales or sales promotion expenses and that is included in the public offering price of the shares of an investment company. A deferred sales charge is an amount properly chargeable to sales or promotional expenses that is paid by a shareholder of an investment company after purchase of the company's shares but before or upon redemption. *See* FINRA Rule 2830(b)(8)(B) and (c); 17 CFR 270.6c–10.

[174] Section 802(f) of the Uniform Trust Code, for example, provides that a trustee may receive compensation from an investment company in which the trustee has invested trust funds and receipt of such compensation will not be presumed to represent a conflict of interest if the investment otherwise complies with the jurisdiction's prudent investor rule. *See* Uniform Trust Code, § 902(f) and related comment (2005). In addition, a bank's receipt of 12b–1 fees from an employee benefit plan for which the bank acts as a fiduciary is governed by the Employee Retirement Income Security Act (''ERISA'') and the regulations and guidance issued by the Department of Labor thereunder. *See* 29 U.S.C. 1001 *et seq.*; DOL Advisory Opinion 2003–09A (June 25, 2003) (discussing conditions under which a directed trustee may receive 12b–1 fees under ERISA).

treatment of, or limitations imposed on, these fees under FINRA Rule 2830.[175]

In light of the comments received, the Agencies have modified Rule 721 to provide additional examples of the types of fees that qualify as relationship compensation under the statute and the rules. For example, the Agencies have modified the rule to include, as additional examples of an administration fee, compensation received by a bank (1) for disbursing funds from, or for recording payments to, a trust or fiduciary account; (2) in connection with securities lending and borrowing transactions conducted for a trust or fiduciary account; and (3) for custody services provided to a trust or fiduciary account (whether or not separately charged).[176] In addition, the Agencies have included (1) as an example of an annual fee, an annual fee paid for assessing the investment performance of a trust or fiduciary account or for reviewing such an account's compliance with applicable investment guidelines or restrictions, and (2) as an example of an assets under management fee, a fee based on the financial performance, such as capital gains or capital appreciation, of trust or fiduciary assets under management. The Agencies believe the characterization of these fees comports with the manner in which banks generally receive compensation for these services. Several commenters noted that banks currently may receive 12b–1 fees, service fees or sub-transfer agent and related fees either directly from a mutual fund or from the fund's distributor, transfer agent, administrator or adviser.[177] In light of these comments, the Agencies have eliminated the language in the proposed rules that required that these types of fees be ''paid by an investment company.''

The examples of an administration fee, annual fee and an asset under management fee included in Rule 721(b) are provided only for illustrative purposes. Other types of fees or fees for other types of services could be an administration fee, annual fee or an AUM fee. In addition, an administration fee, annual fee or assets under management fee attributable to a trust or fiduciary account or a bank's trust or fiduciary business is considered relationship compensation regardless of what entity or person pays the fee, and regardless of whether the fee is related to only securities assets, to a combination of securities and non-securities assets, or to only non-securities assets. These fees are part of the compensation for acting as a trustee or fiduciary.

Some commenters asserted that a bank should be permitted to include within its relationship compensation any per-transaction securities processing fee it charges as a directed trustee or in another fiduciary capacity even if the fee exceeds the bank's costs in processing the transaction.[178] The statute, however, expressly provides that a per-order securities processing fee may be counted towards the statute's chiefly compensated requirement only if the fee is ''equal to not more than the cost incurred by the bank in connection with executing securities transactions'' for its trust or fiduciary customers. For this reason, the Agencies have not modified the rule in the manner requested.

However, as discussed further in Part V, the Agencies have modified the custody exemption (Rule 760) to permit banks that accept securities orders as a directed trustee to do so under that exemption in lieu of the trust and fiduciary exception and related rules. In addition, as the Agencies explained in the proposal, a per order processing fee included in relationship compensation may include the fee charged by the executing broker-dealer as well as any additional fixed or variable costs incurred by the bank in processing the transaction. If a bank includes any such additional fixed or variable costs in the per order processing fees it includes in its relationship compensation, the bank should maintain appropriate policies and procedures governing the allocation of these costs to the orders processed for trust or fiduciary customers. This should help ensure that profits derived from per trade charges are not masked as costs of processing the trades and thereby included in relationship compensation.

3. Excluded Compensation

A number of commenters asserted that the revenues derived from securities transactions conducted by a bank for a trust or fiduciary customer under a *different* exception or exemption (such as the exemption provided in Rule 771 for transactions in Regulation S securities) should be excluded from the account-by-account or bank-wide compensation test completely.[179] Others asked that certain other types of fees, such as internal credits from other areas of the bank, credits received from broker-dealers for brokerage or research services in accordance with Section 28(e) of the Exchange Act, or revenues earned from providing trust or fiduciary services to mutual funds, be excluded from the chiefly compensated calculation as well.

As discussed in Part I.C *supra*, if more than one ''broker'' exception or exemption is available for a securities transaction effected by a bank for a customer, the bank may choose the exception or exemption on which it relies in effecting the transaction. In light of the comments received, the Agencies have modified Rules 721 and 722 to explicitly provide that, if a bank effects a securities transaction for a trust or fiduciary customer in accordance with the terms of an exception or exemption other than Rule 721 or Rule 722, the bank may, at its election, exclude the revenues associated with those transactions from the applicable relationship-total compensation calculation in Rule 721 or Rule 722.[180] As the rules provide, if a bank elects to exclude the revenues associated with transactions conducted under another exception or exemption, the bank must exclude such revenue from *both* the bank's relationship compensation (if the compensation would otherwise qualify as relationship compensation) and total compensation. Of course, the bank also must comply with the conditions applicable to the other available exception or exemption on which the bank chooses to rely.[181]

In addition, compensation that is not derived from the provision of trust or fiduciary services should not be

[175] The rules also do not alter or affect the ability of a nonbank registered investment adviser to receive 12b–1 fees under the federal securities laws or the rules of an SRO. The ''broker'' exceptions for banks in Section 3(a)(4)(B) of the Exchange Act, including the trust and fiduciary exception, are not available to nonbank entities such as nonbank investment advisers.

[176] Rule 721(a)(4)(i)(B), (C) and (D). Because securities lending/borrowing fees and custody fees may be charged on an assets under management basis, the rule also provides that these fees are relationship compensation when charged in this manner. Rule 721(a)(4)(iii)(E). As with other types of relationship compensation, the fees that a bank receives for effecting securities lending/borrowing transactions for a trust or fiduciary account must be consistent with applicable fiduciary principles and standards.

[177] *See* Investment Company Institute (''ICI'') Letter, Federated Investors, Inc. (''Federated Investors'') Letter.

[178] *See*, *e.g.*, Wells Fargo & Company (''Wells Fargo'') Letter, State Street Corp. Letter, Mellon Letter.

[179] *See*, *e.g.*, Institute of Int'l Bankers (''IIB'') Letter, Clearing House Ass'n Letter.

[180] Rule 721(b) and Rule 722(d).

[181] Some commenters asserted that a bank should be allowed to include in its relationship compensation *all* of the revenue from securities transactions conducted for a trust or fiduciary account under another exception or exemption, regardless of whether that revenue otherwise qualifies as relationship compensation. The Agencies have not amended the rule in this manner as it is inconsistent with the terms of the trust and fiduciary exception which sets forth the types of fees that are included in relationship compensation.

included in a bank's relationship or total compensation under either the account-by-account or bank-wide alternative. Such compensation includes, for example, (1) revenue earned by a trust or fiduciary department from providing back-office services to an affiliated or unaffiliated party,[182] (2) revenue from the sale of an office or assets of the trust department, or from the provision on a stand-alone basis of other services (such as custody services or the sale of portfolio management software to a third party that independently operates and uses the software in connection with its own business) that do not involve trust or fiduciary services as defined in section 3(a)(4)(D) of the Act; and (3) internal payments or credits allocated to a bank's trust or fiduciary department or unit from another department or unit of the bank for deposits and other similar services not involving a security. Credits received by a bank from a broker-dealer for brokerage and research services provided by a broker-dealer in accordance with section 28(e) of the Act (15 U.S.C. 78bb(e)) and the regulations issued thereunder also should be excluded from the compensation tests. The Agencies do not believe these credits constitute compensation to the bank for purposes of the exception and rules because these credits must be reasonable in relation to the value of the brokerage and research provided by the broker-dealer in connection with the bank's exercise of investment discretion for its fiduciary accounts.

4. Trust or Fiduciary Accounts

The final rules, like the proposal, define a trust or fiduciary account as an account for which the bank acts in a trustee or ''fiduciary capacity'' as that term is defined in Section 3(a)(4)(D) of the Exchange Act.[183] This definition is based on the definition of ''fiduciary capacity'' in part 9 of the OCC's regulations, which relates to the trust and fiduciary activities of national banks, in effect at the time of enactment of the GLB Act.

Section 3(a)(4)(D) identifies a number of particular situations where a bank serves in a fiduciary capacity.[184] The definition also provides that a bank acts in a ''fiduciary capacity'' if it acts ''in any other similar capacity'' to those specifically identified. Accordingly, the scope of the term ''fiduciary capacity'' is not fixed in time.

The Agencies recognize, moreover, that different nomenclature may be used to identify a fiduciary capacity in the relevant governing documents or state laws. For example, the Uniform Probate Code uses the term ''Personal representative'' and similar successor titles in place of the terms ''executor'' or ''administrator'' to identify the representative of a decedent; the Uniform Custodial Trust Act uses the terms ''Conservator'' and ''Custodial trustee'' to refer to persons that act as a fiduciary for another person who has become incapacitated; and the Uniform Transfers to Minors Act uses both the terms ''Conservator'' and ''Custodian'' to refer to fiduciaries that act on behalf of a minor.[185]

Some commenters asked whether a bank that engages in trust or fiduciary activities may conduct securities transactions under the trust and fiduciary exception and related rules even if the bank does not maintain a separate trust department or has not had to obtain formal trust powers from its appropriate federal banking agency.[186] The trust and fiduciary exception and related rules do not require that a bank effecting securities transactions for a customer in a trust or fiduciary capacity do so through a separate trust department or have obtained formal trust powers from its appropriate federal banking agency. However, securities transactions conducted for a trust or fiduciary customer under the exception and related rules must be effected in a department of the bank ''that is regularly examined for compliance with fiduciary principles and standards'' by the bank's appropriate federal or state banking supervisor.[187] As stated in the proposal, the Agencies will rely on the appropriate federal banking agency for a bank to determine whether the bank's activities are conducted in the bank's trust department or other department regularly examined by the agency's examiners for compliance with fiduciary principles and standards.[188]

5. Exemptions for Special Accounts, Foreign Branches, Transferred Accounts, and a De Minimis Number of Accounts

The Agencies also proposed a rule (Proposed Rule 723) that would permit a bank to exclude certain types of accounts for purposes of determining its compliance with the account-by-account or bank-wide compensation tests. As proposed, Rule 723 allowed a bank, in calculating its compensation under either approach, to exclude compensation received from any trust or fiduciary account open only for a short period of time (less than 3 months) or acquired within the past 12 months as part of a merger or similar transaction. In addition, the Proposed Rule allowed a bank using the account-by-account approach, subject to certain conditions, to (1) exclude the lesser of 1 percent or 500 of its trust or fiduciary accounts in a year from the chiefly compensated test, and (2) transfer any trust or fiduciary account ultimately determined to be non-conforming to a registered broker-dealer or an unaffiliated entity exempt from registration within 3 months of the end of the relevant year.

Commenters generally favored these exemptions. One commenter, however, argued that these exemptions should be eliminated because they would allow banks to manipulate the chiefly compensated test.[189] Several commenters also requested that the Agencies adopt an additional exemption

[182] On the other hand, the revenue derived from providing fiduciary services to investment companies or companies affiliated with the bank should be included in the relevant chiefly compensated calculation.

[183] Rule 721(a)(5).

[184] Section 3(a)(4)(D) of the Exchange Act provides that a bank acts in a ''fiduciary capacity'' if, among other situations, the bank has investment discretion on behalf of another. Thus, for example, if a bank has investment discretion over an escrow account on behalf of another, the bank would be acting in a ''fiduciary capacity'' with respect to the account.

[185] The text of and additional information on these Uniform Codes and Acts, which are developed under the auspices of the National Conference of Commissioners of Uniform State Laws (''NCCUSL''), may be found on NCCUSL's Web site at *http://www.nccusl.org*.

[186] *See*, *e.g.*, ACB Letter, Roundtable Letter. Federal savings associations, for example, are not required to obtain approval from their appropriate federal banking agency to act as a trustee for an individual retirement account under section 408(a) of the Internal Revenue Code. *See* 12 CFR 550.580.

[187] 15 U.S.C. 78c(a)(4)(B)(ii); Rule 722(a)(1). A bank effecting transactions for trust or fiduciary customers through a department examined for compliance with trust or fiduciary principles may use other divisions or departments of the bank, or other affiliated or unaffiliated third parties, to handle aspects of these transactions. The bank must continue to act in a trustee or fiduciary capacity with respect to the account and, accordingly, should exercise appropriate diligence in selecting persons to provide services to the bank's trust or fiduciary customers and in overseeing the services provided in accordance with the bank's fiduciary obligations. No party, other than the bank (including, without limitation, a transfer agent or investment adviser), working in conjunction with the bank may rely on the bank's exception or exemption from ''broker'' status. To the extent that any such third party performs activities that would make that entity a broker under Section 3(a)(4) of the Exchange Act that entity would be required to register as a broker (in the absence of an applicable exemption or regulatory relief) notwithstanding any written or unwritten agreement the third party may have with the bank.

[188] The OTS, for example, is in the process of revising its examination procedures to provide for the regular examination of individual retirement accounts held by a federal savings association as trustee for compliance with fiduciary principles and standards.

[189] NASAA Letter.

permitting banks to exclude trust and fiduciary accounts held at a foreign branch of a bank from the chiefly compensated tests.[190] These commenters contended that few, if any, of the trust and fiduciary accounts of a foreign branch (other than an offshore ''shell'' branch servicing U.S. branches of the bank) likely are to be held by or on behalf of a U.S. person and, accordingly, the costs of applying the chiefly compensated test to the foreign branches of a U.S. bank would significantly outweigh any potential benefits to U.S. persons. After carefully considering these comments, the Agencies have adopted, without change, the exemptions included in Proposed Rule 723. In addition, the Agencies have adopted a new conditional exemption (Rule 723(c)) for trust and fiduciary accounts held at a foreign branch of a bank.

Rule 723(a) permits a bank that uses either the account-by-account or bank-wide compensation test to exclude any trust or fiduciary account that was open for a period of less than 3 months during the relevant year.[191] Rule 723(b) permits a bank to exclude, for purposes of determining its compliance with either compensation test, any trust or fiduciary account that the bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar transaction by the bank for 12 months after the date the bank acquired the account from the other person.[192] A bank that elects to use Rule 723(a) or (b) for one or more accounts must exclude both the relationship compensation and total compensation attributable to such accounts for purposes of the applicable compensation test.

Rule 723(c) provides a new exemption under which a bank using the bank-wide approach may exclude for purposes of the chiefly compensated test the trust or fiduciary accounts held at a ''non-shell'' foreign branch of the bank, provided that the bank has reasonable cause to believe that the trust or fiduciary accounts of the foreign branch held by or for the benefit of a U.S. person constitute less than 10 percent of the total trust or fiduciary accounts of the foreign branch.[193] The rule provides that a bank will be deemed to have reasonable cause to believe that less than 10 percent of the total number of trust or fiduciary accounts of the foreign branch are held by or for the benefit of a U.S. person if the principal mailing address for the accountholder(s) and beneficiary(ies) of the account is not in the United States, or the records of the foreign branch indicate that the accountholder(s) and beneficiary(ies) of the account is not a U.S. person as defined in 17 CFR 230.902(k).

The rule defines a ''non-shell foreign branch'' of a bank to mean a branch of the bank that is located outside the United States and provides banking services to residents of the foreign jurisdiction in which the branch is located, and for which the decisions relating to day-to-day operations and business of the branch are not made by an office of the bank located in the United States.[194] The Agencies believe this exemption provides appropriate relief to banks with respect to foreign branches where the records of the bank indicate that it is not significantly engaged in providing trust or fiduciary services to U.S. customers.

Rule 723(e) permits a bank using the account-by-account approach to exclude, for purposes of the chiefly compensated test, the lesser of (1) 1 percent of the total number of trust or fiduciary accounts held by the bank; or (2) 500 accounts.[195] To rely on this exemption with respect to an account, the bank must not have relied on this exemption for such account during the immediately preceding year.[196] In addition, the bank must maintain records demonstrating that the securities transactions conducted by or on behalf of the excluded account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.[197]

The Agencies believe these exclusions reduce administrative burdens and facilitate compliance. A bank, consistent with its fiduciary duties, may need to conduct a higher level of securities transactions for a trust or fiduciary account at certain times, such as shortly after the account is established or acquired from another person or shortly before the account is closed.[198] The exclusions in Rule 723(a), (b) and (d) are designed to help prevent such short-term fluctuations in the amount of securities transactions conducted for a trust or fiduciary account from distorting, or causing a bank to fail, the relevant compensation test. At the same time, these exclusions promote compliance by requiring that the bank bring the relevant accounts into compliance within a short and prescribed period of time. For this reason, the Agencies do not believe it would be appropriate to expand the Rule 723(d) to allow a bank to exclude an account from the chiefly compensated test in consecutive years as requested by some commenters. Some commenters also asked the Agencies to raise the 500 account maximum in Rule 723(d) to avoid discriminating against large banks.[199] The Agencies expect that most banks that have more than 50,000 trust and fiduciary accounts, and thus would be subject to the 500 account cap in Rule 723(d), will operate under the bank-wide test and for this reason have not made the requested change.

Rule 723(c) also provides that a bank that uses the account-by-account approach will not be considered a broker for purposes of Section 3(a)(4) of the Exchange Act solely because a particular trust or fiduciary account does not meet the ''chiefly compensated'' test if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a registered broker-dealer or another unaffiliated entity (such as an unaffiliated bank) that is not required to be registered as a broker-dealer.[200]

6. Advertising Restrictions

Proposed Rule 721(b) implemented the advertising restrictions in Section 3(a)(4)(B)(ii)(II) of the Act applicable to banks conducting securities transactions under the trust and fiduciary exception. No commenters opposed the advertising restrictions of the rule and the Agencies have adopted these restrictions as proposed. The final rules provide that a bank complies with the advertising restriction applicable under either Rule

[190] *See* ABA Letter, Clearing House Ass'n Letter, Joint ABA/ABASA/Clearing House Ass'n Letter of July 16, 2007.

[191] Rule 723(a).

[192] Rule 723(b).

[193] The Agencies expect that few, if any banks, that use the account-by-account approach to the chiefly compensated test will have foreign branches engaged in trust or fiduciary services and, accordingly, have limited the exemption to banks that use the bank-wide approach.

[194] This definition is designed to exclude branches that are established in certain offshore jurisdictions primarily to provide services to U.S. customers and, for this reason, are managed on a day-to-day basis from the United States.

[195] Rule 723(d). Under the rule, if a bank has less than 100 trust or fiduciary accounts in the aggregate, the bank may exclude 1 account under the exemption in any given year.

[196] Rule 723(d)(3).

[197] Rule 723(d)(1).

[198] For example, after a trust or fiduciary account is acquired or established, the bank may need to conduct a number of securities transactions to invest or rebalance the account's holdings in accordance with the terms of the agreement establishing the account or, in cases where the bank has investment discretion, to implement the bank's investment strategy for the account.

[199] *See*, *e.g.*, ACB Letter; Clearing House Ass'n Letter.

[200] Rule 723(c).

721 or 722 if advertisements by or on behalf of the bank do not advertise that the bank provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services, and do not advertise the securities brokerage services provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.[201]

An ''advertisement'' for these purposes means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, blast e-mail, or telephone directories (other than routine listings).[202] Other types of material or information that is not distributed through public media, such as mailings or e-mails to a bank's own customers, are not considered an advertisement. In addition, in considering whether an advertisement advertises the securities brokerage services provided to trust or fiduciary customers more prominently than the bank's other trust or fiduciary services, the nature, context and prominence of the information presented—and not simply the length of text or information devoted to a particular subject—should be considered.

## IV. Sweep Accounts and Transactions in Money Market Funds

Exchange Act Section 3(a)(4)(B)(v) (''sweep exception'') 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 that holds itself out as a money market fund.'' [203] To provide banks with guidance on the sweep exception, Proposed Rule 740 defined several terms used in the exception, including the terms ''money market fund'' and ''no-load.'' [204] The Agencies also requested comment on a separate exemption (Proposed Rule 741) that would permit banks, without registering as a broker, to effect transactions in securities issued by a money market fund on behalf of a customer in a broader set of circumstances, subject to certain conditions.[205]

Most commenters that addressed Proposed Rules 740 and 741 supported the rules and Rule 741 in particular.[206] One commenter objected to the exemption in Rule 741 on the basis that it would permit banks to effect transactions in money market funds that did not meet the ''no-load'' requirements of the sweep exception.[207] Another commenter asked that the Agencies clarify whether a bank may effect transactions under the rules for deposits held by another bank.

### *A. Rule 740: Definition of Terms Used in Sweep Exception*

As under the proposal, the final rule defines a ''money market fund'' for purposes of the sweep exception to mean an open-end investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) that is regulated as a money market fund pursuant to 17 CFR 270.2a–7.[208] In addition, consistent with FINRA rules, the final rule provides that a class or series of securities of an investment company will be considered ''no-load'' if (1) the class or series is not subject to a sales charge or a deferred sales charge; and (2) total charges against net assets of the class or series of securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts do not exceed 0.0025 of average net assets annually.[209] A bank may effect transactions under the sweep exception and Rule 740 as part of a program to sweep deposit funds of, or collected by, another bank into a no-load money market fund in accordance with the exception and the Rule.

### *B. Exemption Regarding Money Market Fund Transactions*

After carefully considering the comments, the Agencies have adopted Rule 741, which permits 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.[210] To qualify for this exemption, the bank must provide the customer, directly or indirectly, some other product or service, the provision of which would not, in and of itself, require the bank to register as a broker-dealer under Section 15(a) of the Exchange Act.[211] Examples of other products or services that may be a qualifying ''other'' product or service include an escrow, trust, fiduciary or custody account, a deposit account or a loan or other extension of credit. The Agencies have modified the rule to also permit a bank to effect transactions under the exemption on behalf of another bank as part of a program for the investment or reinvestment of the deposit funds of, or collected by, the other bank.[212] This change is designed to allow banks to provide sweep services to other banks under the exemption, as they may do under the sweep exception itself.

The final exemption continues to allow banks to effect transactions only in securities of a registered money market fund. In addition, the rule continues to provide that, if the class or series of money market fund securities is not no-load (as defined in Rule 740), the bank may not characterize or refer to the class or series of securities as no-load *and* the bank must provide the customer, not later than at the time the customer authorizes the bank to effect the transactions, a prospectus for the securities.[213] The Agencies believe these conditions and limitations provide bank customers adequate protections in light of the limited nature of the transactions

[201] Rule 721(b).

[202] Rule 721(b)(2) (referencing Rule 760(g)(2)).

[203] *See* Exchange Act Section 3(a)(4)(B)(v) (15 U.S.C. 78c(a)(4)(B)(v)).

[204] Proposed Rule 740(b) and (c).

[205] Proposed Rule 741.

[206] *See, e.g.*, Federated Investors Letter, ICBA Letter, Clearing House Ass'n Letter, ABA Letter.

[207] *See, e.g.*, NASAA Letter.

[208] Rule 740(b). One commenter requested that Rule 740(b) be modified to allow banks to sweep deposits into an unregistered investment company that operates pursuant to Rule 12d1–1 under the Investment Company Act (17 CFR 270.12d1–1). *See* State Street Corp. Letter. The statutory sweep exception, however, provides only for deposit funds to be swept into an investment company ''registered under the Investment Company Act of 1940.'' Exchange Act Section 3(a)(4)(B)(v).

[209] *See* Rule 740(c); FINRA Rule 2830. Consistent with FINRA Rule 2830, charges for the following are not be considered charges against net assets of a class or series of an investment company's securities for sales or sales promotion expenses, personal service, or the maintenance of shareholder accounts: (1) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares; (2) Aggregating and processing purchase and redemption orders for Investment company shares; (3) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company; (4) Processing dividend payments for the investment company; (5) Providing sub-accounting services to the investment company for shares held beneficially; (6) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or (7) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

[210] Rule 741.

[211] Rule 741(a)(1)(A).

[212] Rule 741(a)(1)(B).

[213] Rule 741(a)(2)(ii). If a bank relies on the exemption to sweep the deposits of another bank into a money market fund that is not ''no-load,'' then neither the deposit-holding bank nor the sweeping bank may characterize the fund as a ''no-load'' fund, and either the deposit-taking bank or the sweeping bank must provide the customer with a prospectus for the fund within the time prescribed by the rule. *See* Rule 741(a)(2)(ii)(A) and (B).

permitted under the exemption.[214] In addition, the exemption recognizes 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 Commission and FINRA rules.

## V. Safekeeping and Custody

### *A. Background*

Section 3(a)(4)(B)(viii) of the Exchange Act provides banks with an exception from the ''broker'' definition for certain bank custody and safekeeping activities (''custody and safekeeping exception''). In particular, this exception allows a bank to perform the following activities as part of its customary banking activities without registering as a ''broker':

- Providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;
- Facilitating the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities;
- Effecting securities lending or borrowing transactions with or on behalf of customers as part of the above described custodial services or investing cash collateral pledged in connection with such transactions;
- Holding securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; and
- 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.[215]

The proposed rules included an exemption to allow banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as custodian.[216] In addition, the proposed exemption allowed banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of custody accounts.[217]

Some commenters contended that an exemption for custodial order-taking activity is unnecessary because, they argued, order-taking activity is permitted directly under the statutory exception.[218] Other commenters stated that the exemption was important because it would allow banks to continue to provide order-taking services to employee benefit plans and individual retirement accounts and similar accounts, or that the restrictions in the exemption were reasonable.[219] Another commenter, however, objected to the proposed exemption arguing that permitting custodial banks to take orders for securities is inconsistent with functional regulation.[220]

### *B. Rule 760: Custody Exemption*

After carefully considering the comments, the Agencies have adopted Rule 760. The Agencies have crafted the exemption to allow banks to continue to accept securities orders in a custodial capacity and to permit bank customers to take advantage of those order-taking services subject to important conditions designed to limit the scope of the activity and provide appropriate investor protections. In this way, the Agencies believe the exemption is consistent with functional regulation and the purposes of the GLBA.

Rule 760 and the other final rules do not implement the statutory custody and safekeeping exception.[221] A bank does not need to rely on the custody exemption in Rule 760 to the extent the bank conducts other custodial activities permitted by Section 3(a)(4)(B)(viii)(I)(aa)–(ee) (*e.g.*, exercising warrants or other rights with respect to securities or effecting securities lending or borrowing transactions on behalf of custodial customers) or another of the final rules (*e.g.*, Rule 772, which permits banks to effect securities lending or borrowing transactions on behalf of certain non-custodial customers).[222] In addition, a bank would not have to rely on Rule 760 to the extent the bank holds securities in custody for a customer and provides clearance and settlement services to the account in connection with such securities, but the bank does not accept orders for securities transactions for the account or engage in other activities with respect to the account that would require the bank to be registered as a broker.

The following discusses the scope and terms of the custody exemption.

#### 1. Order-Taking for Employee Benefit Plan Accounts and Individual Retirement or Similar Accounts

We are adopting, largely as proposed, the sections of Rule 760 providing that a bank will not be considered a broker to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities in an ''employee benefit plan account'' or an ''individual retirement account or similar account'' for which the bank acts as a custodian.[223] The rule defines an ''employee benefit plan account'' as a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan, and provides a number of non-exclusive examples of plans that meet this definition.[224] The rule defines an ''individual retirement account or similar account'' to mean an

[214] Some commenters requested that the prospectus-delivery requirement be eliminated or modified so that delivery is required before a transaction is effected rather than before the customer authorizes the transaction. *See*, *e.g.*, ABA Letter, Clearing House Ass'n Letter, and HSBC Bank Letter. The final rule retains this requirement to ensure that a customer receives notice that its funds are to be invested in a fund that is not ''no-load'' before the customer authorizes the transaction(s). If a customer's funds are invested in a no-load fund and the bank is authorized, under the terms of its agreement with the customer to alter the specific fund into which the customer's balances are invested, the bank should provide the customer a prospectus for any money market fund that is not a ''no-load'' fund prior to the date on which the bank first invests the customer's balances in the fund.

[215] 15 U.S.C. 78c(a)(4)(B)(viii).

[216] Proposed Rule 760(a).

[217] Proposed Rule 760(b).

[218] *See*, *e.g.*, Union Bank Letter, Harris Bank Letter, Clearing House Ass'n Letter, ABA Letter.

[219] *See*, *e.g.*, The Charles Schwab Corp. (''Schwab'') Letter, ICBA Letter.

[220] *See* NASAA Letter.

[221] The Agencies asked for comment on whether the Agencies should adopt rules to implement the statutory custody and safekeeping exception. No commenters requested that the Agencies do so at this time.

[222] One commenter asserted that a bank would not ''accept'' a securities order if it received the order from a custodial customer and at the customer's request transmitted the order to a broker-dealer selected by the customer. *See* Union Bank Letter. Such activities, however, constitute ''accepting'' a securities order for purposes of Rule 760 and a bank engaged in such activities for a custodial customer must comply with Rule 760 unless some other exception or exemption is available for the transaction (*e.g.*, Section 3(a)(4)(B)(x) of the Act if the transaction involves municipal securities).

[223] *See* Rule 760(a).

[224] Rule 760(h)(4). The rule provides that the term ''employee benefit plan account'' includes, without limitation, an employer-sponsored plan qualified under Section 401(a) of the Internal Revenue Code (26 U.S.C. 401(a)), a governmental or other plan described in Section 457 of the Internal Revenue Code (26 U.S.C. 457), a tax-deferred plan described in Section 403(b) of the Internal Revenue Code (26 U.S.C. 403(b)), a church plan, governmental, multi-employer or other plan described in Section 414(d), (e) or (f) of the Internal Revenue Code (26 U.S.C. 414(d), (e) or (f)), an incentive stock option plan described in Section 422 of the Internal Revenue Code (26 U.S.C. 422); a Voluntary Employee Beneficiary Association Plan described in Section 501(c)(9) of the Internal Revenue Code (26 U.S.C. 501(c)(9)), a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan, and a supplemental unemployment benefit plan.

individual retirement account as defined in Section 408 of the Internal Revenue Code (26 U.S.C. 408), a Roth IRA as defined in Section 408A of the Internal Revenue Code (26 U.S.C. 408A), a health savings account as defined in Section 223(d) of the Internal Revenue Code (26 U.S.C. 223(d)), an Archer medical savings account as defined in Section 220(d) of the Internal Revenue Code (26 U.S.C. 220(d)), a Coverdell education savings account as defined in Section 530 of the Internal Revenue Code (26 U.S.C. 530), or other similar account.[225]

A number of commenters supported these definitions of ''employee benefit plan account'' and ''individual retirement account or similar account.'' [226] The Agencies note that both definitions, by their terms, encompass ''other similar'' plans or accounts. So, for example, similar plans or accounts, such as ''lifetime savings accounts,'' that are established under the Internal Revenue Code in the future would be employee benefit plan accounts or individual retirement accounts or similar accounts for purposes of the rule. In addition, the term ''employee benefit plan account'' includes a non-U.S. plan that meets the definition of an employee benefit plan account.

Under the final rules, a bank relying on the employee benefit plan and individual retirement and similar account provisions must comply with the advertising and sales literature limitations in paragraphs (a)(2) and (3), the employee compensation limitations in paragraph (c), and the other conditions in the paragraph (d) of the rule. These conditions are discussed below.

Some commenters asked that the Agencies permit a bank to accept securities orders for other types of accounts that may involve custody of securities, such as accounts for which the bank acts as escrow agent, issuing and paying agent, tender agent, or disbursement agent, subject to the conditions applicable to employee benefit plan accounts and individual retirement and similar accounts, rather than the expanded set of conditions applicable to accommodation orders accepted for other types of custody accounts. The provisions in Rule 760(a) for employee benefit plan accounts and individual retirement and similar accounts are designed to reflect the extent and manner in which banks provide order-taking services for these types of accounts. In addition, these provisions take account of the special mention of these accounts in the custody and safekeeping exception [227] and the additional protections to which these accounts typically are subject under the ERISA, the Internal Revenue Code, and other applicable law. For these reasons, the Agencies have not expanded Rule 760(a) to cover accounts other than employee benefit plan accounts and individual retirement and other similar accounts. Banks may continue to accept orders from other types of accounts for which the bank acts as a custodian under the accommodation provisions of the rule.

a. Employee Compensation Restrictions

We are adopting the employee compensation restrictions in Rule 760(c) as proposed. These restrictions apply when a bank, acting in a custodial capacity, accepts a securities order for an employee benefit plan account or an individual retirement account or similar account under paragraph (a) of the rule, and when a bank accepts a securities order for another type of custodial account under paragraph (b) of the rule. Under these restrictions, if a bank accepts securities orders pursuant to Rule 760, then no employee of the bank may receive compensation (including a fee paid pursuant to a 12b–1 plan) from the bank, the executing broker-dealer, or any other person that is based on: (1) Whether a securities transaction is executed for the account; or (2) the quantity, price, or identity of the securities purchased or sold by the account. These restrictions are designed to be consistent with banking practices and reduce the financial incentives a bank employee might have to encourage a customer to submit securities orders to the bank and use a custody account as the functional equivalent of a securities brokerage account.

Only a few commenters addressed the employee compensation restrictions of the rule. For example, one commenter asserted that the rule should permit a bank to compensate its employees based on the potential revenues associated with a custodial account, including revenues received from processing securities transactions or from a mutual fund in which the account is invested.[228] In addition, a commenter expressed concern that the restrictions would prohibit employees from receiving bonuses based on the total revenues derived from the custodial accounts for which the employee is responsible.

As the Agencies noted in the proposal, the employee compensation restrictions in Rule 760(c) do not prohibit a bank employee from receiving compensation that is based on whether a customer establishes a custodial account with the bank, or that is based on the total amount of assets in a custodial account at account opening or at any other time. Moreover the rule expressly provides that the employee compensation restrictions do not prevent a bank employee from receiving payments under a bonus or similar plan that are permissible under the exception in Rule 700(b)(1) as if a referral had been made by the bank employee, or from receiving any compensation described in Rule 700(b)(2) of the networking rules.[229]

Thus, for example, the rule does prohibit a bank from directly passing on to an employee a portion or percentage of the 12b–1 fees received by the bank from a custody account's investment in a mutual fund, or a portion of a fee that is charged only when, or that varies based on whether, a securities transaction is executed for the account. A bank employee may receive payments under a bonus or similar plan rule that includes within its allocation pool the revenues generated by one or more custodial accounts if the plan meets the criteria for a discretionary, multi-factor bonus program in Rule 700(b)(1), or the bonus program is based on the overall profitability or revenues of the bank, an affiliate, or operating unit and the program complies with the requirements of the safe harbor in Rule 700(b)(2). If a bank's compensation practices are inconsistent with these limitations, the bank may not rely on the exemption to take securities orders in a custodial capacity.

b. Advertisements and Sales Literature

As under the proposed rule, final Rule 760(a)(2) provides that a bank relying on the exemption may not advertise that it accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts or similar accounts for which the bank acts as custodian, except as part of advertising the other custodial or

[225] Rule 760(h)(5).

[226] *See, e.g.,* ABA Letter, Clearing House Assn. Letter, WBA Letter.

[227] *See* Section 3(a)(4)(B)(viii)(I)(ee) of the Exchange Act.

[228] *See, e.g.,* Wells Fargo Letter.

[229] Because the employee compensation restrictions relate to securities transactions conducted in the relevant custody account, they would not prevent a bank employee from receiving a referral fee for referring the customer to a broker-dealer to engage in securities transactions at the broker-dealer that are unrelated to the custody account in accordance with the networking exception or the institutional customer and high net worth customer exemption (Rule 701) for networking arrangements.

safekeeping services the bank provides to these accounts.[230] The bank also may not advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account.[231] Moreover, advertisements and sales literature for individual retirement or similar accounts that are issued by or on behalf of the bank may not describe the securities order-taking services provided by the bank to these accounts more prominently than the other aspects of the custody or safekeeping services the bank provides.[232]

One commenter indicated that these advertising restrictions were reasonable.[233] Another commenter suggested that these advertising limitations should not apply to certain advertisements for which a broker-dealer takes compliance responsibility.[234] The advertising and sales literature restrictions are designed to help prevent a bank from operating a brokerage business out of its custody department and, for this reason, apply to all advertisements and sales literature issued by or on behalf of a bank, whether or not a broker-dealer has some compliance responsibility with respect to the advertisement or sales literature. These limitations would not, however, apply to the advertisements or sales literature that a registered broker-dealer may make to inform the public or others about the availability of brokerage services from the broker-dealer.

c. Other Conditions

A bank that accepts orders for a securities transaction for an employee benefit plan account or individual retirement account or similar account also must comply with the conditions set forth in paragraph (d) of the Rule.[235] These conditions are discussed below in Part V.B.3.[236]

2. Order-Taking as an Accommodation for Other Types of Accounts

The proposed rule also permitted banks to continue to accept securities orders for custodial accounts other than employee benefit plan and individual retirement and similar accounts as an accommodation to the customer, subject to certain conditions designed to help ensure that these services continue to be provided only as an accommodation to customers and that a bank does not operate as a securities broker out of its custody department. While commenters generally supported permitting banks to accept securities orders for other custodial accounts on an accommodation basis, several commenters asked the Agencies to modify or clarify the scope or terms of the exemption, including the meaning of ''accommodation'' and the prohibition on providing investment advice, research, and recommendations.

The Agencies are adopting, largely as proposed, the provisions of the rule permitting banks to accept orders as an accommodation for these other custodial accounts.[237] A bank relying on this part of the exemption must comply with the conditions discussed below.

a. Accommodation Basis

For the reasons stated in the proposing release, the final rule, like the proposal, permits a bank to accept securities orders for other types of custodial accounts only as an accommodation to the customer.[238] Some commenters suggested that the Agencies define the term ''accommodation'' in the rule to mean any trade that is effected solely on the request of the customer or on an unsolicited basis.[239] As noted in the proposal, the Banking Agencies will develop guidance to assist Banking Agency examiners in reviewing, as part of the agencies' ongoing risk-focused supervisory and examination process, the order-taking services provided to these custodial accounts. The guidance will describe the types of policies, procedures and systems that a bank should have in place to help ensure that the bank accepts securities orders for these custodial accounts only as an accommodation to the customer and in a manner consistent with the custody exemption.[240] As part of these reviews, Banking Agency examiners also will, consistent with the rule, consider the form and substance of the relevant accounts, transactions, and activities to prevent evasions of the requirements of the rule.[241] The Agencies believe this approach, rather than adopting by rule a definition of ''accommodation,'' is appropriate given the disparity in the types, characteristics and uses of other custody accounts, the size and operations of banks that provide these services and the manner in which they do so.

b. Employee Compensation Restrictions

For the reasons stated in the proposing release, final Rule 760(b)(2) continues to provide that a bank that accepts orders for other custody accounts must comply with the employee compensation limitations in paragraph (c) of the rule. These limitations were previously discussed in Part V.B.I.a., *supra.* [242]

c. Limitations on Bank Fees

The rule prohibits a bank that accepts accommodation orders for a custody account from charging or receiving any fee that varies based on (1) whether the bank accepted the order for the transaction or (2) the quantity or price of the securities to be bought or sold.[243] These restrictions do not prevent a bank from charging or receiving a fee that is based on the type of security purchased or sold by the account (*e.g.*, a foreign security), provided the fee complies with the conditions set forth in Rule 760(b)(3). Commenters did not raise concerns with these restrictions.

d. Advertising and Sales Literature Restrictions

Under the final rule, the bank's advertisements may not state that the bank accepts orders for securities transactions for a custodial account (other than an employee benefit plan or individual retirement account or similar account). In addition, the bank's sales literature: (1) May state that the bank accepts securities orders for such an account only as part of describing the other custodial or safekeeping services the bank provides to the account, and (2) may not describe the securities order-taking services provided to such an account more prominently than the other aspects of the custody or

[230] Rule 760(h)(2) defines an ''advertisement'' to mean material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings).

[231] Rule 760(a)(2)(i) and (ii).

[232] Rule 760(a)(3). Rule 760(h)(6) defines ''sales literature'' to mean any written or electronic communication, other than an advertisement, that is generally distributed or made generally available to customers of the bank or the public, including circulars, form letters, brochures, telemarketing scripts, seminar texts, published articles, and press releases concerning the bank's products or services.

[233] *See* ICBA Letter.

[234] *See* UMB Bank, N.A. Letter.

[235] Rule 760(a)(1).

[236] The Agencies have made a technical change from the proposal to make clear that a bank operating under Rule 760(a) must comply with the conditions set forth in paragraph (d) as well as with the employee compensation limitations of paragraph (c). *See* Rule 760(a)(1). This should better clarify banks' responsibilities under these provisions, and the Agencies have made a conforming change to the text of Rule 760(b) relating to accommodation trades.

[237] Rule 760(b).

[238] Rule 760(b)(1).

[239] *See* Fiserv Trust Company Letter; Ass'n of Colorado Trust Companies Letter.

[240] *See* 71 FR at 77532–33.

[241] *See* Rule 760(f).

[242] Rule 760(b)(2).

[243] Rule 760(b)(3).

safekeeping services provided by the bank to the account.[244]

e. Investment Advice or Recommendations

The proposed rule imposed certain restrictions on the ability of a bank to provide investment advice or research concerning securities to an account for which it accepts accommodations orders, make recommendations concerning securities to the account, or otherwise solicit securities transactions from the account.[245]

Several commenters, expressed concerns with the proposed limitations on investment advice, research and recommendations. For example, commenters expressed concern that the restrictions would negatively affect a bank's ability to cross-market its trust, fiduciary or other services to custody customers.[246] Some expressed concern that the limitations would interfere with a bank's ability to share research with custody customers or make the bank's views concerning securities or markets available to the public through Web sites, mailings, interviews or other means.[247]

After carefully considering the comments received, the Agencies believe that no change is necessary to accommodate the cross-marketing of other bank services. Accordingly, we are adopting the provisions related to investment advice, research and recommendations without change. The Agencies note that the prohibitions do not prevent a bank from cross-marketing its trust, fiduciary or other services to its custody customers. A bank's marketing to custody account customers may—without violating the rule's general prohibition against providing advice, research or recommendations—include non-account specific information provided in media such as newsletters and websites. In addition, the advice, research, recommendation and solicitation prohibition does not prohibit a bank from providing samples of research, including stock-specific research, to custody customers that the bank provides to other persons for marketing purposes. Thus, the Agencies believe that banks will continue to be able to cross-market their products and services to their custody customers. A custody account, however, is not a fiduciary account, and a bank operating under Rule 760(b) with respect to a custodial account may not provide such samples in such a way or with such a frequency as to provide the custody account securities services that only are permissible for a trust or fiduciary customer. The bank, moreover, may not provide personalized investment advice, research or recommendations regarding particular securities to the custodial account for any reason.[248]

Some commenters questioned whether providing custody customers with a choice of investments from which to select would constitute providing investment advice.[249] Banks may use menus or other lists to make custodial customers aware of the securities available to them through the custodial account. For example, the restrictions in paragraph (b)(6) of the rule do not prevent a bank from providing its customers with an online menu of the mutual funds that the customer is able to purchase through the custody account.

The limitations and restrictions in Rule 760(b), including those relating to investment advice and recommendations, relate only to those custodial accounts for which the bank accepts securities orders on an accommodation basis. Thus, for example, these limitations would not apply to (1) an employee benefit plan account or an individual retirement account or similar account; or (2) a trust or fiduciary account maintained by a customer with a bank even if that customer also maintains a custodial account with the bank.

Commenters asked how the limitations on investment advice and research would apply when a customer has both a custody account and a separate trust or fiduciary account with a bank, and asked the Agencies to clarify that a bank would not violate the restrictions if the bank provides a trust or fiduciary customer with research or advice that the customer then uses to make orders through its custody accounts.[250] Rule 760(b)(6) prohibits banks from providing investment advice, research or recommendations concerning securities to, or soliciting securities transactions from, a custody account for which the bank accepts orders under the accommodation trade authority. The rule does not limit the types of research or other services a bank may provide to a customer's trust or fiduciary account, and the Agencies recognize that a bank may have no control over which account the customer uses to place any orders that result from such research or other services.

The final rule, like the proposal, continues to provide that, in order to prevent evasions of the custody exemption, the Agencies will consider both the form and substance of the relevant account(s), transaction(s) and activities (including advertising activities) in considering whether a bank meets the terms of the exemption.[251] For example, the Agencies will consider the content, format and frequency of any investment research provided to an accommodation custodial account in considering if such research in purpose or effect evades the restrictions in the rule or provides a custody account securities services that only are permissible for a trust or fiduciary customer. Similarly, a bank may not evade the rule's restrictions by providing an accommodation customer that has both a custody account and a trust or fiduciary account with investment advice, recommendations or research that is targeted to the securities held in the customer's custody account. For example, if a customer's custody account has a large position in a particular security and that security is not held in the customer's trust or fiduciary account, a bank may not routinely provide the customer with research focused on that security. Banks should have and maintain policies and procedures to abide by these limitations and bank examiners will review bank compliance with these limits in accordance with the risk-based supervisory and examination process, considering both the form and substance of the cross-marketing activities in applying the anti-evasion provisions of the rule.

The restrictions in Rule 760(b)(6) do not prohibit the bank from advertising its custodial services and disseminating sales literature that meets the conditions in the exemption.[252] These restrictions also will not prevent a bank employee from responding to customer inquiries regarding the bank's safekeeping and

[244] Rule 760(b)(5). One commenter urged the Agencies to abandon the prohibitions on advertising order-taking as an accommodation to other custodial accounts, arguing that the prohibition violates a bank's constitutional free speech rights. *See* CBA Letter. The Agencies believe these restrictions are appropriate to effectuate the purposes of the exemption and have tailored the restrictions to comply with the customary practices of banks and minimize potential disruptions. The Agencies specifically requested comments on the conditions of the rule, and no commenter indicated that the advertising restrictions on accommodation trade would materially disrupt their business or operations.

[245] Rule 760(b)(6).

[246] *See, e.g.,* Harris Bank Letter; U.S. Trust Letter.

[247] *See, e.g.,* PNC Letter; National City Corp. Letter.

[248] This would include providing personalized advice, research or recommendations concerning securities to the account in an effort to convert the account to another type of account, for goodwill or to obtain referrals.

[249] *See* Harris Bank Letter; PNC Letter.

[250] *See* ABA Letter; Harris Bank Letter.

[251] Rule 760(e).

[252] Rule 760(b)(6)(i).

custody services by providing advertisements or sales literature describing the safekeeping, custody and related services the bank offers (provided those advertisements and sales literature comply with the restrictions in the proposed exemption), a prospectus prepared by a registered investment company, sales literature prepared by a registered investment company or by the broker-dealer that is the principal underwriter of the registered investment company pertaining to the registered investment company's products, or information based on any of those materials.[253] The exemption allows a bank's employees to respond to customer inquiries concerning the bank's safekeeping, custodial or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.[254]

3. Other Conditions Applicable to Order-Taking for All Custody Accounts

The proposed exemption provided that a bank may accept orders for a securities transaction for a custody account under the exemption only if the bank (1) does not act in a trustee or fiduciary capacity (as defined in section 3(a)(4)(D) of the Exchange Act) with respect to the account; (2) complies with section 3(a)(4)(C) of the Act in handling any order for a securities transaction for the account; and (3) complies with section 3(a)(4)(B)(viii)(II) of the Act regarding carrying broker activities.

a. Directed Trustees

Some commenters requested that the Agencies modify the exemption to allow a bank that acts as a directed trustee for an account to accept orders and effect transactions for the account under the custody exemption in Rule 760 in lieu of relying on the trust and fiduciary rules (Rule 721 to 723) for the transaction.[255] In light of the comments and the protections included in Rule 760, the Agencies have modified the final rule to provide that a bank that acts as a directed trustee for an account may rely on the custody exception to accept orders for, and effect transactions in, securities for the account.[256] If a bank acting as directed trustee relies on the rule to effect transactions for an employee benefit plan account or an individual retirement account or similar account, the bank must comply with the conditions in Rule 760(a). If a bank acting as directed trustee relies on the rule to effect transactions for another type of account, the bank must comply with the conditions governing accommodation accounts in Rule 760(b).

The rule defines a directed trustee as ''a trustee that does not exercise investment discretion with respect to the account.'' [257] The Agencies also have modified the definition of ''an account for which the bank acts as a custodian'' to include an account for which a bank acts as a directed trustee.[258] Although a bank acting as directed trustee for an account may effect transactions under the custody exemption, the bank's trustee relationship with the account remains a trust and fiduciary relationship and, as such, the bank must continue to comply with applicable fiduciary principles and standards in its relationships with the account.

b. Broker Execution Requirement

Consistent with the requirements of the custody and safekeeping exception, Rule 760(d)(2) requires a bank that accepts orders for a custody account under the rule to comply with Section 3(a)(4)(C) of the Exchange Act [259] in handling any order for a securities transaction for the account.[260] Under this provision, (i) the bank must direct the trade to a registered broker-dealer for execution, or (ii) the trade must be a cross trade or other substantially similar trade of a security that is made by the bank or between the bank and an affiliated fiduciary and is not in contravention of fiduciary principles established under applicable Federal or State law, or (iii) the trade must be conducted in some other manner permitted under rules, regulations, or orders as the Commission may prescribe or issue.

c. Carrying Broker Provisions

A number of commenters addressed the proposed provision limiting the availability of the custody exemption to banks that comply with Section 3(a)(4)(B)(viii)(II) of the Exchange Act [261] relating to carrying broker activities.[262] Some stated that the Agencies should define the term ''carrying broker'' by rule rather than by interpretation.[263] One commenter requested that we interpret the term based on the view that the essence of a carrying broker relationship is ''complete dependence'' of a broker-dealer on another entity for back office functions and execution.[264] Another commenter took the position that a custodian bank should not be deemed a carrying broker so long as ''it is not enabling'' broker-dealers to avoid the net capital requirements applicable to carrying brokers.[265] One commenter generally suggested that we either eliminate the carrying broker limitation from the proposed rules, or amend it to avoid affecting the ability of banks to undertake traditional banking activities.[266]

Section 3(a)(4)(B)(viii)(II) of the Exchange Act provides that a bank relying on the custody exception may not act as a ''carrying broker,'' as that term and different formulations of the term are used in Section 15(c)(3) of the Act and the underlying rules and regulations, for a broker-dealer other than with respect to government securities. Section 15(c)(3) of the Act in relevant part requires broker-dealers to comply with the Commission's regulations with respect to financial responsibility and related customer protection practices of broker-dealers.[267] The Commission's financial responsibility and customer protection rules expand on what it means to carry

[253] Rule 760(b)(6)(ii). ''Principal underwriter'' has the same meaning as in section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29)). Rule 760(h)(7).

[254] Rule 760(b)(6)(iii).

[255] *See* Teachers Insurance and Annuity Association of America and College Retirement Equities Fund (''TIAA–CREF'') Letter; ACB Letter; Roma Bank Letter. Commenters asserted, for example, that a bank acting as a directed trustee provides services that are functionally similar to those provided as a custodian and in either case does not have investment discretion with respect to the account.

[256] *See* Rule 760(d)(1). Alternatively, the bank may continue to effect transactions for the account under the rules relating to trust or fiduciary accounts.

[257] Rule 760(h)(3).

[258] *See* Rule 760(h)(1).

[259] 15 U.S.C. 78c(a)(4)(C).

[260] *See* Rule 760(d)(2).

[261] 15 U.S.C. 78c(a)(4)(B)(viii)(II). This provision prohibits a custodian bank from acting as a carrying broker (as such term, and different formulations thereof, are used in Exchange Act Section 15(c)(3) and the rules and regulations under that Section) for any broker-dealer, unless such carrying broker activities are engaged in with respect to government securities.

[262] Rule 760(d)(3).

[263] *See* ABA Letter; State Street Corp. Letter; PNC Letter.

[264] *See* Clearing House Ass'n Letter.

[265] *See* U.S. Trust Letter.

[266] *See* HSBC Bank Letter. In addition, a few commenters asserted that the description of potential carrying broker activity in prior rulemakings under the GLB Act would, if adopted, be highly problematic and disruptive for banks and broker-dealers. *See* Clearing House Ass'n Letter; ABA Letter.

[267] Exchange Act Section 15(c)(3)(A), 15 U.S.C. 78o(c)(3)(A).

customer securities.[268] In general, broker-dealers establish carrying arrangements in which other broker-dealers carry their accounts to permit the non-carrying broker-dealer to be subject to lesser financial responsibility requirements under the Exchange Act. A broker-dealer entering into such an agreement with a carrying entity that is not a registered broker-dealer, however, may not take advantage of those lesser requirements.[269]

After carefully considering the comments, the Agencies have retained this limitation as a condition of the custody exemption without change as it is a term of the statutory custody exception. Banks may look to certain key factors to help distinguish permissible custodial activity from impermissible carrying broker activity. In particular, key factors in considering whether the existence of shared customers between a broker-dealer and a bank may entail impermissible carrying broker activity by the bank are the broker-dealer's own regulatory obligations and whether the broker-dealer either makes formal or informal arrangements with the bank or structures its operations or offerings to cause the broker-dealer's customers generally (or one or more broad segments of the broker-dealer's customers) to use the bank's custody accounts instead of maintaining funds and securities in accounts at the broker-dealer (thereby avoiding the broker-dealer's financial and related responsibilities). The existence of a substantial number of common customers between a broker-dealer and a bank's custody department in the absence of such an arrangement or structure would not cause the bank to act as a carrying broker for the broker-dealer.

Similarly, a bank may perform or share systems that perform limited back-office functions on behalf of a broker-dealer without becoming a carrying broker for the broker-dealer. A broker-dealer, for example, may contract with an unregistered party such as a bank to send out transaction confirmations on behalf of the broker-dealer or have an arrangement with an affiliated bank to provide customers with combined statements, with the broker-dealer remaining responsible for the accuracy and completeness of those confirmations and the broker-dealer aspects of the statements. A bank and an affiliated broker-dealer also may share or coordinate risk management systems such as, for example, those relating to Bank Secrecy Act and anti-money laundering compliance.[270] A broker-dealer, however, may not delegate core functions to a bank or other unregistered entity or functions that would require an individual to pass a qualification examination or register with an SRO.[271] A broker-dealer also must maintain possession or control over the broker-dealer's proprietary cash or securities and its customers' cash or securities in accordance with the Commission's financial responsibility rules.[272] Of course, a bank may serve as custodian for proprietary or customer cash or securities of the broker-dealer and may accept and use in the ordinary course of its banking business cash deposited with the bank by the broker-dealer or its customers.[273]

4. Custodians, Subcustodians and Administrators/Recordkeepers

a. ''Account for which a bank acts as a custodian''

As a general matter, the exemption in Rule 760 is available only for an ''account for which the bank acts as a custodian.'' The proposed rule defined this term to mean an account that is: (i) An employee benefit plan account for which the bank acts as a custodian; (ii) an individual retirement account or similar account for which the bank acts as a custodian; or (iii) 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.[274] As discussed in Part V.B.3.a *supra,* the Agencies have amended this definition in the final rule also to include an account for which a bank acts as a directed trustee.

A few commenters asked whether a bank performing custodial functions in a non-trustee and non-fiduciary capacity (such as escrow agent, fiscal agent or paying agent) may use the custody exemption even if it is not formally designated as ''custodian'' by the bank-customer agreement.[275] Whether a bank serves as custodian for the securities or other assets of an account depends on the services the bank provides to the account with respect to such securities or assets, not the label used to identify the account or the bank's services in the agreement between the bank and the customer. Thus, for example, a bank that acts as an escrow agent, fiscal agent or paying agent with respect to an account, and that provides safekeeping or custody services for the securities or other assets in the account, is considered to be a custodian for the account for purpose of the rule regardless of whether the account agreement uses the term ''custodian'' or any other particular language.

b. Administrators/Recordkeepers and Subcustodians

The proposed exemption permitted a bank acting as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan to accept securities orders for the plan on behalf of a custodian bank.[276] Under the proposed exemption, both the administrator/recordkeeper bank and the custodial bank had to comply with the requirements relating to employee

[268] The Commission's net capital rule specifies that a broker-dealer shall be deemed to carry customer or broker-dealer accounts ''if, in connection with its activities as a broker or dealer, it receives checks, drafts, or other evidences of indebtedness made payable to itself or persons other than the requisite registered broker or dealer carrying the account of a customer, escrow agent, issuer, underwriter, sponsor, or other distributor of securities'' or ''if it does not promptly forward or promptly deliver all of the securities of customers or of other brokers or dealers received by the firm in connection with its activities as a broker or dealer.'' Exchange Act Rule 15c3–1(a)(2)(i)

The Commission's customer protection rule governing reserves and custody of securities defines the term ''securities carried for the account of a customer'' to mean ''securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer,'' as well as securities sold to, or bought for, a customer by a broker-dealer. Exchange Act Rule 15c3–3(a)(2).

[269] 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.

[270] Other examples of current permissible coordination arrangements between banks and broker-dealers include legal and compliance functions, accounting and finance functions (such as payroll and expense account reporting), information technology, operations functions (such as disaster recovery services), and administration functions (such as human resources and internal audits). *See* NASD Notice to Members 05–48 (July 2005) at 2.

[271] NASD Notice to Members 05–48 (July 2005), ''Outsourcing,'' provides guidance to member firms regarding the outsourcing activities and functions that, if performed directly by members, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to NASD Rule 3010.

[272] *See e.g.*, Rules 15c3–1 and 15c3–3 [17 CFR 240.15c3–1, 15c3–3]. This is true even if the broker-dealer is not ''completely dependent'' on the bank for all back office functions and execution.

[273] *See* Rule 15c3–3(c)(5).

[274] Proposed Rule 760(g)(1).

[275] *See* Union Bank Letter, Wells Fargo Letter.

[276] Proposed Rule 760(e).

benefit plan accounts.[277] In addition, the proposed rule prohibited an administrator/recordkeeper bank from executing a cross-trade with or for the employee benefit plan or from netting orders for securities for the plan, other than orders for shares of open-end investment companies not traded on an exchange.[278]

A few commenters supported these provisions, but opposed the restrictions on cross-trading and netting.[279] One commenter maintained that the administrator/recordkeeper provisions should also be available to banks providing administrative services to individual retirement accounts.[280]

Some commenters also questioned whether or how the proposed exemption would apply to a bank that acts as a subcustodian for the trust or fiduciary or custody accounts of another bank. For example, some commenters asserted that a bank acting as a subcustodian for another bank's trust or fiduciary accounts should be permitted to accept orders for those accounts under the less restrictive conditions in Rule 760(a) regardless of the type of accounts actually involved.[281] Other commenters suggested that a subcustodian bank be permitted to effect trades for the accounts of the other bank with a direct custodial relationship with the customer under the same rules (*e.g.,* trust and fiduciary or custody), and subject to the same conditions, that would apply to the other bank if it conducted the transactions directly.[282] Commenters also noted that banks, and particularly smaller banks, at times use subcustodian arrangements with other banks to provide their customers custodial services more efficiently and at lower cost than they may be able to do on their own.

After carefully considering the comments, the Agencies have adopted Rule 760(e), which permits a bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan for which another bank acts as a custodian to accept orders for the account under Rule 760.[283] In addition, the Agencies have adopted a new paragraph (f) of the rule that permits a bank that acts as a subcustodian for any type of account for which another bank acts as custodian to accept orders for the account under Rule 760. This change was made in response to comments that greater flexibility and clarity was needed for banks that use, and banks that provide, subcustodial services. Under these provisions of the final rule, the administrator/recordkeeper bank or subcustodian bank, as well as the initial custodian bank for the account, must comply with the provisions of Rule 760 applicable to the type of account involved (*i.e.* employee benefit plan account, individual retirement account or similar account, or other types of accounts).[284]

The final rule generally prohibits a recordkeeper/administrator bank or subcustodian bank relying on the exemption from executing a cross-trade or netting orders with or for the relevant account.[285] However, the Agencies have expanded the exceptions to this general prohibition in light of the comments received. In particular, the final rule permits the administrator/recordkeeper bank or subcustodian bank to cross or net orders for shares of open-end investment companies not traded on an exchange.[286] In addition, the final rule permits the administrator/recordkeeper bank or subcustodian bank to cross orders between or net orders for accounts of the custodian bank that contracted with the administrator/recordkeeper bank or subcustodian bank for services.[287] Permitting this additional type of cross-trade and netting activity is consistent with the exceptions to broker execution requirement in section 3(a)(4)(C) of the Exchange Act and should allow cost-savings for the customer by eliminating the need for a broker intermediary. At the same time, by prohibiting an administrator/recordkeeper bank or subcustodian bank operating under the rule from executing cross-trades or netting orders among the accounts of *different* custodian banks to which it provides services will help prevent banks from establishing a market for securities under the exemption.

The Agencies note that these provisions do not apply to a bank that provides custody and order-taking services to the *trust or fiduciary* accounts of another bank. In these circumstances, the bank providing custodial services is treated as a custodian, and not a subcustodian, for purposes of the rule and may provide order-taking services to the account in accordance with the provisions of Rule 760(a) or (b) applicable to the type of account involved.

5. Evasions

The Agencies are adopting, as proposed, the provision that states the Agencies will consider both the form and substance of the relevant accounts, transactions and activities (including advertising activities) in considering whether a bank meets the terms of the exemption, to prevent evasions of the exemption.[288] We received no comments on this anti-evasion provision. As part of the regular risk-focused examination process, the Banking Agencies will monitor the securities transactions in custodial accounts. If the appropriate Banking Agency were to find that a bank is evading the terms of the custody exemption to run a brokerage business out of its custody department, the agency would take appropriate action to address the problem.

## VI. Other Exemptions

The Agencies also are adopting certain other exemptions relating to the securities ''broker'' activities of banks. These are discussed below.

### *A. Exemption for Regulation S Transactions With Non-U.S. Persons and Broker-Dealers*

We are adopting Rule 771 of Regulation R to exempt banks from the definition of ''broker'' under the Exchange Act for certain agency transactions involving Regulation S securities.[289] As with Rule 3a5–2 under

[277] Proposed Rule 760(e)(1).

[278] Proposed Rule 760(e)(2).

[279] *See* ABA Letter; Clearing House Ass'n Letter; CBA Letter. The commenters asserted that the cross-trading and netting restrictions were too restrictive and noted that section 3(a)(4)(C) of the Exchange Act permits bank custodians to engage in a broader range of cross-trade and netting activities.

[280] *See* CBA Letter.

[281] *See, e.g.,* ABA Letter, CBA Letter, PNC Letter, Schwab Letter.

[282] *See* TIAA–CREF Letter.

[283] The Agencies understand that the type of administrator/recordkeeper arrangements described in Rule 760(e) are not typically used with respect to accounts other than employee benefit plan accounts and, for this reason, have not expanded the paragraph to cover other types of accounts.

[284] *See* Rule 760(e)(1) and (f)(1) and (2). The Agencies made a technical change to Rule 760(e) to clarify that the administrator/recordkeeper bank and the custodial bank for employee benefit accounts need to comply only with the requirements in the rule applicable to employee benefit plan accounts and do not need to comply with the conditions applicable to accommodation trades.

[285] Rule 760(e)(2) and (f)(3).

[286] *See* Rule 760(e)(2)(i) and (f)(3)(i).

[287] *See* Rule 760(e)(2)(ii) and (f)(3)(ii).

[288] Rule 760(g).

[289] The Commission's Regulation S (17 CFR 230.901 *et seq.*) provides that offers and sales of securities conducted in accordance with the terms of the regulation will not be deemed to constitute an offer, offer to sell, sale or offer to buy within the United States for purposes of the securities registration requirements of Section 5 of the Securities Act. *See* 17 CFR 230.901. Specifically, Rule 903 of Regulation S provides that an offer or sale of securities by the issuer, a distributor, or an affiliate or a person acting on their behalf shall be deemed to occur outside the U.S. within the meaning of Rule 901 if the offer or sale is made in an offshore transaction (as defined in Rule 901), and no directed selling efforts are made in the U.S. by the issuer, a distributor, affiliate, or person acting

the Exchange Act, which the Commission separately is adopting to permit banks to engage in certain Regulation S transactions on a riskless principal basis without being ''dealers,'' Rule 771 recognizes that non-U.S. persons located outside the United States generally will not rely on the protections of the U.S. securities laws when purchasing Regulation S securities from U.S. banks, and that those persons may purchase the same securities from foreign banks located outside the U.S. without subjecting the foreign bank to U.S. broker-dealer registration.

Commenters generally supported the proposal while suggesting certain modifications and clarifications.[290] For example, commenters requested that the Agencies clarify that the exemption is available to banks both during and after any applicable distribution compliance period for the securities required by Regulation S, and allow banks to conduct resales of eligible securities for either non-U.S. persons or registered broker-dealers if the bank has a reasonable belief that the securities were initially sold in compliance with Regulation S.[291] In addition, some commenters argued that the exemption should not require a bank to comply with the resale restrictions in Rule 904 of Regulation S if the bank effects a resale of an eligible security in accordance with Rule 903 of Regulation S prior to the end of any applicable distribution compliance period for the security.[292] Commenters also urged the Agencies to make the proposed ''broker'' exemption in Regulation R and the ''dealer'' exemption proposed by the Commission as consistent as possible and to make both exemptions as consistent as possible with Regulation S.

The Agencies have modified the rule in several respects in light of the comments, to enhance its clarity and to better conform it to Regulation S. The final rule, like the proposed rule, continues to have three parts. The first part permits a bank to effect a sale of an eligible security in compliance with the requirements of Rule 903 of Regulation S to a purchaser who is not in the United States.[293] The term ''purchaser'' is defined to mean a person who purchases an eligible security and who is not a U.S. person under Rule 902(k) of Regulation S.[294]

The second part permits a bank to effect, by or on behalf of a person who is not a U.S. person under Rule 902(k) of Regulation S, a resale of an eligible security after its initial sale to a purchaser who is not in the United States or to a registered broker-dealer.[295] To take advantage of this second exemption, the bank (1) must have a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with Rule 903 of Regulation S, and (2) if the resale is made prior to any applicable distribution compliance period specified in Rules 903(b)(2) or (b)(3) of Regulation S, the resale must be made in compliance with the requirements of Rule 904 of Regulation S.[296]

The third part of the exemption permits a bank to effect, by or on behalf of a registered broker-dealer, a resale of an eligible security after its initial sale to a purchaser who is not in the United States.[297] As under the second part, the bank must have a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with Rule 903 of Regulation S and, if the resale is made prior to the expiration of any applicable distribution compliance period in Rules 903(b)(2) or (b)(3) of Regulation S, the bank must effect the resale in compliance with the requirements of Rule 904 of Regulation S. The proposed rule would have allowed a bank to rely on a reasonable belief that the security was sold in compliance with Regulation S only when it purchases a security from a non-U.S. person but not when it purchases a security from a broker-dealer. In light of comments received, the reasonable belief standard is also available under the final rule for a bank's transactions with a broker-dealer because the process of determining whether a security initially was issued in compliance with Regulation S should be similar whether the purchase is from a broker-dealer or a non-U.S. person.[298] As the rule makes clear, a bank effecting a resale of an eligible security under the exemption must effect the transaction in accordance with the conditions of Rule 904 if the transaction occurs during, but not after, any applicable distribution compliance period for the security under Rule 903(b)(2) or (b)(3) of Regulation S.

The final rule continues to require, however, that any sale effected under paragraph (b)(1) of the Rule, or resale effected under paragraphs (b)(2) or (b)(3) of the Rule (other than one to a registered broker-dealer), be to a ''purchaser who is not in the United States.'' This is true even if the applicable distribution compliance period for the overseas offering of the security under Regulation S has expired. Consistent with Regulation S, which permits the offshore resale of securities, the purpose of the exemption in Rule 771 is to permit U.S. banks to sell Regulation S securities to customers outside the United States. It does not permit banks to sell those securities domestically (other than to a registered

on their behalf. Other conditions may also apply depending on the place of incorporation and reporting status of the issuer, and the amount of U.S. market interest in the securities.

Rule 904 of Regulation S provides that an offer or sale of securities by any person other than the issuer, a distributor, an affiliate (except an officer or director who is an affiliate solely by virtue of that position) or person acting on their behalf will be deemed to occur outside the U.S. within the meaning of Rule 901 if the offer or sale is made in an offshore transaction (as defined in Rule 901), and no directed selling efforts are made in the U.S. by the seller, an affiliate or person acting on their behalf. Additional conditions apply in the case of resales of certain types of securities by dealers and persons receiving selling concessions, and in the case of resales by certain affiliates of the issuer or a distributor.

[290] *See* IIB Letter; ABA Letter; Clearing House Ass'n Letter.

[291] *See* IIB Letter; Clearing House Ass'n Letter. Rules 903(b)(2) and (b)(3) of Regulation S subject Category 2 securities and Category 3 debt securities to a 40-day distribution compliance period, and subject Category 3 equity securities to a one-year distribution compliance period, during which certain restrictions apply to offers or sales of the securities in order to preserve the foreign nature of the transactions. Under Rule 903 of Regulation S, Category 1 encompasses certain securities: (i) Issued by a foreign issuer, for which there is no substantial U.S. market interest, (ii) that are offered and sold in an overseas directed offering, (iii) that are backed by the full faith and credit of a foreign government, or (iv) that are offered and sold to employees of the issuer or its affiliates pursuant to certain foreign employee benefit plans. Category 2 encompasses securities, not eligible for Category 1, that are equity securities of a reporting foreign issuer, or debt securities of a reporting issuer or of a non-reporting foreign issuer. Category 3 applies to all offerings of securities that do not fall within Category 1 or 2.

[292] *See* IIB Letter.

[293] Rule 771(a)(1).

[294] Rule 771(b)(3). Rule 902(k) of Regulation S defines the term ''U.S. person'' to mean: (i) Any natural person resident in the U.S.; (ii) any partnership or corporation organized or incorporated under the laws of the U.S.; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the U.S.; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; and (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the U.S., and (viii) any partnership or corporation if (A) organized or incorporated under the laws of any foreign jurisdiction, and (B) formed by a U.S. person principally for the purpose of investing in securities not registered under the Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a) under the Securities Act) who are not natural persons, estates or trusts.

[295] Rule 771(a)(2).

[296] Rule 771(a)(2).

[297] Rule 771(a)(3).

[298] *See* IIB Letter and Clearing House Ass'n Letter.

broker-dealer).[299] For purposes of the exemption, an ''eligible security'' means any security other than a security that is being sold from the inventory of the bank or an affiliate of the bank or that is 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.[300] Commenters requested that the Agencies clarify that the definition of ''eligible security'' would not prohibit a bank from effecting transactions under the exemption in securities that have been issued by the bank or an affiliate.[301] A security that is issued by a bank or an affiliate of a bank, such as a structured note or share in a pooled investment vehicle, may be an eligible security if it otherwise meets the terms of paragraph (b)(2) of Rule 771.

**B. Exemption for Non-Custodial Securities Lending Transactions**

The Agencies are adopting, as proposed, Rule 772 of Regulation R to provide banks engaged in certain securities lending transactions with a conditional exemption from the definition of ''broker.'' The exemption allows a bank to engage in securities lending transactions as agent in circumstances where the bank does not have custody of the securities or has custody of such securities for less than the entire period of the transaction. This exemption reinstates, without modification, an exemption that the Commission adopted previously.[302]

Most commenters that addressed the exemption supported its adoption.[303] One commenter opposed the exemption, arguing that securities lending and borrowing transactions should be conducted only by broker-dealers or, alternatively, banks providing such services should be subject to additional disclosure and customer approval requirements.[304] The Agencies continue to believe that the exemption is appropriate and necessary. The exemption enables sizable and sophisticated customers to divide custody and securities lending management between two expert entities when the customer decides such actions are in the customer's interest, and permits banks to continue to provide the types of non-custodial securities lending services that they currently provide without disruption. The Agencies note, moreover, that the statutory custody and safekeeping exception permits banks to effect securities lending transactions (and provide related securities lending services) when the bank has custody of the securities. A bank need not rely on the exemption in Rule 772 to engage in securities lending transactions when acting in this capacity.

Rule 772 provides that a bank is exempt from the broker definition to the extent that, as agent, it engages in or effects certain ''securities lending transactions'' [305] and ''securities lending services'' [306] in connection with such transactions.[307] The exemption applies only to securities lending activities with or on behalf of a person that the bank reasonably believes to be: (1) A qualified investor as defined in Section 3(a)(54)(A) of the Exchange Act;[308] or (2) any employee benefit plan that owns and invests, on a discretionary basis, not less than $25 million in investments. One commenter requested that the Agencies modify the rule to allow banks to engage in securities lending transactions under the exemption as agent for institutional customers that have less than $25 million in investments.[309] We have not amended the investment requirements, however, as we believe they are consistent with the nature of customers that utilize banks for non-custodial securities lending transactions.[310]

Another commenter suggested that the Agencies exempt banks involved, as agent, in securities repurchase and reverse repurchase transactions in non-exempt securities from the ''broker'' definition, stating that repurchase and reverse repurchase activities are functionally equivalent to securities lending.[311] As discussed in the accompanying release, moreover, a number of commenters also requested that banks be exempted from the ''dealer'' definition for repurchase and reverse repurchase agreement activities involving non-exempt securities they undertake in a principal capacity.[312] The Agencies have not acted on these requests at this time because we believe additional information from banks and other interested parties would be helpful in understanding the issues raised by these requests. For this reason, we invite comment on the following matters, as well as any other matters that interested parties believe may be relevant to the Agencies' consideration of the issues posed by the requests: (1) The nature, structure (including term and type of security involved), and purpose of repurchase and reverse repurchase agreements currently conducted with respect to non-exempt securities; (2) the types of customers

[299] The Agencies recognize that the ''offshore transaction'' condition in Rules 903 and 904 of Regulation S also require that the offer not be made to a person in the United States. *See* 17 CFR 230.902(h), 230.903(a)(1) and 230.904(a)(1). For this reason, one commenter stated that the rule simply should refer to sales to a ''purchaser,'' rather than to a purchaser who is outside the United States. *See* IIB Letter. The Agencies have retained the ''purchaser who is not in the United States'' language in the final rule, even for those transactions that must be conducted in accordance with Rule 903 or 904 of Regulation S, to highlight and reaffirm that these transactions must be with persons outside the United States.

[300] Rule 771(b)(1). For purposes of the rule, the term ''distributor'' has the same meaning as in Rule 902(k) of Regulation S (17 CFR 230.902(k)).

[301] *See* IIB Letter, ABA Letter.

[302] *See* Exchange Act Release No. 47364 (Feb. 13, 2003), 68 FR 8686 (Feb. 24, 2003) (adopting Exchange Act Rule 15a–11 to provide an exemption from the definitions of both ''broker'' and ''dealer'' for banks engaging in securities lending transactions). The broker provisions of the Rule 15a–11 exemption, which never became operable due to the temporary exemption applicable to all bank broker activities, will become void under the Regulatory Relief Act with the Agencies' adoption of a single set of final ''broker'' rules. *See* Pub. L. No. 109–351, § 101(a)(3), 120 Stat. 1968 (1999). In light of this, the Commission separately has amended Rule 15a–11 to remove the ''broker'' aspects of that rule. As discussed in the accompanying release, the Commission is re-adopting, without modification, the ''dealer'' portions of Rule 15a–11, as Exchange Act Rule 3a5–3. *See* Exchange Act Release No. 56502 (Sept. 24, 2007).

[303] *See, e.g.*, State Street Corp. Letter, PNC Letter, Mellon Letter, and ABA Letter.

[304] *See* NASAA Letter.

[305] Rule 772(b) defines the term ''securities lending transaction'' to mean 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 of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties.

[306] Rule 772(c) defines the term ''securities lending services'' to mean: (1) Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower; (2) receiving, delivering, or directing the receipt or delivery of loaned securities; (3) receiving, delivering, or directing the receipt or delivery of collateral; (4) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (5) investing, or directing the investment of, cash collateral; or (6) indemnifying the lender of securities with respect to various matters.

[307] Rule 772(a).

[308] 15 U.S.C. 78c(a)(54)(A). In part, this definition encompasses corporations and partnerships with at least $25 million in investments.

[309] *See* Union Bank Letter.

[310] *See, e.g.* Letter from Edward J. Rosen, Cleary, Gottlieb, Stein & Hamilton, to Annette Nazareth, Director, Division of Market Regulation, Commission, dated Oct. 9, 2002 (requesting that the exemption encompass banks' securities lending activity involving any entity that owns and invests on a discretionary basis at least $25 million in investments).

[311] *See* Clearing House Ass'n Letter. Banks are permitted by statutory exception to engage in repurchase and reverse repurchase activities with respect to exempt securities such as government securities. Exchange Act Section 3(a)(5)(C)(i)(II).

[312] *See* Exchange Act Release No. [_____] (Sept. ____, 2007).

and financial institutions currently involved in repurchase and reverse repurchase agreements with respect to non-exempt securities; (3) the extent to and manner in which banks currently engage, as agent or principal, in repurchase and reverse repurchase agreements with respect to non-exempt securities; (4) recent developments or trends in the market for repurchase and reverse repurchase agreements with respect to non-exempt securities; (5) any material similarities or differences in the use, structure, customer base, or legal, regulatory, tax or accounting treatment of repurchase and reverse repurchase agreements with respect to non-exempt securities, on the one hand, and repurchase or reverse repurchase agreements with respect to exempt securities or securities lending transactions involving exempt or non-exempt securities. The information we receive through this process should help inform any future actions the Agencies may take in this area.

*C. Exemption for Banks Effecting Certain Excepted or Exempted Transactions in Investment Company Securities and Variable Insurance Products*

The Agencies are adopting Rule 775 of Regulation R to allow banks to take advantage of certain exceptions and exemptions to the broker definition for transactions involving mutual funds, variable annuity contracts and variable life insurance policies without having to comply with the broker-execution requirement of Exchange Act Section 3(a)(4)(C)(i).[313] The rule as proposed permitted banks to effect transactions in open-end mutual funds through the National Securities Clearing Corporation (''NSCC'') or the fund's transfer agent, rather than through a broker-dealer.

A number of commenters stated, however, that the exemption should be broadened to also encompass variable annuities and variable life insurance, with some commenters noting that only variable annuities and mutual funds are permissible investments for 403(b) plans.[314] Commenters noted that transactions in variable annuity and variable life products typically are effected directly with the relevant insurance company.[315]

In light of these comments, the Agencies have expanded the rule to cover transactions involving variable annuities and variable life insurance policies, as well as transactions involving mutual funds. Applying the exemption to transactions in variable insurance products, as well as to transactions involving mutual funds, will avoid needless disruptions and costs with respect to banks' transactions with customers in which interposing an executing broker-dealer would be inefficient, inconsistent with market practice and unnecessary for investor protection.

Specifically, Rule 775 as modified is available for transactions involving securities issued by an open-end company, as defined by Section 5(a)(1) of the Investment Company Act,[316] that is registered under that Act,[317] as well as variable insurance contracts funded by any separate account, as defined by Section 2(a)(37) of the Investment Company Act, that is registered under that Act. To take advantage of the exemption, the security must not be traded on a national securities exchange or traded through the facilities of a national securities association or an interdealer quotation system.[318] In addition, the securities must be distributed by a registered broker-dealer, or the sales charge must be no more than the amount permissible for a security sold by a registered broker-dealer pursuant to any applicable rules of a registered securities association.[319] Finally, the transaction must be effected through the NSCC, or directly with a transfer agent or with an insurance company or a separate account that is excluded from the definition of transfer agent in Section 3(a)(25) of the Exchange Act.[320]

*D. Exemption for Certain Transactions involving a Company's Securities for its Employee Benefit Plans and Participants*

In response to issues raised by a commenter, the Agencies are adopting an additional exemption (Rule 776) to permit banks that rely on certain exceptions and exemptions to effect certain transactions involving the securities of a company for the company's employee benefit plans and participants without complying with the broker-execution requirements of Exchange Act Section 3(a)(4)(C)(i).[321] The commenter stated that banks that act as trustee or custodian for the defined benefit or defined contribution plans of a company at times effect in-kind contributions, purchases and sales, and distribution transactions for the plan involving the securities of the company without the involvement of a broker-dealer. The commenter indicated that these transactions are effected through the company's transfer agent and that no commission is charged in connection with the transaction.[322]

In light of these comments, Rule 776 permits a bank utilizing particular exceptions and exemptions to effect a transaction in the securities of a company to do so directly with a transfer agent acting for the company, subject to four conditions. First, no commission may be charged with respect to the transaction.[323] Second, the transaction must be conducted solely for the benefit of an employee benefit plan.[324] Third, the security must be obtained directly from the company or an employee benefit plan of the company.[325] And fourth, the security must be transferred only to the company or an employee benefit plan of the company.[326] Securities obtained from, or transferred to, a participant in an employee benefit plan on behalf of the

[313] As discussed above, Section 3(a)(4)(C) generally provides that a bank effecting a transaction in any ''publicly traded security'' in the United States under the trust and fiduciary, stock purchase plan, or custody and safekeeping exception must direct the resulting trade to a broker-dealer for execution unless the trade is a cross trade or similar trade or the trade otherwise is permitted by Commission rule, regulation or order. 15 U.S.C. 78c(a)(4)(C). Rule 760, the exemption for order-taking by banks acting as custodians, also requires banks to comply with Section 3(a)(4)(C). *See* Rule 760(d)(2).

[314] *See* ABA Letter; TIAA–CREF Letter; American Council of Life Insurers Letters of March 26 (''ACLI March 26 Letter'') and August 2, 2007, Roundtable Letter, Business Law Section Letter, The Depository Trust & Clearing Corp. (''DTCC'') Letter.

[315] *See* ACLI March 26 Letter, DTCC Letter.

[316] Rule 775(b)(1). We note that banks may effect transactions in securities that meet the conditions to be an ''exempted security'' under Exchange Act Section 3(a)(12)(A)(iv) without complying with the exemption provided by Rule 775. Exchange Act Section 3(a)(4)(B)(iii)(II) permits banks to effect transactions involving ''exempted securities'' without registering as a broker and without effecting the transaction through a registered broker-dealer.

[317] Rule 775(b)(2).

[318] Rule 775(a)(1).

[319] Rule 775(a)(2). FINRA currently is the only registered securities association. FINRA Rule 2830 limits the sales charges associated with open-end mutual funds. Currently, there are no FINRA rules limiting the sales charges associated with the insurance securities subject to Rule 775. Therefore currently, in all cases, these insurance securities would satisfy the condition under Rule 775(a)(2) that the sales charge be no more than the amount permissible under applicable registered securities association rules.

[320] Rule 775(a)(3).

[321] *See* note 313 supra for a listing of the relevant exceptions and exemptions.

[322] *See* The Northern Trust Company Letter. The commenter further stated that ERISA effectively prohibits a commission from being charged in connection with in-kind contributions by a company of its stock to the company's benefit plans and direct purchases and sales by the company of its stock with the company's plans.

[323] Rule 776(a)(1).

[324] Rule 776(a)(2). For these purposes, an ''employee benefit plan'' is defined to mean any pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan. Rule 776(b).

[325] Rule 776(a)(3).

[326] Rule 776(d).

plan are considered to be obtained from, or transferred to, the plan.

We are adopting this rule because we believe that requiring banks to send these types of transactions to a broker-dealer for execution—as would be required to comply with Section 3(a)(4)(C)(i) of the Exchange Act—at times would preclude plans from engaging in these transactions, would disrupt existing practices and otherwise would introduce cost and complexity to those transactions without materially promoting functional regulation and investor protection.[327]

*E. Temporary and Permanent Exemption for Contracts Entered Into by Banks From Being Considered Void or Voidable*

The Agencies are adopting as proposed Rule 780, which grants one temporary and one permanent exemption from section 29(b) of the Exchange Act, which addresses inadvertent failures by banks that could trigger rescission of contracts between a bank and a customer.[328] Under the temporary exemption, no contract entered into before 18 months after the effective date of the exemption would be void or considered voidable by reason of Section 29 of the Exchange Act because any bank that is a party to the contract violated the registration requirements of Section 15(a) of the Exchange Act, any other applicable provision of that Act, or the rules and regulations adopted under the Exchange Act based solely on the bank's status as a broker when the contract was created.[329]

Under the permanent exemption, no contract entered into is void or considered voidable by reason of Section 29(b) of the Exchange Act because any bank that is a party to the contract violated the registration requirements of Section 15(a) of the Exchange Act or the rules and regulations adopted thereunder based solely on the bank's status as a broker when the contract was created if two conditions are met. First, at the time the contract was created, the bank must have acted in good faith and had reasonable policies and procedures in place to comply with Section 3(a)(4)(B) of the Exchange Act, and the rules and regulations, thereunder. Second, any violation of the registration requirements by the bank must not have resulted in any significant harm, financial loss or cost to the person seeking to void the contract. This exemption is provided because a bank that is acting in good faith and has reasonable policies and procedures in effect at the time a securities contract is created should not be subject to rescission claims as a result of an inadvertent failure to comply with the requirements under Section 3(c)(4) of the Exchange Act if customers are not significantly harmed. One commenter supported the exemptions,[330] and no commenters objected to their adoption.

*F. Extension of Time and Transition Period*

The Agencies are further extending the time that banks have to come into compliance with the Exchange Act provisions relating to the definition of ''broker.'' Under the final rule, a bank is exempt from the definition of ''broker'' under Section 3(a)(4) of the Exchange Act until the first day of its first fiscal year commencing after September 30, 2008. This is an additional calendar quarter beyond the date (June 30, 2008) provided in the proposed rule. A bank that has a fiscal year based on the calendar year, for example, must comply with the new exceptions for banks and these rules beginning on January 1, 2009. Some commenters noted that banks and broker-dealers would need sufficient time to make the changes necessary to come into compliance with the statute and these rules.[331] The Agencies believe that the extension granted by the rule, which is a minimum of one year, should provide banks a reasonable period of time to come into compliance with these provisions.

The Administrative Procedure Act (''APA'') permits an agency to issue a rule without delaying its effective date for 30 days from the date of publication if, among other reasons, the rule is a substantive rule which grants or recognizes an exemption or relieves a restriction, or if the agency finds good cause and publishes its finding with the rule.[332] The Agencies find that this Rule 781 grants or recognizes an exemption or relieves a restriction and also that there is good cause for adopting Rule 781 without a delayed effective date because it is in the public interest that banks not unnecessarily incur costs to comply with the statutory exceptions and related rules before such exceptions and rules would become effective in accordance with Rule 781.[333]

## VII. Finding That the Exemptions are Appropriate in the Public Interest and Consistent With the Protection of Investors

Section 36(a)(1) of the Exchange Act generally provides that the Commission may conditionally or unconditionally exempt any person or class of persons from any provision of the Exchange Act to the extent that an exemption is necessary or appropriate in the public interest and consistent with the protection of investors.[334] Taken as a whole, the exemptions will implement the bank broker provisions of the GLBA while providing banks with flexibility to structure their business models under conditions designed to preserve key investor protections, and therefore, as discussed above more fully, are appropriate in the public interest and consistent with the protection of investors.

## VIII. Withdrawal of Proposed Regulation B and Removal of Exchange Act Rules 3a4–2 Through 3a4–6, and 3b–17

Under the Regulatory Relief Act, a final single set of rules or regulations jointly adopted by the Board and Commission in accordance with that Act shall supersede any other proposed or final rule issued by the Commission on or after the date of enactment of Section 201 of the GLBA with regard to the definition of ''broker'' under Exchange Act Section 3(a)(4).[335] Moreover, the law states that ''[n]o such other rule, whether or not issued in final form, shall have any force or effect on or after that date of enactment.''

In 2001, the Commission adopted Interim Rules discussing the way in

[327] The commenter also stated that banks acting as trustees and custodians at times directly effect transactions with and for different employee benefit plans involved in a corporate spin-off transaction with respect to company stock of both companies involved in the spin-off transaction. *See* Northern Trust letter. We understand that the same bank typically is the trustee or custodian for the different plans in such transactions and conducts such transactions through cross-trades within the bank. Accordingly, no additional exemption is required for these transactions.

[328] 15 U.S.C. 78cc(b). Exchange Act Section 29(b) provides, in pertinent part, that every contract made in violation of the Exchange Act or of any rule or regulation adopted under the Exchange Act (with certain exceptions) shall be void.

[329] Rule 780(a).

[330] ICBA Letter.

[331] *See, e.g.,* HSBC Securities Letter.

[332] The APA provides that publication of a substantive rule must be made not less than 30 days prior to its effective date, except ''(1) a substantive rule which grants or recognizes an exemption or relieves a restriction; (2) interpretive rules and statements of policy; or (3) otherwise provided by the agency for good cause found and published with the rule.'' 5 U.S.C. 553(d).

[333] This finding also satisfies the requirements of 5 U.S.C. Section 808(2), which allows a rule to become effective immediately notwithstanding the requirements of 5 U.S.C. Section 801 if an agency ''for good cause finds that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.''

[334] 15 U.S.C. 78mm(a)(1).

[335] President Clinton signed the GLBA into law on November 12, 1999.

which the Commission would interpret the GLBA.[336] The rules that address the definition of ''broker'' under Section 3(a)(4) of the Exchange Act (and applicable exemptions) are Exchange Act Rules 3a4–2 through 3a4–6 and Rule 3b–17.[337] In 2004, the Commission proposed to revise and restructure the ''broker'' provisions of the Interim Rules and codify them in a new regulation, proposed Regulation B, which would consist of proposed new Exchange Act Rules 710 through 781.[338] By operation of the Regulatory Relief Act, the joint adoption of these final rules by the Board and the Commission supersedes Exchange Act Rules 3a4–2 through 3a4–6, 3b–17, and proposed Rules 710 through 781. Any discussion or interpretation of these prior rules in their accompanying releases does not apply to this single set of rules adopted by the Agencies.

## IX. Administrative Law Matters

### *A. Paperwork Reduction Act Analysis*

Certain provisions of Rules 701, 723, and 741, contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995.[339] The Commission has submitted these information collections to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The Board has reviewed the rules under authority delegated by OMB.[340]

The collections of information under Rules 701, 723, and 741 are new. The Commission's title for the new collection of information under Rule 701 is ''Rule 701: Exemption from the definition of 'broker' for certain institutional referrals.'' The Commission's title for the new collection of information under Rule 723 is ''Rule 723: Exemptions for special accounts, foreign branches, transferred accounts, and a *de minimis* number of accounts.'' The Commission's title for the new collection of information under Rule 741 is ''Rule 741: Exemption for banks effecting transactions in money market funds.'' The Commission's OMB control number for the three rules is 3235–0624. The Board's title for the new collection of information under Rules 701, 723, and 741 is ''Recordkeeping and Disclosure Requirements Associated with Regulation R'' (FR 4025). The Board's OMB control number will be 7100–0316. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.[341] We received no comments on the paperwork reduction analysis in the proposal.

1. Rule 701

Rule 701 provides a conditional exemption from the requirements under the networking exception under the Exchange Act. This exemption permits bank employees to receive payment of more than a nominal amount for referring institutional customers and high net worth customers to a broker-dealer and permits such payments to be contingent on whether the customer effects a securities transaction with the broker-dealer.

a. Collection of Information

Rules 701(a)(2)(i), (a)(3)(i) and (b) require banks or their broker-dealer partners that utilize the exemption provided in this rule to make certain disclosures to high net worth or institutional customers. Specifically, these disclosures must clearly and conspicuously disclose (1) the name of the broker-dealer; and (2) that the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker-dealer and payment of this fee may be contingent on whether the referral results in a transaction with the broker-dealer.[342] These requirements were modified from the proposal to permit timely oral disclosure of this information, followed by written disclosure, to better accommodate the variety of circumstances in which referrals may occur.

In addition, one of the conditions of the exemption is that the broker-dealer and the bank need to have a contractual or other written arrangement containing certain elements, including notification and information requirements.[343] Rule 701(a)(3)(v) requires the written agreement to obligate a broker-dealer to notify its bank partner if the broker-dealer determines that (1) the customer referred under the exemption is not a high net worth or institutional customer, as applicable; or (2) the bank employee making the referral is subject to statutory disqualification (as defined in Section 3(a)(39) of the Exchange Act).[344] In addition, Rule 701(a)(3)(iv) requires the written agreement to obligate the broker-dealer to notify the customer if the securities transaction(s) to be conducted by the customer or the customer do not meet the applicable suitability or sophistication determination standards set forth in the rule.[345] Similarly, the bank is required to provide its broker-dealer partner with the name of the bank employee receiving the referral fee and certain other identifying information.[346]

b. Use of Information

The purpose of the collection of information in Rules 701(a)(2)(i), (a)(3)(i) and (b) is to provide a customer of a bank relying on the exemption with information to assist the customer in identifying and assessing any conflict of interest on the part of the bank employee making a referral to a broker-dealer and for which the bank employee may receive a higher-than-nominal and/or contingent referral fee. The collection of information in Rule 701(a)(2)(iii) and (a)(3)(v) is designed to help a bank determine whether it is acting in compliance with the exemption. The collection of information in Rule 701(a)(3)(iv) is designed to provide the customer with information that may be helpful to the customer in deciding whether to engage in a securities transaction with the broker-dealer.

c. Respondents

The collections of information in Rule 701 will apply to banks that wish to utilize the exemption provided in this rule and broker-dealers with which those banks enter into networking arrangements.

d. Disclosure Burden

The Agencies estimate that approximately 1,000 banks annually will use the exemption in Rule 701 and that each bank, individually or working with its partner broker-dealer, will on average make the required referral fee disclosures to 200 customers annually. In addition, we estimate that each bank will provide one notice annually to its broker-dealer partner regarding names and other identifying information about bank employees. The Agencies also estimate that broker-dealers will, on average, notify each of the 1,000 banks approximately twice a year about a determination regarding a customer's high net worth or institutional status as well as a bank employee's statutory

[336] Exchange Act Release No. 44291 (May 11, 2001), 66 FR 27760 (May 18, 2001).

[337] 17 CFR 240.3a4–2 through 3a4–6 and 17 CFR 240.3b–17.

[338] 17 CFR 242.710 through 781. *See* Exchange Act Release No. 49879 (June 17, 2004), 69 FR 39682 (June 30, 2004).

[339] 44 U.S.C. 3501, *et seq.*

[340] 5 CFR 1320.16; Appendix A.1.

[341] 44 U.S.C. 3512.

[342] *See* Rules 701(a)(2)(i), (a)(3)(i) and (b).

[343] *See* Rule 701(a) and (a)(3).

[344] *See* Rule 701(a)(3)(v). The latter requirement does not apply to subparagraph (E) of Section 3(a)(39) of the Exchange Act ((15 U.S.C. 78c(a)(39)).

[345] *See* Rule 701(a)(3)(iv).

[346] *See* Rule 701(a)(2)(iii).

disqualification status. The Agencies further estimate that each broker-dealer will notify three customers of each partner bank per year concerning transaction suitability or the customer's financial sophistication.

Based on these estimates, the Agencies anticipate that Rule 701 will result in approximately 200,000 disclosures to customers, 1,000 notices to broker-dealers about bank employees, 2,000 notices to banks about customer status, and 3,000 notices to customers per year about suitability or sophistication. The Agencies further estimate (based on the level of difficulty and complexity of the applicable activities) that a bank or broker-dealer will spend approximately 5 minutes per customer to comply with the disclosure requirement, and that a bank will spend approximately 15 minutes per notice to a broker-dealer. The Agencies also estimate that a broker-dealer will spend approximately 15 minutes per notice to a bank or customer. Thus, the estimated total annual disclosure burden for these requirements in Rule 701 is approximately 8,583 hours for banks and approximately 9,583 hours for broker-dealers.[347]

e. Collection of Information Is Mandatory

This collection of information is mandatory for banks relying on Rule 701 and their broker-dealer partners.

f. Confidentiality

A bank relying on the exemption provided in Rule 701 or its partner broker-dealer is required to provide certain referral fee disclosures to the customers referred by the bank under this rule. Banks relying on the exemption provided in Rule 701 are required also to enter into agreements with a broker-dealer obligating the broker-dealer to notify the bank upon becoming aware of certain information with respect to the customer or the bank employee, and to notify the customer upon becoming aware of certain information concerning the customer or the nature of a securities transaction.[348] Similarly, a bank is required to notify a broker-dealer about the name of the bank employee receiving a referral fee and certain other identifying information.

g. Record Retention Period

Rule 701 does not include a specific record retention requirement. Banks, however, are required to retain the records in compliance with any existing or future recordkeeping or disclosure requirements established by the Banking Agencies. Broker-dealers are also required to retain records in compliance with existing or future recordkeeping or disclosure requirements established by the Commission or any self-regulatory organization.

2. Rule 723

a. Collection of Information

Rule 723(e)(1) requires a bank that desires to exclude a trust or fiduciary account in determining its compliance with the chiefly compensated test, pursuant to a de minimis exclusion,[349] to maintain records demonstrating that the securities transactions conducted by or on behalf of the account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account.[350]

b. Use of Information

The collection of information in Rule 723 is designed to help ensure that a bank relying on the de minimis exclusion is able to demonstrate that it was acting in a trust or fiduciary capacity with respect to an account excluded from the chiefly compensated test in Rule 721(a)(1).

c. Respondents

The collection of information in Rule 723 will apply to banks relying on the de minimis exclusion from the chiefly compensated test.

d. Recordkeeping Burden

Because the Agencies expect a small number of banks may use the account-by-account approach in monitoring their compliance with the chiefly compensated test, the Agencies estimate that approximately 50 banks annually will use the de minimis exclusion in Rule 723 and each such bank will, on average, need to maintain records with respect to 10 trust or fiduciary accounts annually conducted in the exercise of the banks' trust or fiduciary responsibilities. Therefore, the Agencies estimate that Rule 723 will result in approximately 500 accounts annually for which records are required to be maintained. The Agencies anticipate that these records will consist of records that are generally created as part of the securities transaction and the account relationship and minimal additional time will be required in maintaining these records. Based on this analysis, the Agencies estimate that a bank will spend approximately 15 minutes per account to comply with the record maintenance requirement of Rule 723. Thus, the estimated total annual recordkeeping burden for Rule 723 is 125 hours.

e. Collection of Information Is Mandatory

This collection of information is mandatory for banks desiring to rely on *de minimis* exclusion contained in Rule 723.

f. Confidentiality

Rule 723 does not address or restrict the confidentiality of the documentation prepared by banks under the rule. Accordingly, banks will have to make the information available to regulatory authorities or other persons to the extent otherwise provided by law.

g. Record Retention Period

Rule 723 will include a requirement to maintain records related to certain securities transactions. Banks will be required to retain these records in compliance with any existing or future recordkeeping requirements established by the Banking Agencies.

3. Rule 741

a. Collection of Information

Rule 741(a)(2)(ii)(A) requires a bank relying on this exemption (*i.e.*, the exemption from the definition of the term ''broker'' under Section 3(a)(4) of the Exchange Act for effecting transactions on behalf of a customer in securities issued by a money market fund) to provide customers with a prospectus of the money market fund securities, not later than the time the customer authorizes the bank to effect the transaction in such securities, if they are not no-load. In situations where a bank effects transactions under the exemption as part of a program for the investment or reinvestment of deposits funds of, or collected by, another bank, the rule permits either the effecting bank or deposit-taking bank to provide the customer a prospectus for the money market fund securities.

b. Use of Information

The purpose of the collection of information in Rule 741 is to help ensure that a customer of a bank whose

[347] Because banks and broker-dealers will share the disclosure obligation under the final rule, these estimates attribute 50 percent of that disclosure burden to banks and 50 percent to broker-dealers.

[348] These requirements are discussed in more detail in section 1.d (Rule 701, Disclosure Burden), *supra*.

[349] *See* Rule 723(e)(2), which requires that the total number of accounts excluded by the bank, under the exclusion from the chiefly compensated test in Rule 721(a)(1), do not exceed the lesser of 1 percent of the total number of trust or fiduciary accounts held by the bank (if the number so obtained is less than 1, the amount will be rounded up to 1) or 500.

[350] *See* Rule 723(e)(1).

funds or deposits are invested into a money market fund that is not a no-load fund under the exemption will have sufficient information upon which to make an informed investment decision, in particular, regarding the fees the customer will pay with respect to the securities.

c. Respondents

The collection of information in Rule 741 applies to banks that directly or indirectly rely on the exemption provided in the rule in the manner described above.

d. Disclosure Burden

The Agencies believe that banks generally sweep or invest their customer funds into no-load money market funds. Accordingly, the Agencies estimate that approximately 500 banks annually will use the exemption in Rule 741 and each bank (or its partner bank), on average, will deliver the prospectus required by the rule to approximately 1,000 customers annually. Therefore, the Agencies estimate that Rule 741 will result in approximately 500,000 disclosures per year. The Agencies estimate further that a bank will spend approximately 5 minutes per response to comply with the delivery requirement of Rule 741. Thus, the estimated total annual disclosure burden for Rule 741 is 41,667 hours.

e. Collection of Information Is Mandatory

This collection of information is mandatory for banks relying on the exemption.

f. Confidentiality

The collection of information delivered pursuant to Rule 741 must be provided by banks relying on the exemption in this rule (or in the case of programs involving deposits of another bank, the other bank) to customers that are engaging in transactions in securities issued by a money market fund that is not a no-load fund.

g. Record Retention Period

Rule 741 does not include a record retention requirement.

*B. Consideration of Benefits and Costs*

1. Introduction

Prior to enactment of the GLBA, banks were exempted from the definition of ''broker'' in Section 3(a)(4) of the Exchange Act. Therefore, notwithstanding the fact that banks may have conducted activities that will have brought them within the scope of the broker definition, they were not required by the Exchange Act to register as such. The GLBA replaced banks' historic exemption from the definition of ''broker'' with eleven exceptions.[351]

While banks' efforts to comply with the GLBA and the exemptions will result in certain costs, the Agencies have sought to minimize these burdens to the extent possible consistent with the language and purposes of the GLBA. For example, the Agencies are adopting exemptions and interpretations that are expected to provide banks with increased options and flexibility and help to reduce overall costs. Some commenters noted that the rules as proposed will give banks flexibility in structuring their operations, and one bank trade association stated that small banks will be able to comply with the proposed rules without significantly altering their activities.[352] Two commenters stated that the Agencies had underestimated the costs associated with coming into compliance with Regulation R and also provided estimates of ongoing compliance costs.[353]

2. Discussion of Rule Interpretations and Exemptions

The benefits and costs of the principal exemptions and interpretations in the rules are discussed below.

a. Networking Exception

Exchange Act Section 3(a)(4)(B)(i) excepts banks from the definition of ''broker'' if they enter into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to bank customers. This networking exception is subject to several conditions. The Section also prohibits banks from paying unregistered bank employees—such as tellers, loan officers, and private bankers—''incentive compensation'' for any brokerage transaction, except that bank employees may receive a ''nominal'' referral fee for referring bank customers to their broker-dealer networking partners.[354]

Under the rule, a ''nominal'' referral fee is defined as a fee that does not exceed any of the following standards: (1) 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 base salary established by the bank for the current or prior year for the job family that includes the employee; (2) twice the employee's actual base hourly wage or 1/1000th of the employee's actual annual base salary; or (3) twenty-five dollars ($25), as adjusted for inflation pursuant to Rule 700(f).

The Agencies believe these alternatives likely will provide banks appropriate flexibility while being consistent with the statute. For example, some banks, and particularly small banks, may find it most useful to establish a flat fee or inflation-adjusted fee for securities referrals as this method is easy to understand and requires no complicated calculations. In addition, permitting banks to pay referral fees based on either an employee's base hourly or annual rate of pay or the average hourly or annual rate of pay for a job family gives banks objective and easily calculable approaches to paying their employees referrals while remaining consistent with the requirements of the GLBA that such fees be ''nominal'' in relation to the overall compensation of the referring employees. While some start-up costs may be incurred by banks in the process of developing a fee structure in line with the requirements of the GLBA, the ability to choose among alternative methods (as reflected in the rules) is expected to enable banks to minimize their overall costs based on their individual referral programs and cost structures. Several commenters supported these alternatives, or stated that the rules implementing the networking exception as a whole struck an appropriate balance.[355]

In light of the statutory provision allowing banks to pay a ''nominal one-time cash fee,'' the rule requires that all referral fees paid under the exception be paid in cash. At the same time, the Agencies have clarified that banks have the flexibility to use cash-equivalent points, paid no less often than quarterly, in paying nominal referral fees under the exception.

Rule 700(b) also contains a definition of ''incentive compensation'' and excludes from this definition compensation paid by a bank under a bonus or similar plan that meets certain criteria. The bonus or similar program must be paid on a discretionary basis and based on multiple factors or variables. These factors or variables must include multiple, significant factors or variables that are not related to securities transactions at the broker-

[351] *See* Exchange Act Section 3(a)(4)(B)(i)–(xi).

[352] *See* Citigroup Letter, ACB Letter, ICBA Letter.

[353] *See* Fiserv Letter, Colorado Trust Letter.

[354] Exchange Act Section 3(a)(4)(B)(i)(VI) limits such referral fees to a ''nominal one-time cash fee of a fixed dollar amount'' and requires that the payment of the fees not be contingent on whether the referral results in a transaction.

[355] *See* ABA Letter, Roundtable Letter, ACB Letter.

dealer. Moreover, a referral made by the employee may not be a factor or variable in determining the employee's compensation under the plan and the employee's compensation under the plan may not be determined by reference to referrals made by any other person. Rule 700(b) also provides a conditional safe harbor from the definition of ''incentive compensation'' for certain bonus or similar plans that are based on any measure of the overall profitability of a bank; an affiliate of a bank (other than a broker-dealer); an operating unit of a bank or of an affiliate of a bank (other than a broker-dealer); or a broker-dealer (if the bonus plan meets certain criteria designed to ensure, among other things, that the plan includes other factors or variables). The final definition has been revised from the proposal to give banks more flexibility in using their existing bonus plans within the framework required by the GLBA.

The rules also include a conditional exemption to permit a bank to pay an employee a contingent referral fee of more than a nominal amount for referring an institutional customer or high net worth customer to a broker-dealer with which the bank has a contractual or other written networking arrangement. This exemption provides a benefit to banks by expanding the types of referral fees that banks may utilize with respect to institutional customers and high net worth customers. A number of commenters supported granting an exemption for such referrals.[356] There likely will be costs associated with complying with the conditions in the exemption (such as the requirement for banks to make certain disclosures to high net worth or institutional customers and the requirement for broker-dealers to make certain determinations and provide certain notifications to banks or a customer)[357] as well as the other terms and conditions in the statutory networking exception. These costs, however, will be either a result of the statutory requirements or costs voluntarily incurred by banks because they want to take advantage of the exemption.

b. Trust and Fiduciary Activities Exception

Exchange Act Section 3(a)(4)(B)(ii) permits a bank, under certain conditions, to effect transactions in a trustee or fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards without registering as a broker. To qualify for the trust and fiduciary activities exception, Exchange Act Section 3(a)(4)(B)(ii) requires that the bank be ''chiefly compensated'' for such transactions on the basis of the types of fees specified in the GLBA and comply with certain advertising restrictions set forth in the statute.

The Agencies believe that the rules dealing with the trust and fiduciary activities exception will provide a number of benefits to banks and their customers without imposing significant costs on either group.[358] The provisions regarding the ''chiefly compensated'' condition and related exemptions, while imposing some costs related to systems necessary to perform the calculations and track compensation, are expected to reduce banks' compliance costs and make the trust and fiduciary activities exception more useful. For example, the rules permit a bank to follow an alternate test to the account-by-account approach to the ''chiefly compensated'' condition. Under this exemption, a bank may calculate the compensation it receives from its trust and fiduciary business as a whole on a bank-wide basis, subject to certain conditions.[359] This alternative is designed to provide banks with a potentially less costly approach for determining compliance with the trust and fiduciary activities exception. Some commenters noted that this alternative approach was workable.[360] Similarly, the Agencies' exemptions from the ''chiefly compensated'' condition for certain short-term accounts, accounts acquired as part of a business combination or asset acquisition, accounts held at a non-shell foreign branch, accounts transferred to a broker-dealer or other unaffiliated entity, and a *de minimis* number of accounts are expected also to reduce banks' compliance costs by facilitating banks' ability to comply with the ''chiefly compensated'' condition.[361] While compliance with the conditions in these exemptions likely will result in some costs, such as the recordkeeping requirement associated with the *de minimis* exclusion, these costs are likely more than justified by the benefits associated with the exemptions given that banks could individually determine whether they wish to utilize the exemptions.

As previously noted, banks are likely to incur some costs to comply with the GLBA. The rules, however, include a number of exemptions which are intended to help to reduce overall costs. As a result, the Agencies do not believe that banks will incur significant additional costs to comply with the liberalized exemptions of Rules 722 through 723 or the definitional guidance of Rule 721.

c. Sweep Accounts and Transactions in Money Market Funds

Section 3(a)(4)(B)(v) of the Exchange Act provides a bank with an exception 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 for a customer or on behalf of another bank into any no-load, open-end management investment company registered under the Investment Company Act that holds itself out as a money market fund. The rules provide guidance, consistent with FINRA rules,[362] regarding the definition of ''no-load'' as used in the exception. This guidance likely will benefit banks by clarifying the types of charges that are permissible and by providing greater legal certainty.

The rules also contain an exemption that permits banks to effect transactions on behalf of a customer, or for the deposit funds of another bank, in securities issued by a money market fund, subject to certain conditions.[363] While compliance with the conditions associated with this exemption, such as the prospectus delivery requirement in certain circumstances, may require banks to incur some costs, these costs are likely to be more than justified by the investor protection benefits enjoyed by the banks' customers and the enhanced flexibility granted banks by the exemption. Furthermore, because banks are free to determine whether to incur these costs, the exemption is expected to provide a net benefit for banks that wish to utilize the exemption.

d. Safekeeping and Custody Exception

Section 3(a)(4)(B)(viii) of the Exchange Act provides banks with an exception from the definition of ''broker'' for certain bank custody and safekeeping activities. The rules contain an exemption that permits a bank, subject to certain conditions, to accept orders to effect transactions in securities for accounts for which the bank acts as a custodian (including an account for which a bank acts as directed trustee),

[356] *See* State Street Letter, SIMFA Letter, U.S. Trust Letter, BISA Letter.

[357] Rule 701(a)(2)(i), (a)(3)(iii)–(v), and 701(b).

[358] The trust and fiduciary exception is addressed in Rules 721–723.

[359] *See* Rule 722.

[360] *See, e.g.*, ABA Letter, WBA Letter, U.S. Trust Letter, PNC Letter.

[361] *See* Rule 723.

[362] *See* FINRA Rule 2830.

[363] *See* Rule 741.

or, in some cases, for which the bank acts as a subcustodian or a non-fiduciary administrator or recordkeeper. Specifically, this custody exemption (Rule 760) allows banks, subject to certain conditions, to accept orders for securities transactions from employee benefit plan accounts and individual retirement and similar accounts for which the bank acts as a custodian. In addition, the exemption allows banks, subject to certain conditions, to accept orders for securities transactions on an accommodation basis from other types of custodial accounts. This exemption allows banks to accept orders from custody accounts while imposing conditions designed to prevent a bank from operating a brokerage business out of its custody department.

The exemption is designed to benefit banks by permitting certain order-taking activities for securities transactions. While banks may incur some costs in complying with the conditions contained in the exemption, such as developing systems for making determinations regarding compliance with advertising and compensation restrictions, the Agencies believe the conditions contained in the rules are consistent with the practices of banks and any costs will only be imposed on banks that choose to utilize the exemption.

e. Other Rules

The Agencies are also adopting certain special purpose exemptions. Specifically, we are adopting an exemption that permits banks to effect transactions in Regulation S securities with non-U.S. persons or registered broker-dealers.[364] Another exemption also allows, under certain conditions, a bank to effect transactions in investment company securities and variable life insurance and variable annuities through the National Securities Clearing Corporation or directly with a transfer agent or insurance company or separate account that is excluded from the definition of transfer agent, instead of through a broker-dealer.[365] In addition, an exemption permits banks that rely on certain exceptions and exemptions to effect certain transactions involving the securities of a company for the company's employee benefit plans and participants through the National Securities Clearing Corporation or directly with a transfer agent or insurance company or separate account that is excluded from the definition of transfer agent, instead of through a broker-dealer. An additional exemption permits a bank, as agent, to effect securities lending transactions (and engage in related securities lending services) for securities that they do not hold in custody with or on behalf of a person the bank reasonably believes is a qualified investor (as defined in Section 3(a)(54)(A) of the Exchange Act) or any employee benefit plan that owns and invests on a discretionary basis at least $25 million in investments.[366] We also are extending the exemption from rescission liability under Exchange Act Section 29 to contracts entered into by banks acting in a broker capacity until a date that is 18 months after the effective date of the final rule.[367] This exemption also provides, under certain circumstances, protections from rescission liability under Exchange Act Section 29 resulting solely from a bank's status as a broker, if the bank has acted in good faith, adopted reasonable policies and procedures, and any violation of broker registration requirements did not result in significant harm or financial loss to the person seeking to void the contract.[368] Finally, we are issuing a temporary general exemption from the definition of ''broker'' under Section 3(a)(4) of the Exchange Act until the first day of a bank's first fiscal year commencing after September 30, 2008.[369]

The Agencies believe these provisions offer a number of benefits to banks and their customers. In particular, the Regulation S exemption helps ensure that U.S. banks that effect transactions in Regulation S securities with non-U.S. customers will be more competitive with foreign banks or other entities that offer those services without being registered as broker-dealers. The exemption from rescission liability under Exchange Act Section 29 also provides banks some legal certainty, both temporarily and on a permanent basis, as they conduct their securities activities. The exemption related to securities lending services enables banks to engage in the types of services in which they currently engage thereby minimizing compliance costs, while providing the banks' customers with continuity of service. The temporary general exemption from the definition of ''broker'' also benefits banks by providing them with an adequate period of time to transition to the requirements under the statute and the rules.

The Agencies estimate that the costs of these exemptions will be minimal and are justified by the benefits the exemptions offer. For example, the Regulation S exemption may impose certain costs on banks that are designed to ensure that they remain in compliance with the conditions under the exemption. In particular, the exemption permits banks to rely on the exemption only for transactions in ''eligible securities'' and with either broker-dealers or purchasers who are not U.S. persons within the meaning of Section 903 of Regulation S. Banks may incur certain administrative costs to ensure that a transaction meets these requirements. Nevertheless, the exemption is an accommodation to banks that wish to effect transactions in Regulation S securities and, as a result, the compliance costs will be imposed only on those banks that believe that it is in their best business interests to take advantage of the exemption.

Given that Exchange Act Section 29 is rarely used as a remedy, we do not anticipate that this exemption will impose significant costs on the industry or on investors.

3. General Costs and Benefits

Based on the burden hours discussed in the Paperwork Reduction Act Analysis section, *supra,* the Agencies expect the ongoing requirements of the rules to result in a total of 50,375 annual burden hours for banks and 9583 annual burden hours for broker-dealers, for a grand total of 59,958 annual burden hours.[370] The Agencies estimate that the hourly costs for these burden hours will be approximately $68 per hour.[371] Therefore, the annual total costs will be approximately $4,077,144.

In addition to the costs associated with burden hours discussed in the Paperwork Reduction Act Analysis section, supra, the Agencies expect that many banks also could incur start-up costs for legal and other professional services.[372] Many banks will utilize their in-house counsel, accountants, compliance officers, and programmers in an effort to achieve compliance with the rules. Industry sources indicate the

[364] *See* Rule 771.

[365] *See* Rule 775.

[366] *See* Rule 772.

[367] *See* Rule 780.

[368] *Id.*

[369] *See* Rule 781.

[370] *See infra* at VIII.A.1.d., VIII.A.2.d., and VIII.A.3.d.

[371] $68/hour figure for a clerk (e.g. compliance clerk) is from the Securities Industry Association (now SIFMA) *Report on Office Salaries in the Securities Industry 2005,* modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

[372] For example, banks may incur start-up costs in the process of reviewing or developing their networking arrangements in line with the requirements of the rules. *See supra* at VIII.B.2.a. In addition, there likely will be costs for developing systems for making determinations regarding compliance with advertising and compensation restrictions pursuant to the rules regarding safekeeping and custody. *See supra* at VIII.B.2.d.

following hourly labor costs: Attorneys—$324 per hour, intermediate accountants—$162 per hour, compliance manager—$205 per hour, and senior programmer—$268.[373] Taking an average of these professional costs, the Agencies estimate a general hourly in-house labor cost of $240 per hour for professional services.

Based on our expectation that most start-up costs will involve bringing systems into compliance and that many banks will be able to do so either using existing systems or by slightly modifying existing systems, the Agencies estimate that the rules will require banks to utilize an average of 30 hours of professional services. The Agencies expect that most banks affected by the rules will either use in-house counsel or employees resulting in an average total cost of $7,200 per affected bank.[374] The Agencies estimate that the rules will apply to approximately 9,475 banks and approximately 25 percent of these banks will incur more than a de minimis cost. Using these values, the Agencies estimate total start-up costs of $17,055,000 (9,475 × .25 × $7,200). As previously discussed, the Agencies have sought to minimize these costs to the extent possible consistent with the language and purposes of the GLBA.

Two commenters stated that the Agencies' estimates of hourly rates in the proposal were fair, but that the estimates of the time requirements were too low. These commenters estimated startup costs of between $43,000 and $55,000.[375] In addition, these commenters estimated ongoing costs to be between $60,000 and $95,000 per year. Based on these commenters' estimates, startup costs would range from $101.9 million (9475 banks × 0.25 affected × $43,000) to $130.3 million (9475 × 0.25 × $55,000), and a range of annual ongoing costs of $142.1 million (9475 × 0.25 × $60,000) to $225 million (9475 × 0.25 × $95,000). The Agencies, however, believe that these cost estimates are not representative of the costs for the majority of banks affected by Regulation R. The Agencies received approximately 60 comments, primarily from banks and banking industry groups, and the comments generally were favorable. Only these two commenters stated that the Agencies had underestimated start-up and continuing compliance costs. The Agencies therefore believe that the estimates in the proposal reflect the costs that the majority of the banks affected by the rules are likely, on average, to incur, and are appropriately used to estimate the overall compliance costs of Regulation R.

The Agencies believe that the rules will provide greater legal certainty for banks in connection with their determination of whether they meet the terms and conditions for an exception to the definition of broker under the Exchange Act as well as provide additional relief through the exemptions. Without the rules, banks may have difficulty planning their businesses and determining whether their operations are in compliance with the GLBA. This, in turn, could hamper their business. The Agencies anticipate these benefits will be useful to banks in a number of ways.

The Agencies expect that one component of the benefits to banks will be savings in legal fees, given that difficulties in interpreting the GLBA absent any regulatory guidance could result in the need for greater input from outside counsel. Based on the number of interpretive issues raised by the GLBA, the Agencies estimate that, absent any regulatory guidance, banks on average will use the services of outside counsel for approximately 25 more hours for the initial year and 5 more hours per year thereafter, than with the existence of the rules. Industry sources indicate that the hourly costs for hiring outside counsel are approximately $400 per hour. The rules will therefore result in an average total cost savings of approximately $10,000 per affected bank per year during the initial year and $2,000 per affected bank per year thereafter. The Agencies estimate that the rules will apply to approximately 9,475 banks and approximately 25 percent of these banks will enjoy more than a de minimis cost savings benefit. Using these values, the Agencies estimate a cost savings related to reduced legal fees of $23,687,500 (9,475 × 0.25 × $10,000) for the initial year and $4,737,500 (9,475 × 0.25 × $2,000) per year thereafter.

The Agencies believe that the benefits of Regulation R justify the costs.

*C. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation*

Exchange Act Section 3(f) requires the Commission, whenever it engages in rulemaking and is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.[376] Exchange Act Section 23(a)(2) requires the Commission, in adopting rules under that Act, to consider the impact that any such rule will have on competition. This Section also prohibits the Commission from adopting any rule that will impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.[377]

The Agencies have designed the interpretations, definitions, and exemptions to minimize any burden on competition. Indeed, the Agencies believe that by providing legal certainty to banks that conduct securities activities, by clarifying the GLBA requirements, and by exempting a number of activities from those requirements, the rules allow banks to continue to conduct securities activities consistent with the GLBA.

The rules define terms in the statutory exceptions to the definition of broker added to the Exchange Act by Congress in the GLBA, and provide guidance to banks as to the appropriate scope of those exceptions. In addition, the rules contain a number of exemptions that provide banks flexibility in conducting their securities activities, which will promote competition and reduce costs.

*D. Final Regulatory Flexibility Analysis*

The Agencies have prepared a Final Regulatory Flexibility Analysis (''FRFA''), in accordance with the provisions of the Regulatory Flexibility Act (''RFA''),[378] regarding the rules.

1. Reasons for the Action

Section 201 of the GLBA amended the definition of ''broker'' in Section 3(a)(4) of the Exchange Act to replace a blanket exemption from that term for ''banks,'' as defined in Section 3(a)(6) of the Exchange Act. Congress replaced this blanket exemption with eleven specific exceptions for securities activities conducted by banks.[379] On October 13, 2006, President Bush signed into law

[373] The hourly figures for an attorney, intermediate account, and compliance manager is from the SIA *Report on Management & Professional Earnings in the Securities Industry 2005,* modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead.

[374] Some banks may choose to utilize outside counsel, either exclusively or as a supplement to in-house resources. The Agencies estimate these costs as being similar to the in-house costs (Industry sources indicate the following hourly costs for hiring external workers: Attorneys—$400, accountant—$250, auditor—$250, and programmer—$160.).

[375] *See* Fiserv Letter, Colorado Trust Letter.

[376] 15 U.S.C. 78c(f).

[377] 15 U.S.C. 78w(a)(2).

[378] 5 U.S.C. 604.

[379] 15 U.S.C. 78c(a)(4).

the Regulatory Relief Act.[380] Section 101 of that Act, among other things, requires the Agencies jointly to issue a single set of rules implementing the bank broker exceptions in Section 3(a)(4) of the Exchange Act.[381] These rules are being adopted by the Agencies to fulfill this requirement. The rules are designed generally to provide guidance on the GLBA's bank exceptions from the definition of broker in Exchange Act Section 3(a)(4) and to provide conditional exemptions from the broker definition consistent with the purposes of the Exchange Act and the GLBA.

2. Objectives

The rules provide guidance to the industry with respect to the GLBA requirements. The rules also provide certain conditional exemptions from the broker definition to allow banks to perform certain securities activities. The Supplementary Information section, *supra,* contains more detailed information on the objectives of the rules.

3. Legal Basis

Pursuant to Section 101 of the Regulatory Relief Act, the Agencies are issuing the rules.

4. Small Entities Subject to the Rule

The rules apply to ''banks,'' which is defined in Section 3(a)(6) of the Exchange Act to include banking institutions organized in the United States, including members of the Federal Reserve System, Federal savings associations, as defined in Section 2(5) of the Home Owners' Loan Act, and other commercial banks, savings associations, and nondepository trust companies that are organized under the laws of a state or the United States and subject to supervision and examination by state or federal authorities having supervision over banks and savings associations.[382] Congress did not exempt small entity banks from the application of the GLBA. Moreover, because the rules are intended to provide guidance to, and exemptions for, all banks that are subject to the GBLA, the Agencies determined that it would not be appropriate or necessary to exempt small entity banks from the operation of the rules. The rules generally apply to all banks, including banks that would be considered small entities (i.e., banks with total assets of $165 million or less) for purposes of the RFA.[383] The Agencies, however, have adopted several interpretations or exceptions that likely will be particularly useful for small banks such as, for example, the fixed inflation-adjusted dollar alternative to the ''nominal'' requirement in the networking exception and the exception in Rule 723 from the chiefly compensated test for a de minimis number of trust or fiduciary accounts.

The Agencies estimate that the rules will apply to approximately 9,475 banks, approximately 5,816 of which could be considered small banks with assets of $165 million or less. Moreover, we do not anticipate any significant costs to small entity banks as a result of the rules. We note that a trade association whose membership consists primarily of small banking organizations indicated that small banks would be able to comply with the rules as proposed without significantly altering their activities.[384]

5. Reporting, Recordkeeping and Other Compliance Requirements

The rules will not impose any significant reporting, recordkeeping, or other compliance requirements on banks that are small entities.[385]

6. Duplicative, Overlapping, or Conflicting Federal Rules

The Agencies believe that no other rules duplicate, overlap, or conflict with the final rules.

7. Significant Alternatives

Pursuant to Section 3(a) of the RFA,[386] the Agencies must consider the following types of alternatives: (1) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rules, or any part thereof, for small entities.

As discussed above, the GLBA does not exempt small entity banks from the Exchange Act broker registration requirements and because the rules are intended to provide guidance to, and exemptions for, all banks that are subject to the GLBA and are designed to accommodate the business practices of all banks (including small entity banks), the Agencies determined that it would not be appropriate or necessary to exempt small entity banks from the operation of the rules. Moreover, providing one or more special exemptions for small banks could place broker-dealers, including small broker-dealers, or larger banks at a competitive disadvantage versus small banks.

The rules are intended to clarify and simplify compliance with the GLBA by providing guidance with respect to exceptions and by providing additional exemptions. As such, the rules are expected to facilitate compliance by banks of all sizes, including small entity banks.

The Agencies do not believe that it is necessary to consider whether small entity banks should be permitted to use performance rather than design standards to comply with the rules because the rules already use performance standards. Moreover, the rules do not dictate for entities of any size any particular design standards (e.g., technology) that must be employed to achieve the objectives of the rules.

*E. Plain Language*

Section 722 of the GLBA (12 U.S.C. 4809) requires the Board to use plain language in all proposed and final rules published by the Board after January 1, 2000. The Board believes the rules, to the maximum extent possible, are presented in a simple and straightforward manner.

**X. Statutory Authority**

Pursuant to authority set forth in the Exchange Act and particularly Sections 3(a)(4), 3(b), 15, 17, 23(a), and 36 thereof (15 U.S.C. 78c(a)(4), 78c(b), 78*o*, 78q, 78w(a), and 78mm, respectively) the Commission is repealing by operation of statute current Rules 3a4–2, 3a4–3, 3a4–4, 3a4–5, 3a4–6, and 3b–17 (§§ 240.3a4–2, 240.3a4–3, 240.3a4–4, 240.3a4–5, 240.3a4–6, and 240.3b–17, respectively). The Commission is repealing Exchange Act Rules 15a–7 and 15a–8 (§ 240.15a–7 and § 240.15a–8, respectively). The Commission, jointly with the Board of Governors of the Federal Reserve System, is also adopting new Rules 700, 701, 721, 722, 723, 740, 741, 760, 771, 772, 775, 776, 780, and 781 under the Exchange Act (§§ 247.700, 247.701, 247.721, 247.722, 247.723, 247.740,

[380] Pub. L. No. 109–351, 120 Stat. 1966 (2006).

[381] *See* Exchange Act Section 3(a)(4)(F), as added by Section 101 of the Regulatory Relief Act. The Regulatory Relief Act also requires that the Board and SEC consult with, and seek the concurrence of, the OCC, FDIC and OTS prior to jointly adopting final rules. As noted above, the Board and the SEC also have consulted extensively with the OCC, FDIC and OTS in developing these joint rules.

[382] *See* 15 U.S.C. 78c(a)(6); Pub. L. No. 109–351, 120 Stat. 1966 (2006).

[383] Small Business Administration regulations define ''small entities'' to include banks and savings associations with total assets of $165 million or less. 13 CFR 121.201.

[384] *See* ICBA Letter.

[385] The Agencies' estimates related to recordkeeping and disclosure are detailed in the ''Paperwork Reduction Act Analysis'' Section of this Release.

[386] 5 U.S.C. 604(a).

247.741, 247.760, 247.771, 247.772, 247.775, 247.776, 247.780, and 247.881, respectively).

## XI. Text of Rules and Rule Amendment

### List of Subjects

*12 CFR Part 218*

Banks, Brokers, Securities.

*17 CFR Part 240*

Broker-dealers, Reporting and recordkeeping requirements, Securities.

*17 CFR Part 247*

Banks, Brokers, Securities.

### Federal Reserve System

*Authority and Issuance*

■ For the reasons set forth in the preamble, the Board amends Title 12, Chapter II of the Code of Federal Regulations by adding a new Part 218 as set forth under Common Rules at the end of this document:

## PART 218—EXCEPTIONS FOR BANKS FROM THE DEFINITION OF BROKER IN THE SECURITIES EXCHANGE ACT OF 1934 (REGULATION R)

Sec.
218.100 Definition.
218.700 Defined terms relating to the networking exception from the definition of ''broker.''
218.701 Exemption from the definition of ''broker'' for certain institutional referrals.
218.721 Defined terms relating to the trust and fiduciary activities exception from the definition of ''broker.''
218.722 Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.
218.723 Exemptions for special accounts, transferred accounts, and a de minimis number of accounts.
218.740 Defined terms relating to the sweep accounts exception from the definition of ''broker.''
218.741 Exemption for banks effecting transactions in money market funds.
218.760 Exemption from definition of ''broker'' for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.
218.771 Exemption from the definition of ''broker'' for banks effecting transactions in securities issued pursuant to Regulation S.
218.772 Exemption from the definition of ''broker'' for banks engaging in securities lending transactions.
218.775 Exemption from the definition of ''broker'' for banks effecting certain excepted or exempted transactions in investment company securities.
218.776 Exemption from the definition of ''broker'' for banks effecting certain excepted or exempted transactions in a company's securities for its employee benefit plans.
218.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.
218.781 Exemption from the definition of ''broker'' for banks for a limited period of time.

**Authority:** 15 U.S.C. 78c(a)(4)(F).

### Securities and Exchange Commission

*Authority and Issuance*

■ For the reasons set forth in the preamble, the Commission amends Title 17, Chapter II of the Code of Federal Regulations as follows:

## PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

■ 1. The authority citation for part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

### §§ 240.3a4–2 through 240.3a4–6, 240.3b–17, 240.15a–7, and 240.15a–8 [Removed and Reserved]

■ 2. Sections 240.3a4–2 through 240.3a4–6, 240.3b–17, 240.15a–7, and 240.15a–8 are removed and reserved.

■ 3. Part 247 is added as set forth under Common Rules at the end of this document:

## PART 247—REGULATION R—EXEMPTIONS AND DEFINITIONS RELATED TO THE EXCEPTIONS FOR BANKS FROM THE DEFINITION OF BROKER

Sec.
247.100 Definition.
247.700 Defined terms relating to the networking exception from the definition of ''broker.''
247.701 Exemption from the definition of ''broker'' for certain institutional referrals.
247.721 Defined terms relating to the trust and fiduciary activities exception from the definition of ''broker.''
247.722 Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.
247.723 Exemptions for special accounts, transferred accounts, and a *de minimis* number of accounts.
247.740 Defined terms relating to the sweep accounts exception from the definition of ''broker.''
247.741 Exemption for banks effecting transactions in money market funds.
247.760 Exemption from definition of ''broker'' for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.
247.771 Exemption from the definition of ''broker'' for banks effecting transactions in securities issued pursuant to Regulation S.
247.772 Exemption from the definition of ''broker'' for banks engaging in securities lending transactions.
247.775 Exemption from the definition of ''broker'' for banks effecting certain excepted or exempted transactions in investment company securities.
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.
247.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.
247.781 Exemption from the definition of ''broker'' for banks for a limited period of time.

**Authority:** 15 U.S.C. 78c, 78*o*, 78q, 78w, and 78mm.

### Common Rules

The common rules that are adopted by the Commission as Part 247 of Title 17, Chapter II of the Code of Federal Regulations and by the Board as Part 218 of Title 12, Chapter II of the Code of Federal Regulations follow:

### § ___.100 Definition.

For purposes of this part the following definition shall apply: *Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

### § ___.700 Defined terms relating to the networking exception from the definition of ''broker.''

When used with respect to the Third Party Brokerage Arrangements (''Networking'') Exception from the definition of the term ''broker'' in section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i)) in the context of transactions with a customer, the following terms shall have the meaning provided:

(a) *Contingent on whether the referral results in a transaction* means dependent on whether the referral results in a purchase or sale of a security; whether an account is opened with a broker or dealer; whether the referral results in a transaction involving a particular type of security; or whether it results in multiple securities transactions; provided, however, that a referral fee may be contingent on whether a customer:

(1) Contacts or keeps an appointment with a broker or dealer as a result of the referral; or

(2) Meets any objective, base-line qualification criteria established by the bank or broker or dealer for customer referrals, including such criteria as minimum assets, net worth, income, or

marginal federal or state income tax rate, or any requirement for citizenship or residency that the broker or dealer, or the bank, may have established generally for referrals for securities brokerage accounts.

(b)(1) *Incentive compensation* means compensation that is intended to encourage a bank employee to refer customers to a broker or dealer or give a bank employee an interest in the success of a securities transaction at a broker or dealer. The term does not include compensation paid by a bank under a bonus or similar plan that is:

(i) Paid on a discretionary basis; and

(ii) Based on multiple factors or variables and:

(A) Those factors or variables include multiple significant factors or variables that are not related to securities transactions at the broker or dealer;

(B) A referral made by the employee is not a factor or variable in determining the employee's compensation under the plan; and

(C) The employee's compensation under the plan is not determined by reference to referrals made by any other person.

(2) Nothing in this paragraph (b) shall be construed to prevent a bank from compensating an officer, director or employee under a bonus or similar plan on the basis of any measure of the overall profitability or revenue of:

(i) The bank, either on a stand-alone or consolidated basis;

(ii) Any affiliate of the bank (other than a broker or dealer), or any operating unit of the bank or an affiliate (other than a broker or dealer), if the affiliate or operating unit does not over time predominately engage in the business of making referrals to a broker or dealer; or

(iii) A broker or dealer if:

(A) Such measure of overall profitability or revenue is only one of multiple factors or variables used to determine the compensation of the officer, director or employee;

(B) The factors or variables used to determine the compensation of the officer, director or employee include multiple significant factors or variables that are not related to the profitability or revenue of the broker or dealer;

(C) A referral made by the employee is not a factor or variable in determining the employee's compensation under the plan; and

(D) The employee's compensation under the plan is not determined by reference to referrals made by any other person.

(c) *Nominal one-time cash fee of a fixed dollar amount* means a cash payment for a referral, to a bank employee who was personally involved in referring the customer to the broker or dealer, in an amount that meets any of the following standards:

(1) The payment does not exceed:

(i) 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

(ii) 1/1000th 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; or

(2) The payment does not exceed twice the employee's actual base hourly wage or 1/1000th of the employee's actual annual base salary; or

(3) The payment does not exceed twenty-five dollars ($25), as adjusted in accordance with paragraph (f) of this section.

(d) *Job family* means a group of jobs or positions involving similar responsibilities, or requiring similar skills, education or training, that a bank, or a separate unit, branch or department of a bank, has established and uses in the ordinary course of its business to distinguish among its employees for purposes of hiring, promotion, and compensation.

(e) *Referral* means the action taken by one or more bank employees to direct a customer of the bank to a broker or dealer for the purchase or sale of securities for the customer's account.

(f) *Inflation adjustment*—(1) *In general.* On April 1, 2012, and on the 1st day of each subsequent 5-year period, the dollar amount referred to in paragraph (c)(3) of this section shall be adjusted by:

(i) Dividing the annual value of the Employment Cost Index For Wages and Salaries, Private Industry Workers (or any successor index thereto), as published by the Bureau of Labor Statistics, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(ii) Multiplying the dollar amount by the quotient obtained in paragraph (f)(1)(i) of this section.

(2) *Rounding.* If the adjusted dollar amount determined under paragraph (f)(1) of this section for any period is not a multiple of $1, the amount so determined shall be rounded to the nearest multiple of $1.

**§ ____.701 Exemption from the definition of ''broker'' for certain institutional referrals.**

(a) *General.* A bank that meets the requirements for the exception from the definition of ''broker'' under section 3(a)(4)(B)(i) of the Act (15 U.S.C. 78c(a)(4)(B)(i)), other than section 3(a)(4)(B)(i)(VI) of the Act (15 U.S.C. 78c(a)(4)(B)(i)(VI)), is exempt from the conditions of section 3(a)(4)(B)(i)(VI) of the Act solely to the extent that a bank employee receives a referral fee for referring a high net worth customer or institutional customer to a broker or dealer with which the bank has a contractual or other written arrangement of the type specified in section 3(a)(4)(B)(i) of the Act, if:

(1) *Bank employee.* (i) The bank employee is:

(A) Not registered or approved, or otherwise required to be registered or approved, in accordance with the qualification standards established by the rules of any self-regulatory organization;

(B) Predominantly engaged in banking activities other than making referrals to a broker or dealer; and

(C) Not subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; and

(ii) The high net worth customer or institutional customer is encountered by the bank employee in the ordinary course of the employee's assigned duties for the bank.

(2) *Bank determinations and obligations*—(i) *Disclosures.* The bank provides the high net worth customer or institutional customer the information set forth in paragraph (b) of this section

(A) In writing prior to or at the time of the referral; or

(B) Orally prior to or at the time of the referral and

(*1*) The bank provides such information to the customer in writing within 3 business days of the date on which the bank employee refers the customer to the broker or dealer; or

(*2*) The written agreement between the bank and the broker or dealer provides for the broker or dealer to provide such information to the customer in writing in accordance with paragraph (a)(3)(i) of this section.

(ii) *Customer qualification.* (A) In the case of a customer that is a not a natural person, the bank has a reasonable basis to believe that the customer is an institutional customer before the referral fee is paid to the bank employee.

(B) In the case of a customer that is a natural person, the bank has a reasonable basis to believe that the customer is a high net worth customer prior to or at the time of the referral.

(iii) *Employee qualification information.* Before a referral fee is paid to a bank employee under this section,

the bank provides the broker or dealer the name of the employee and such other identifying information that may be necessary for the broker or dealer to determine whether the bank employee is registered or approved, or otherwise required to be registered or approved, in accordance with the qualification standards established by the rules of any self-regulatory organization or is subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section.

(iv) *Good faith compliance and corrections.* A bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of this section shall not be considered a ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely because the bank fails to comply with the provisions of this paragraph (a)(2) with respect to a particular customer if the bank:

(A) Takes reasonable and prompt steps to remedy the error (such as, for example, by promptly making the required determination or promptly providing the broker or dealer the required information); and

(B) Makes reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for the referral that does not, following any required remedial action, meet the requirements of this section and that exceeds the amount otherwise permitted under section 3(a)(4)(B)(i)(VI) of the Act (15 U.S.C. 78c(a)(4)(B)(i)(VI)) and § ____.700.

(3) *Provisions of written agreement.* The written agreement between the bank and the broker or dealer shall require that:

(i) *Broker-dealer written disclosures.* If, pursuant to paragraph (a)(2)(i)(B)(*2*) of this section, the broker or dealer is to provide the customer in writing the disclosures set forth in paragraph (b) of this section, the broker or dealer provides such information to the customer in writing:

(A) Prior to or at the time the customer begins the process of opening an account at the broker or dealer, if the customer does not have an account with the broker or dealer; or

(B) Prior to the time the customer places an order for a securities transaction with the broker or dealer as a result of the referral, if the customer already has an account at the broker or dealer.

(ii) *Customer and employee qualifications.* Before the referral fee is paid to the bank employee:

(A) The broker or dealer determine that the bank employee is not subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section; and

(B) The broker or dealer has a reasonable basis to believe that the customer is a high net worth customer or an institutional customer.

(iii) *Suitability or sophistication determination by broker or dealer*—(A) *Contingent referral fees.* In any case in which payment of the referral fee is contingent on completion of a securities transaction at the broker or dealer, the broker or dealer, before such securities transaction is conducted, perform a suitability analysis of the securities transaction in accordance with the rules of the broker or dealer's applicable self-regulatory organization as if the broker or dealer had recommended the securities transaction.

(B) *Non-contingent referral fees.* In any case in which payment of the referral fee is not contingent on the completion of a securities transaction at the broker or dealer, the broker or dealer, before the referral fee is paid, either:

(*1*) Determine that the customer:

(*i*) Has the capability to evaluate investment risk and make independent decisions; and

(*ii*) Is exercising independent judgment based on the customer's own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations; or

(*2*) Perform a suitability analysis of all securities transactions requested by the customer contemporaneously with the referral in accordance with the rules of the broker or dealer's applicable self-regulatory organization as if the broker or dealer had recommended the securities transaction.

(iv) *Notice to the customer.* The broker or dealer inform the customer if the broker or dealer determines that the customer or the securities transaction(s) to be conducted by the customer does not meet the applicable standard set forth in paragraph (a)(3)(iii) of this section.

(v) *Notice to the bank.* The broker or dealer promptly inform the bank if the broker or dealer determines that:

(A) The customer is not a high net worth customer or institutional customer, as applicable; or

(B) The bank employee is subject to statutory disqualification, as that term is defined in section 3(a)(39) of the Act (15 U.S.C. 78c(a)(39)), except subparagraph (E) of that section.

(b) *Required disclosures.* The disclosures provided to the high net worth customer or institutional customer pursuant to paragraphs (a)(2)(i) or (a)(3)(i) of this section shall clearly and conspicuously disclose

(1) The name of the broker or dealer; and

(2) That the bank employee participates in an incentive compensation program under which the bank employee may receive a fee of more than a nominal amount for referring the customer to the broker or dealer and payment of this fee may be contingent on whether the referral results in a transaction with the broker or dealer.

(c) *Receipt of other compensation.* Nothing in this section prevents or prohibits a bank from paying or a bank employee from receiving any type of compensation that would not be considered incentive compensation under § ____.700(b)(1) or that is described in § ____.700(b)(2).

(d) *Definitions.* When used in this section:

(1) *High net worth customer*—(i) *General. High net worth customer* means:

(A) Any natural person who, either individually or jointly with his or her spouse, has at least $5 million in net worth excluding the primary residence and associated liabilities of the person and, if applicable, his or her spouse; and

(B) Any revocable, inter vivos or living trust the settlor of which is a natural person who, either individually or jointly with his or her spouse, meets the net worth standard set forth in paragraph (d)(1)(i)(A) of this section.

(ii) *Individual and spousal assets.* In determining whether any person is a high net worth customer, there may be included in the assets of such person

(A) Any assets held individually;

(B) If the person is acting jointly with his or her spouse, any assets of the person's spouse (whether or not such assets are held jointly); and

(C) 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.

(2) *Institutional customer* means any corporation, partnership, limited liability company, trust or other non-natural person that has, or is controlled by a non-natural person that has, at least:

(i) $10 million in investments; or

(ii) $20 million in revenues; or

(iii) $15 million in revenues if the bank employee refers the customer to the broker or dealer for investment banking services.

(3) *Investment banking services* includes, 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.

(4) *Referral fee* means a fee (paid in one or more installments) for the referral of a customer to a broker or dealer that is:

(i) A predetermined dollar amount, or a dollar amount determined in accordance with a predetermined formula (such as a fixed percentage of the dollar amount of total assets placed in an account with the broker or dealer), that does not vary based on:

(A) The revenue generated by or the profitability of securities transactions conducted by the customer with the broker or dealer; or

(B) The quantity, price, or identity of securities transactions conducted over time by the customer with the broker or dealer; or

(C) The number of customer referrals made; or

(ii) A dollar amount based on a fixed percentage of the revenues received by the broker or dealer for investment banking services provided to the customer.

(e) *Inflation adjustments*—(1) *In general.* On April 1, 2012, and on the 1st day of each subsequent 5-year period, each dollar amount in paragraphs (d)(1) and (d)(2) of this section shall be adjusted by:

(i) Dividing the annual value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the Department of Commerce, for the calendar year preceding the calendar year in which the adjustment is being made by the annual value of such index (or successor) for the calendar year ending December 31, 2006; and

(ii) Multiplying the dollar amount by the quotient obtained in paragraph (e)(1)(i) of this section.

(2) *Rounding.* If the adjusted dollar amount determined under paragraph (e)(1) of this section for any period is not a multiple of $100,000, the amount so determined shall be rounded to the nearest multiple of $100,000.

**§ ____.721 Defined terms relating to the trust and fiduciary activities exception from the definition of "broker."**

(a) *Defined terms for chiefly compensated test.* For purposes of this part and section 3(a)(4)(B)(ii) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)), the following terms shall have the meaning provided:

(1) *Chiefly compensated—account-by-account test. Chiefly compensated* shall mean the *relationship-total compensation percentage* for each *trust or fiduciary account* of the bank is greater than 50 percent.

(2) The *relationship-total compensation percentage* for a *trust or fiduciary account* shall be the mean of the *yearly compensation percentage* for the account for the immediately preceding year and the *yearly compensation percentage* for the account for the year immediately preceding that year.

(3) The *yearly compensation percentage* for a *trust or fiduciary account* shall be

(i) Equal to the relationship compensation attributable to the *trust or fiduciary account* during the year divided by the total compensation attributable to the *trust or fiduciary account* during that year, with the quotient expressed as a percentage; and

(ii) Calculated within 60 days of the end of the year.

(4) *Relationship compensation* means any compensation a bank receives attributable to a trust or fiduciary account that consists of:

(i) An administration fee, including, without limitation, a fee paid—

(A) For personal services, tax preparation, or real estate settlement services;

(B) For disbursing funds from, or for recording receipt of payments to, a trust or fiduciary account;

(C) In connection with securities lending or borrowing transactions;

(D) For custody services; or

(E) In connection with an investment in shares of an investment company for personal service, the maintenance of shareholder accounts or any service described in paragraph (a)(4)(iii)(C) of this section;

(ii) An annual fee (payable on a monthly, quarterly or other basis), including, without limitation, a fee paid for assessing investment performance or for reviewing compliance with applicable investment guidelines or restrictions;

(iii) A fee based on a percentage of assets under management, including, without limitation, a fee paid

(A) Pursuant to a plan under § 270.12b–1;

(B) In connection with an investment in shares of an investment company for personal service or the maintenance of shareholder accounts;

(C) Based on a percentage of assets under management for any of the following services—

(I) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(II) Aggregating and processing purchase and redemption orders for investment company shares;

(III) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(IV) Processing dividend payments for the investment company;

(V) Providing sub-accounting services to the investment company for shares held beneficially;

(VI) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(VII) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares;

(D) Based on the financial performance of the assets in an account; or

(E) For the types of services described in paragraph (a)(4)(i)(C) or (D) of this section if paid based on a percentage of assets under management;

(iv) A flat or capped per order processing fee, paid by or on behalf of a customer or beneficiary, that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts; or

(v) Any combination of such fees.

(6) *Trust or fiduciary account* means an account for which the bank acts in a trustee or fiduciary capacity as defined in section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)).

(7) *Year* means a calendar year, or fiscal year consistently used by the bank for recordkeeping and reporting purposes.

(b) *Revenues derived from transactions conducted under other exceptions or exemptions.* For purposes of calculating the *yearly compensation percentage* for a *trust or fiduciary account*, a bank may at its election exclude the compensation associated with any securities transaction conducted in accordance with the exceptions in section 3(a)(4)(B)(i) or sections 3(a)(4)(B)(iii)–(xi) of the Act (15 U.S.C. 78c(a)(4)(B)(i) or 78c(a)(4)(B)(iii)–(xi)) and the rules issued thereunder, including any exemption related to such exceptions jointly adopted by the Commission and the Board, *provided that* if the bank elects to exclude such compensation, the bank must exclude the compensation from both the relationship compensation (if applicable) and total compensation for the account.

(c) *Advertising restrictions*—

(1) *In general.* A bank complies with the advertising restriction in section 3(a)(4)(B)(ii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(II)) if advertisements by or on behalf of the bank do not advertise—

(i) That the bank provides securities brokerage services for trust or fiduciary accounts except as part of advertising the bank's broader trust or fiduciary services; and

(ii) The securities brokerage services provided by the bank to trust or fiduciary accounts more prominently than the other aspects of the trust or fiduciary services provided to such accounts.

(2) *Advertisement.* For purposes of this section, the term advertisement has the same meaning as in § ____.760(g)(2).

**§ ____.722 Exemption allowing banks to calculate trust and fiduciary compensation on a bank-wide basis.**

(a) *General.* A bank is exempt from meeting the ''chiefly compensated'' condition in section 3(a)(4)(B)(ii)(I) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(I)) to the extent that it effects transactions in securities for any account in a trustee or fiduciary capacity within the scope of section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)) if:

(1) The bank meets the other conditions for the exception from the definition of the term ''broker'' under sections 3(a)(4)(B)(ii) and 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(B)(ii) and 15 U.S.C. 78c(a)(4)(C)), including the advertising restrictions in section 3(a)(4)(B)(ii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(II) as implemented by § __.721(c); and

(2) The aggregate relationship-total compensation percentage for the bank's trust and fiduciary business is at least 70 percent.

(b) *Aggregate relationship-total compensation percentage.* For purposes of this section, the *aggregate relationship-total compensation percentage* for a bank's trust and fiduciary business shall be the mean of the bank's *yearly bank-wide compensation percentage* for the immediately preceding year and the bank's *yearly bank-wide compensation percentage* for the year immediately preceding that year.

(c) *Yearly bank-wide compensation percentage.* For purposes of this section, a bank's *yearly bank-wide compensation percentage* for a year shall be

(1) Equal to the *relationship compensation* attributable to the bank's trust and fiduciary business as a whole during the year divided by the total compensation attributable to the bank's trust and fiduciary business as a whole during that year, with the quotient expressed as a percentage; and

(2) Calculated within 60 days of the end of the year.

(d) *Revenues derived from transactions conducted under other exceptions or exemptions.* For purposes of calculating the *yearly compensation percentage* for a *trust or fiduciary account,* a bank may at its election exclude the compensation associated with any securities transaction conducted in accordance with the exceptions in section 3(a)(4)(B)(i) or sections 3(a)(4)(B)(iii)–(xi) of the Act (15 U.S.C. 78c(a)(4)(B)(i) or 78c(a)(4)(B)(iii)–(xi)) and the rules issued thereunder, including any exemption related to such sections jointly adopted by the Commission and the Board, *provided that* if the bank elects to exclude such compensation, the bank must exclude the compensation from both the relationship compensation (if applicable) and total compensation of the bank.

**§ ____.723 Exemptions for special accounts, transferred accounts, foreign branches and a *de minimis* number of accounts.**

(a) *Short-term accounts.* A bank may, in determining its compliance with the chiefly compensated test in § ____.721(a)(1) or § ____.722(a)(2), exclude any trust or fiduciary account that had been open for a period of less than 3 months during the relevant year.

(b) *Accounts acquired as part of a business combination or asset acquisition.* For purposes of determining compliance with the chiefly compensated test in § ____.721(a)(1) or § ____.722(a)(2), any *trust or fiduciary account* that a bank acquired from another person as part of a merger, consolidation, acquisition, purchase of assets or similar transaction may be excluded by the bank for 12 months after the date the bank acquired the account from the other person.

(c) *Non-shell foreign branches*—(1) *Exemption.* For purposes of determining compliance with the chiefly compensated test in § ____.722(a)(2), a bank may exclude the trust or fiduciary accounts held at a non-shell foreign branch of the bank if the bank has reasonable cause to believe that trust or fiduciary accounts of the foreign branch held by or for the benefit of a U.S. person as defined in 17 CFR 230.902(k) constitute less than 10 percent of the total number of trust or fiduciary accounts of the foreign branch.

(2) *Rules of construction.* Solely for purposes of this paragraph (c), a bank will be deemed to have reasonable cause to believe that a trust or fiduciary account of a foreign branch of the bank is not held by or for the benefit of a U.S. person if

(i) The principal mailing address maintained and used by the foreign branch for the accountholder(s) and beneficiary(ies) of the account is not in the United States; or

(ii) The records of the foreign branch indicate that the accountholder(s) and beneficiary(ies) of the account is not a U.S. person as defined in 17 CFR 230.902(k).

(3) *Non-shell foreign branch.* Solely for purposes of this paragraph (c), a non-shell foreign branch of a bank means a branch of the bank

(i) That is located outside the United States and provides banking services to residents of the foreign jurisdiction in which the branch is located; and

(ii) For which the decisions relating to day-to-day operations and business of the branch are made at that branch and are not made by an office of the bank located in the United States.

(d) *Accounts transferred to a broker or dealer or other unaffiliated entity.* Notwithstanding section 3(a)(4)(B)(ii)(I) of the Act (15 U.S.C. 78c(a)(4)(B)(ii)(I)) and § ____.721(a)(1) of this part, a bank operating under § ____.721(a)(1) shall not be considered a broker for purposes of section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) solely because a *trust or fiduciary account* does not meet the chiefly compensated standard in § ____.721(a)(1) if, within 3 months of the end of the year in which the account fails to meet such standard, the bank transfers the account or the securities held by or on behalf of the account to a broker or dealer registered under section 15 of the Act (15 U.S.C. 78o) or another entity that is not an affiliate of the bank and is not required to be registered as a broker or dealer.

(e) *De minimis exclusion.* A bank may, in determining its compliance with the chiefly compensated test in § ____.721(a)(1), exclude a *trust or fiduciary account* if:

(1) The bank maintains records demonstrating that the securities transactions conducted by or on behalf of the account were undertaken by the bank in the exercise of its trust or fiduciary responsibilities with respect to the account;

(2) The total number of accounts excluded by the bank under this paragraph (d) does not exceed the lesser of—

(i) 1 percent of the total number of trust or fiduciary accounts held by the bank, *provided that* if the number so obtained is less than 1 the amount shall be rounded up to 1; or

(ii) 500; and

(3) The bank did not rely on this paragraph (d) with respect to such account during the immediately preceding year.

**§ ____.740 Defined terms relating to the sweep accounts exception from the definition of ''broker.''**

For purposes of section 3(a)(4)(B)(v) of the Act (15 U.S.C. 78c(a)(4)(B)(v)), the following terms shall have the meaning provided:

(a) *Deferred sales load* has the same meaning as in 17 CFR 270.6c–10.

(b) *Money market fund* means an open-end company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) that is regulated as a money market fund pursuant to 17 CFR 270.2a–7.

(c)(1) *No-load*, in the context of an investment company or the securities issued by an investment company, means, for securities of the class or series in which a bank effects transactions, that:

(i) That class or series is not subject to a sales load or a deferred sales load; and

(ii) Total charges against net assets of that class or series of the investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts do not exceed 0.25 of 1% of average net assets annually.

(2) For purposes of this definition, charges for the following will not be considered charges against net assets of a class or series of an investment company's securities for sales or sales promotion expenses, for personal service, or for the maintenance of shareholder accounts:

(i) Providing transfer agent or sub-transfer agent services for beneficial owners of investment company shares;

(ii) Aggregating and processing purchase and redemption orders for investment company shares;

(iii) Providing beneficial owners with account statements showing their purchases, sales, and positions in the investment company;

(iv) Processing dividend payments for the investment company;

(v) Providing sub-accounting services to the investment company for shares held beneficially;

(vi) Forwarding communications from the investment company to the beneficial owners, including proxies, shareholder reports, dividend and tax notices, and updated prospectuses; or

(vii) Receiving, tabulating, and transmitting proxies executed by beneficial owners of investment company shares.

(d) *Open-end company* has the same meaning as in section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–5(a)(1)).

(e) *Sales load* has the same meaning as in section 2(a)(35) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(35)).

**§ ____.741 Exemption for banks effecting transactions in money market funds.**

(a) A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that it effects transactions on behalf of a customer in securities issued by a money market fund, provided that:

(1) The bank either

(A) Provides the customer, directly or indirectly, any other product or service, the provision of which would not, in and of itself, require the bank to register as a broker or dealer under section 15(a) of the Act (15 U.S.C. 78o(a)); or

(B) Effects the transactions on behalf of another bank as part of a program for the investment or reinvestment of deposit funds of, or collected by, the other bank; and

(2)(i) The class or series of securities is no-load; or

(ii) If the class or series of securities is not no-load

(A) The bank or, if applicable, the other bank described in paragraph (a)(1)(B) of this section provides the customer, not later than at the time the customer authorizes the securities transactions, a prospectus for the securities; and

(B) The bank and, if applicable, the other bank described in paragraph (a)(1)(B) of this section do not characterize or refer to the class or series of securities as no-load.

(b) *Definitions*. For purposes of this section:

(1) *Money market fund* has the same meaning as in § ____.740(b).

(2) *No-load* has the same meaning as in § ____.740(c).

**§ ____.760 Exemption from definition of ''broker'' for banks accepting orders to effect transactions in securities from or on behalf of custody accounts.**

(a) *Employee benefit plan accounts and individual retirement accounts or similar accounts*. A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities for an employee benefit plan account or an individual retirement account or similar account for which the bank acts as a custodian if:

(1) *Employee compensation restriction and additional conditions.* The bank complies with the employee compensation restrictions in paragraph (c) of this section *and the other conditions in paragraph (d) of this section*;

(2) *Advertisements*. Advertisements by or on behalf of the bank do not:

(i) Advertise that the bank accepts orders for securities transactions for employee benefit plan accounts or individual retirement accounts or similar accounts, except as part of advertising the other custodial or safekeeping services the bank provides to these accounts; or

(ii) Advertise that such accounts are securities brokerage accounts or that the bank's safekeeping and custody services substitute for a securities brokerage account; and

(3) *Advertisements and sales literature for individual retirement or similar accounts*. Advertisements and sales literature issued by or on behalf of the bank do not describe the securities order-taking services provided by the bank to individual retirement accounts or similar accounts more prominently than the other aspects of the custody or safekeeping services provided by the bank to these accounts.

(b) *Accommodation trades for other custodial accounts*. A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) to the extent that, as part of its customary banking activities, the bank accepts orders to effect transactions in securities for an account for which the bank acts as custodian other than an employee benefit plan account or an individual retirement account or similar account if:

(1) *Accommodation*. The bank accepts orders to effect transactions in securities for the account only as an accommodation to the customer;

(2) *Employee compensation restriction and additional conditions*. The bank complies with the employee compensation restrictions in paragraph (c) of this section and the other conditions in paragraph (d) of this section;

(3) *Bank fees*. Any fee charged or received by the bank for effecting a securities transaction for the account does not vary based on:

(i) Whether the bank accepted the order for the transaction; or

(ii) The quantity or price of the securities to be bought or sold;

(4) *Advertisements.* Advertisements by or on behalf of the bank do not state that the bank accepts orders for securities transactions for the account;

(5) *Sales literature.* Sales literature issued by or on behalf of the bank:

(i) Does not state that the bank accepts orders for securities transactions for the account except as part of describing the other custodial or safekeeping services the bank provides to the account; and

(ii) Does not describe the securities order-taking services provided to the account more prominently than the other aspects of the custody or safekeeping services provided by the bank to the account; and

(6) *Investment advice and recommendations.* The bank does not provide investment advice or research concerning securities to the account, make recommendations to the account concerning securities or otherwise solicit securities transactions from the account; provided, however, that nothing in this paragraph (b)(6) shall prevent a bank from:

(i) Publishing, using or disseminating advertisements and sales literature in accordance with paragraphs (b)(4) and (b)(5) of this section; and

(ii) Responding to customer inquiries regarding the bank's safekeeping and custody services by providing:

(A) Advertisements or sales literature consistent with the provisions of paragraphs (b)(4) and (b)(5) of this section describing the safekeeping, custody and related services that the bank offers;

(B) A prospectus prepared by a registered investment company, or sales literature prepared by a registered investment company or by the broker or dealer that is the principal underwriter of the registered investment company pertaining to the registered investment company's products;

(C) Information based on the materials described in paragraphs (b)(6)(ii)(A) and (B) of this section; or

(iii) Responding to inquiries regarding the bank's safekeeping, custody or other services, such as inquiries concerning the customer's account or the availability of sweep or other services, so long as the bank does not provide investment advice or research concerning securities to the account or make a recommendation to the account concerning securities.

(c) *Employee compensation restriction.* A bank may accept orders pursuant to this section for a securities transaction for an account described in paragraph (a) or (b) of this section only if no bank employee receives compensation, including a fee paid pursuant to a plan under 17 CFR 270.12b–1, from the bank, the executing broker or dealer, or any other person that is based on whether a securities transaction is executed for the account or that is based on the quantity, price, or identity of securities purchased or sold by such account, provided that nothing in this paragraph shall prohibit a bank employee from receiving compensation that would not be considered incentive compensation under § ____.700(b)(1) as if a referral had been made by the bank employee, or any compensation described in § ____.700(b)(2).

(d) *Other conditions.* A bank may accept orders for a securities transaction for an account for which the bank acts as a custodian under this section only if the bank:

(1) Does not act in a trustee or fiduciary capacity (as defined in section 3(a)(4)(D) of the Act (15 U.S.C. 78c(a)(4)(D)) with respect to the account, other than as a directed trustee;

(2) Complies with section 3(a)(4)(C) of the Act (15 U.S.C. 78c(a)(4)(C)) in handling any order for a securities transaction for the account; and

(3) Complies with section 3(a)(4)(B)(viii)(II) of the Act (15 U.S.C. 78c(a)(4)(B)(viii)(II)) regarding carrying broker activities.

(e) *Non-fiduciary administrators and recordkeepers.* A bank that acts as a non-fiduciary and non-custodial administrator or recordkeeper for an employee benefit plan account for which another bank acts as custodian may rely on the exemption provided in this section if:

(1) Both the custodian bank and the administrator or recordkeeper bank comply with paragraphs (a), (c) and (d) of this section; and

(2) The administrator or recordkeeper bank does not execute a cross-trade with or for the employee benefit plan account or net orders for securities for the employee benefit plan account, other than:

(i) Crossing or netting orders for shares of open-end investment companies not traded on an exchange, or

(ii) Crossing orders between or netting orders for accounts of the custodian bank that contracted with the administrator or recordkeeper bank for services.

(f) *Subcustodians.* A bank that acts as a subcustodian for an account for which another bank acts as custodian may rely on the exemptions provided in this section if:

(1) For employee benefit plan accounts and individual retirement accounts or similar accounts, both the custodian bank and the subcustodian bank meet the requirements of paragraphs (a), (c) and (d) of this section;

(2) For other custodial accounts, both the custodian bank and the subcustodian bank meet the requirements of paragraphs (b), (c) and (d) of this section; and

(3) The subcustodian bank does not execute a cross-trade with or for the account or net orders for securities for the account, other than:

(i) Crossing or netting orders for shares of open-end investment companies not traded on an exchange, or

(ii) Crossing orders between or netting orders for accounts of the custodian bank.

(g) *Evasions.* In considering whether a bank meets the terms of this section, both the form and substance of the relevant account(s), transaction(s) and activities (including advertising activities) of the bank will be considered in order to prevent evasions of the requirements of this section.

(h) *Definitions.* When used in this section:

(1) *Account for which the bank acts as a custodian* means an account that is:

(i) An employee benefit plan account for which the bank acts as a custodian;

(ii) An individual retirement account or similar account for which the bank acts as a custodian;

(iii) 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

(iv) An account for which the bank acts as a directed trustee.

(2) *Advertisement* means any material that is published or used in any electronic or other public media, including any Web site, newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, or telephone directories (other than routine listings).

(3) *Directed trustee* means a trustee that does not exercise investment discretion with respect to the account.

(4) *Employee benefit plan account* means a pension plan, retirement plan, profit sharing plan, bonus plan, thrift savings plan, incentive plan, or other similar plan, including, without limitation, an employer-sponsored plan qualified under section 401(a) of the Internal Revenue Code (26 U.S.C. 401(a)), a governmental or other plan described in section 457 of the Internal Revenue Code (26 U.S.C. 457), a tax-deferred plan described in section 403(b) of the Internal Revenue Code (26 U.S.C. 403(b)), a church plan, governmental, multiemployer or other plan described in section 414(d), (e) or (f) of the Internal Revenue Code (26 U.S.C. 414(d), (e) or (f)), an incentive

stock option plan described in section 422 of the Internal Revenue Code (26 U.S.C. 422); a Voluntary Employee Beneficiary Association Plan described in section 501(c)(9) of the Internal Revenue Code (26 U.S.C. 501(c)(9)), a non-qualified deferred compensation plan (including a rabbi or secular trust), a supplemental or mirror plan, and a supplemental unemployment benefit plan.

(5) *Individual retirement account or similar account* means an individual retirement account as defined in section 408 of the Internal Revenue Code (26 U.S.C. 408), Roth IRA as defined in section 408A of the Internal Revenue Code (26 U.S.C. 408A), health savings account as defined in section 223(d) of the Internal Revenue Code (26 U.S.C. 223(d)), Archer medical savings account as defined in section 220(d) of the Internal Revenue Code (26 U.S.C. 220(d)), Coverdell education savings account as defined in section 530 of the Internal Revenue Code (26 U.S.C. 530), or other similar account.

(6) *Sales literature* means any written or electronic communication, other than an advertisement, that is generally distributed or made generally available to customers of the bank or the public, including circulars, form letters, brochures, telemarketing scripts, seminar texts, published articles, and press releases concerning the bank's products or services.

(7) *Principal underwriter* has the same meaning as in section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29)).

**§ __.771 Exemption from the definition of ''broker'' for banks effecting transactions in securities issued pursuant to Regulation S.**

(a) A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)), to the extent that, as agent, the bank:

(1) Effects a sale in compliance with the requirements of 17 CFR 230.903 of an eligible security to a purchaser who is not in the United States;

(2) Effects, by or on behalf of a person who is not a U.S. person under 17 CFR 230.902(k), a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903 to a purchaser who is not in the United States or a registered broker or dealer, provided that if the resale is made prior to the expiration of any applicable distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the resale is made in compliance with the requirements of 17 CFR 230.904; or

(3) Effects, by or on behalf of a registered broker or dealer, a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside of the United States within the meaning of and in compliance with the requirements of 17 CFR 230.903 to a purchaser who is not in the United States, provided that if the resale is made prior to the expiration of any applicable distribution compliance period specified in 17 CFR 230.903(b)(2) or (b)(3), the resale is made in compliance with the requirements of 17 CFR 230.904.

(b) *Definitions.* For purposes of this section:

(1) *Distributor* has the same meaning as in 17 CFR 230.902(d).

(2) *Eligible security* means a security that:

(i) Is not being sold from the inventory of the bank or an affiliate of the bank; and

(ii) 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.

(3) *Purchaser* means a person who purchases an eligible security and who is not a U.S. person under 17 CFR 230.902(k).

**§ ____.772 Exemption from the definition of ''broker'' for banks engaging in securities lending transactions.**

(a) A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)), to the extent that, as an agent, it engages in or effects securities lending transactions, and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be:

(1) A qualified investor as defined in section 3(a)(54)(A) of the Act (15 U.S.C. 78c(a)(54)(A)); or

(2) Any employee benefit plan that owns and invests on a discretionary basis, not less than $ 25,000,000 in investments.

(b) *Securities lending transaction* means 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 of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties.

(c) *Securities lending services* means:

(1) Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower;

(2) Receiving, delivering, or directing the receipt or delivery of loaned securities;

(3) Receiving, delivering, or directing the receipt or delivery of collateral;

(4) Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction;

(5) Investing, or directing the investment of, cash collateral; or

(6) Indemnifying the lender of securities with respect to various matters.

**§ ____.775 Exemption from the definition of ''broker'' for banks effecting certain excepted or exempted transactions in investment company securities.**

(a) A bank that meets the conditions for an exception or exemption from the definition of the term ''broker'' except for the condition in section 3(a)(4)(C)(i) of the Act (15 U.S.C. 78c(a)(4)(C)(i)), is exempt from such condition to the extent that it effects a transaction in a *covered security,* if:

(1) Any such security is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system;

(2) The security is distributed by a registered broker or dealer, or the sales charge is no more than the amount permissible for a security sold by a registered broker or dealer pursuant to any applicable rules adopted pursuant to section 22(b)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a–22(b)(1)) by a securities association registered under section 15A of the Act (15 U.S.C. 78o–3); and

(3) Any such transaction is effected:

(i) Through the National Securities Clearing Corporation; or

(ii) Directly with a transfer agent or with an insurance company or separate account that is excluded from the definition of transfer agent in Section 3(a)(25) of the Act.

(b) *Definitions.* For purposes of this section:

(1) *Covered security* means:

(i) Any security issued by an open-end company, as defined by section 5(a)(1) of the Investment Company Act (15 U.S.C. 80a5(a)(1)), that is registered under that Act; and

(ii) Any variable insurance contract funded by a separate account, as defined by section 2(a)(37) of the Investment Company Act (15 U.S.C. 80a–2(a)(37)), that is registered under that Act.

(2) *Interdealer quotation system* has the same meaning as in 17 CFR 240.15c2–11.

(3) *Insurance company* has the same meaning as in 15 U.S.C. 77b(a)(13).

**§ ____.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.**

(a) A bank that meets the conditions for an exception or exemption from the definition of the term ''broker'' except for the condition in section 3(a)(4)(C)(i) of the Act (15 U.S.C. 78c(a)(4)(C)(i)), is exempt from such condition to the extent that it effects a transaction in the securities of a company directly with a transfer agent acting for the company that issued the security, if:

(1) No commission is charged with respect to the transaction;

(2) The transaction is conducted by the bank solely for the benefit of an employee benefit plan account;

(3) Any such security is obtained directly from:

(i) The company; or

(ii) An employee benefit plan of the company; and

(4) Any such security is transferred only to:

(i) The company; or

(ii) An employee benefit plan of the company.

(b) For purposes of this section, the term *employee benefit plan account* has the same meaning as in § ____.760(h)(4).

**§ ____.780 Exemption for banks from liability under section 29 of the Securities Exchange Act of 1934.**

(a) No contract entered into before March 31, 2009, shall be void or considered voidable by reason of section 29(b) of the Act (15 U.S.C. 78cc(b)) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Act (15 U.S.C. 78o(a)), any other applicable provision of the Act, or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created.

(b) No contract shall be void or considered voidable by reason of section 29(b) of the Act (15 U.S.C. 78cc(b)) because any bank that is a party to the contract violated the registration requirements of section 15(a) of the Act (15 U.S.C. 78o(a)) or the rules and regulations thereunder based solely on the bank's status as a broker when the contract was created, if:

(1) At the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with section 3(a)(4)(B) of the Act (15 U.S.C. 78c(a)(4)(B)) and the rules and regulations thereunder; and

(2) At the time the contract was created, any violation of the registration requirements of section 15(a) of the Act by the bank did not result in any significant harm or financial loss or cost to the person seeking to void the contract.

**§ ____.781 Exemption from the definition of ''broker'' for banks for a limited period of time.**

A bank is exempt from the definition of the term ''broker'' under section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)) until the first day of its first fiscal year commencing after September 30, 2008.

By order of the Board of Governors of the Federal Reserve System, September 24, 2007.

**Jennifer J. Johnson,**

*Secretary of the Board.*

Dated: September 24, 2007.

By the Securities and Exchange Commission.

**Nancy M. Morris,**

*Secretary.*

[FR Doc. 07–4769 Filed 9–28–07; 8:45 am]

**BILLING CODE 8011–01–P; 6210–01–P**

---

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

**[Release No. 34–56502; File No. S7–23–06]**

**RIN 3235–AJ77**

## Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** The Securities and Exchange Commission (''Commission'') is adopting rules and rule amendments regarding exemptions from the definitions of ''broker'' and ''dealer'' under the Securities Exchange Act of 1934 (''Exchange Act'') for banks' securities activities. In particular, the Commission is adopting a conditional exemption that will allow banks to effect riskless principal transactions with non-U.S. persons pursuant to Regulation S under the Securities Act of 1933 (''Securities Act''). The Commission also is amending and redesignating an existing exemption from the definition of ''dealer'' for banks' securities lending activities as a conduit lender. In addition, the Commission is conforming a rule that grants a limited exemption from U.S. broker-dealer registration for foreign broker-dealers to the amended definitions of ''broker'' and ''dealer'' under the Exchange Act. Finally, the Commission is withdrawing three rules under the Exchange Act: A rule defining the term ''bank'' for purposes of the Exchange Act's definitions of ''broker'' and ''dealer,'' due to judicial invalidation; a time-limited exemption for banks' securities activities, due to the passage of time; and an exemption from the definitions of ''broker'' and ''dealer'' for savings associations and savings banks, as the exemption no longer necessary in light of subsequent legislation.

**DATES:** *Effective Date:* The final rules are effective on November 2, 2007.

**FOR FURTHER INFORMATION CONTACT:** Catherine McGuire, Chief Counsel, Linda Stamp Sundberg, Senior Special Counsel, Joshua Kans, Senior Special Counsel, John Fahey, Branch Chief, or Elizabeth K. MacDonald, Special Counsel, at (202) 551–5550, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Commission is adopting new Rules 3a5–2 [17 CFR 240.3a5–2] and 3a5–3 [17 CFR 3a5–3], amending Rule 15a–6 [17 CFR 240.15a–6], and withdrawing Rules 3b–9 [17 CFR 240.3b–9], 15a–8 [17 CFR 240.15a–8], 15a–9 [17 CFR 240.15a–9] and 15a–11 [17 CFR 15a–11] under the Exchange Act.

**Table of Contents**

I. Introduction and Background
II. Adopted Rules and Rule Amendments
A. Regulation S Transactions with Non-U.S. Persons
B. Amendment to Exchange Act Rule 15a–6
C. Securities Lending by Bank Dealers
D. Withdrawal of Exchange Act Rule 3b–9, Rule 15a–8, and Rule 15a–9
III. Administrative Law Matters
A. Paperwork Reduction Act Analysis
B. Consideration of Benefits and Costs
C. Consideration of Burden on Competition, and on Promotion of Efficiency, Competition, and Capital Formation
D. Regulatory Flexibility Certification
IV. Statutory Authority
V. Text of Final Rules and Rule Amendments

### I. Introduction and Background

The rules and rule amendments discussed below complement Regulation R, which we are adopting jointly with the Board of Governors of the Federal Reserve System (''Board'').[1] These rules and rule amendments in large part reflect changes that the

[1] Exchange Act Release No. 56501 (Sept. 24, 2007).