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Regulation R Guidance

The Gramm-Leach-Bliley Act (GLBA) lowered many of the barriers that were erected between the banking and securities industries via the Securities and Exchange Act of 1934 (Exchange Act). Although GLBA repealed the blanket exception that prevented banks from having to register as brokers, it provided conditional exceptions for banking activities. In accordance with the Financial Regulatory Relief Act of 2006, the U.S. Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System have adopted a uniform set of rules to implement those exceptions (Regulation R). The rules became mandatory on the first day of a bank's fiscal year that commenced after September 30, 2008. The definition of a bank in Section 3(a)(6) of the Exchange Act includes any institution exercising fiduciary powers under the laws of any state. Therefore, all South Dakota-chartered trust companies as well as banks, exercising fiduciary powers must develop and implement policies and procedures needed to ensure Regulation R compliance. Financial institutions exercising fiduciary powers are required to document a review of the exemption(s) and supporting workpapers within 60 days of the testing period.

In short, Regulation R allows financial institutions to continue performing certain securities related transactions without registering as a broker-dealer with the SEC but limits those activities to certain broker exceptions as defined under Section 3(a)(4)(B) of the Exchange Act. The exceptions most likely to benefit South Dakota financial institutions are:

- Third-Party Networking Arrangements – Section 3(a)(4)(B)(i)
- Trust and Fiduciary Activities – Section 3(a)(4)(B)(ii)
- Deposit "Sweep" Activities – Section 3(a)(4)(B)(v)
- Custody and Safekeeping Activities – Section 3(a)(4)(B)(viii)

In addition, smaller financial institutions having no more than 500 securities transactions as agent for its customers in a calendar year, 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. Important note: block trades and mutual fund trades are counted at the beneficial account level and not as a block. For example, if a mutual fund trade is made for 10,000 units but involved 20 accounts; this would be 20 trades as opposed to one. Also, it is highly unlikely that the "de minimis exception" will apply if the financial institution utilizes a daily cash management sweep to money market mutual funds due to the sheer number of transactions. Other administrative exceptions provided in Regulation R include transactions in Regulation S securities, non-custodial securities lending activities, as well as certain exemptions from the Exchange Act's Section 3(a)(4)(C)(i) trade execution requirements.

Financial institutions are strongly encouraged to consult with legal counsel or others with knowledge and expertise in the field in developing a program for Regulation R compliance that is specific to each institution's respective business plan.

Networking Exception

The networking exception allows a financial institution to enter into a contractual or other written arrangement with a registered broker-dealer under which the broker-dealer offers brokerage services to the institution's customers. Although the exception does not limit the amount of compensation a broker-dealer may pay the financial institution for referrals, it prohibits incentive compensation to unregistered employees and limits the amount they may receive for referrals. Employees may receive only a nominal, one-time cash fee of a fixed-dollar amount for each referral to a broker-dealer. Although unlicensed employees may not provide investment advice or make recommendations to customers regarding securities, they may describe in general terms the types of investment vehicles available from the financial institution and the broker-dealer under the arrangement. The use of the "de minimis exception" is not available with this exception.

Trust and Fiduciary Exception

The trust and fiduciary exception permit a financial institution to effect securities transactions for its trust or fiduciary customers if the institution is chiefly compensated for those transactions by certain types of fees, referred to as "relationship compensation." Relationship compensation includes the following types of fees:

- Administration or annual fees;
- a percentage of assets under management;
- flat or capped per-order processing fees that do not exceed the cost the financial institution incurs in executing such securities transactions; or,
- any combination of such fees.

Relationship compensation includes 12b-1 fees, service fees, and sub-transfer and sub-accounting fees that financial institutions receive from mutual funds or their service providers. Regulation R provides several other examples of the types of fees that qualify as relationship compensation.

Regulation R states that a financial institution may exclude trust and fiduciary accounts that were opened for fewer than three months during the relevant year or that were acquired during the previous 12 months as part of a merger and acquisition transaction. This exclusion applies to both a financial institution-wide approach and an account-by-account approach.

Please note that an advertising restrictions/prohibition applies to this exception. The prohibition on solicitation of brokerage business restricts the extent to which a financial institution can advertise that it effects securities transactions. In its advertisements, a financial institution may only indicate that it effects securities transactions in connection with its trust and fiduciary services. The fact that a financial institution effects securities transactions cannot be made more prominent than the material advertising the institution's provision of trust and fiduciary services.

Chiefly Compensated Defined:

A financial institution that operates on a calendar-year basis was required to start monitoring its compliance on either an account-by-account basis or institution-wide basis beginning January 1, 2009, meeting the applicable compensation restriction after the conclusion of year end 2010 (based on the average of the institution's year-end compensation ratios for 2009 and 2010).

- Account-by-account basis: The relationship-total compensation percentage attributable to each trust and fiduciary account is greater than 50 percent.
- Financial institution-wide: The relationship-total compensation attributable to the financial institution's trust and fiduciary business equates to at least 70 percent of the institution's total compensation attributable to the trust and fiduciary business.

- To allow for short-term fluctuations in compensation, the percentage of relationship-total compensation is to be calculated on a two-year rolling average for the two immediately preceding years (calendar or fiscal). The calculation is to occur within 60 days of the end of the year.

The commonly used financial institution-wide approach is calculated as follows:
- Divide the relationship compensation (RC) attributable to trust and fiduciary business during each of the immediately preceding two years by the total compensation (TC) attributable to trust and fiduciary business during the relevant year.
- Translate the quotient obtained for each of the two years into a percentage.
- Take the average of the percentages obtained for each of the two immediately preceding years; for example:

Relationship Total Compensation % = ((RCy-1/TCy-1) + (RCy-2/TCy-2)) x 100 / 2

To meet the financial institution-wide approach, the relationship total compensation percentage must be greater than or equal to 70 percent. In the example above, y-1 is first year of 2009, and y-2 is 2010. Again, management should document a thorough review of the exemption and supporting documentation within 60 days of the testing period. In this case, management is required to document its review within 60 days of year-end 2010.

Sweep Exception

The sweep exception allows a financial institution to sweep funds from accounts into "no-load" money market funds without registering as a broker-dealer. To qualify as a "no-load" fund, a fund must have no front-end or back-end loads and no more than 25 basis points in asset-based sales charges and service fees. Financial institutions are also permitted to sweep deposits into a "load" money market fund if, among other things, it does not characterize the fund as being "no-load" and provides the fund's prospectus to the customer before the sweep transactions are authorized. Furthermore, a financial institution can invest customer funds into a money market mutual fund if it provides the customer with some other product or service that would not require broker-dealer registration, such as an escrow, trust, or custody account.

The sweep exception is only used if a cash sweep arrangement is the only service provided for the account. If the daily sweep arrangement is ancillary to other services provided to the account, there is no need to consider the sweep exception. For example, if the financial institution acts as the trustee of a revocable trust with a daily cash sweep arrangement, it is exempt under the trust/fiduciary exception so there is no need to consider the sweep exception.

Safekeeping and Custody Exception

The safekeeping and custody exception permit a financial institution to perform specified services deemed as customary in connection with safekeeping and custody of securities without registering as a broker. The safekeeping and custody exception also sets a limitation that a financial institution may not rely on this exception if it functions as a “carrying broker.” Regulation R provides key factors to assist a financial institution in identifying whether it is acting as an impermissible “carrying broker.” Although, under Rule 760 of Regulation R, financial institutions may take orders for securities transactions: (a) from employee benefit plan accounts and individual retirement accounts (IRAs) for which the institution acts as a directed trustee and similar accounts for which the institution acts as a custodian, and (b) from other safekeeping and custody accounts on an accommodation basis.

If a financial institution accepts securities orders under Rule 760 with respect to a custody account, no employee may receive compensation from the institution, the executing broker or dealer, or any other person, that is based on whether a securities transaction is executed for an account, or on the quantity, price, or identity of the securities purchased or sold by the account. These restrictions, however, do not prevent a financial institution employee from receiving payments under a bonus plan that would be permissible under the networking rules.

Furthermore, a financial institution cannot advertise that it accepts orders for securities transactions for employee benefit plan accounts or IRAs, except as part of advertising the institution's overall custodial or safekeeping services, and such accounts may not be advertised as securities brokerage accounts. Under subsection (e) of this exception, a financial institution acting as a non-fiduciary/non-custodial administrator or record keeper for a plan for which another financial institution acts as custodian may accept securities orders from such a plan without being considered a broker, provided both comply with the conditions specified in this exception.

Individual Retirement Accounts and Employee Benefit Plan Accounts:
Regulation R permits a financial institution, under certain conditions, to accept orders for securities transactions from IRAs, employee benefit plans, and similar accounts for which the institution acts as custodian. This includes pension plans, retirement plans, profit sharing plans, bonus plans, thrift savings plans, and incentive plans, among other.

Accommodation Basis:
Conditions apply when a financial institution accepts securities orders for "other accounts" on an accommodation basis. The financial institution will not be able to advertise its securities order-taking services at all in public media. It will be permitted to distribute sales literature to customers and others describing the order-taking services provided to these accounts, so long as the order-taking services are not described independently of the financial institution's other custody services. Moreover, the financial institution will not be able to provide investment advice or research or make recommendations concerning securities to the account or solicit securities transactions from the account. The amounts charged by the financial institution for effecting a securities transaction for the account cannot vary based on whether the institution accepted the order for the transaction, or on the quantity or price of the securities to be bought or sold.

Compliance Program

Even though most, if not all, of South Dakota-chartered financial institutions will fall within one or more of the above described exceptions/exemptions, all financial institutions must develop and implement written policies and procedures to address Regulation R reporting requirements. Written policies and procedures should be specific to each financial institution's operating model. Prior to analyzing activities under Regulation R, a financial institution should first engage in a general analysis of whether certain activities are broker-dealer activities by answering the following questions:

- Does the activity involve a security as defined under Section 3(a)(10) of the Exchange Act, which is not an exempted security as defined under Section 3(a)(12)?
- Is the activity considered to be a broker-dealer activity as defined under Sections 3(a)(4) and 3(a)(5) of the Exchange Act and applicable to SEC review?

- Does the activity fall within one of several exceptions provided under Section 3(a)(4)(B) or 3(a)(5)(C) of the Exchange Act, or under Regulation R?

Once the analysis is completed, management should maintain a compliance program that considers and/or implements the following actions:

- Thoroughly review Regulation R, Exchange Act “broker-dealer” exceptions, and GLBA.
- Identify and document applicable exceptions.
- Analyze and understand the trust accounting software and discuss options with the system provider.
- Determine that account and fee codes are reliable or in need of adjustments.
- Separate fees assessed into appropriate buckets.
- Compile fees assessed to support the “chiefly compensated” calculations under the trust and fiduciary activities exception.
- Develop a recordkeeping mechanism or spreadsheet.
- Develop processes to ensure that the advertising restrictions are being followed.
- Develop written policies and procedures including record retention policies and procedures to ensure retention of records to document the calculation of the “chiefly compensated” test, compliance with advertisement restrictions, and with safekeeping and custody provisions.
- Create an employee training program.
- Adjust risk management, audit, and compliance systems to include Regulation R compliance measures established.
- Inform board and/or committee(s) of progress in complying with Regulation R.