Financial Services Regulatory Highlights

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SEC and FRB Issue Final Rule on Regulation R

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Background

In late September, the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System (FRB) announced the adoption of a final joint rule to implement the bank brokerage exceptions contained in the Gramm-Leach-Bliley Act. These exceptions to the definition of a "broker" contained in the Securities Exchange Act of 1934 ("Exchange Act") outline the activities that a bank may conduct, without meeting the definition of a "broker." Banks and savings institutions (hereinafter "banks") may continue to engage in the enumerated permissible activities without registering with the SEC as a broker/dealer or pushing those activities out of the bank to a registered broker/dealer.

The final rules contain slight modifications to the initial proposed rules issued in December 2006. The final rules become effective for banks on the first day of their fiscal year that commences after September 30, 2008. This delayed effectiveness will afford banks with a transitional period to assure compliance with the new provisions once effective.

Networking Arrangements

In general, this exception preserves the approach to networking arrangements and referral payments to bank employees outlined in the Interagency Statement on Retail Sales of Nondeposit Investment Products ("NDIP Statement" or "NDIP") issued by the federal banking agencies in 1994. The NDIP Statement permitted banks to enter into networking arrangements with third party broker/dealers to provide brokerage services on the bank's premises subject to certain conditions. Under the NDIP, banks could compensate unlicensed bank employees for NDIP customer referrals as long as the referral program did not improperly encourage referral activity. Permissible referral payments had to satisfy the following conditions: 1) a one-time, nominal fee; 2) a fixed dollar amount for each referral;

and 3) a referral payment occurred regardless whether a sale or new account results.

Regulation R preserves this general approach. Banks may continue to enter contractual arrangements with third party broker/dealers to provide brokerage services to bank customers and bank employees may continue to receive "a nominal one-time cash fee of fixed dollar amount" for referring bank customers to the broker-dealer. The payment of the referral fee may not be "not contingent on whether the referral results in a transaction." The rule also specifies that bank employees may not receive incentive compensation for brokerage transactions.

The final rule defines a series of terms such as "nominal one-time cash fee for a fixed dollar amount," "contingent on whether the referral results in a transaction," and "incentive compensation." It appears that the SEC and FRB expended considerable effort to preserve consistency with previously issued guidance while providing banks with a flexible approach to evaluating the permissibility of referral fees to bank employees.

Regulation R defines the "nominal" component of a "nominal one-time cash fee for a fixed dollar amount" as a payment that does not exceed:

- Twice the average of the minimum and maximum hourly wage 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;
- Twice the employee's actual base hourly wage or 1/1000th of the employee's actual annual base salary; or
- Twenty-five dollars, as adjusted for inflation every five years.

Banks may satisfy the "one-time cash fee" requirement by using a "points" system to monitor the number of qualifying referrals made by the employee during a quarterly, or more frequent period, and the referral fees that employee should receive at the end of that period. In all cases, the points must translate into cash payments and the cash that a bank employee will receive under the referral program must be fixed before the referral.

Regulation R also preserves the NDIP's statement guidance concerning contingent referral fees. Payment of the fee cannot be contingent on whether the referral results in a securities transaction, multiple transactions, or an account opening with the broker/dealer. However, payment of the fee may be contingent on whether the customer keeps an appointment with the broker/dealer or whether the customer meet certain base-line financial criteria for referred customers.

Bank employees may not receive "incentive compensation" for the referral or any securities transactions conducted by the referred customer. "Incentive compensation" encourages a bank employee to refer customers to a broker/dealer or gives the bank employee an interest in the success of securities transaction. The term does not include discretionary, multiple factor bonus plans that meet certain conditions. Regulation R also contains a safe harbor provision for bonus plans based on overall profitability or total revenue that satisfy certain requirements.

Finally, Regulation R contains an exception for referrals of "institutional customers" or "high net worth customers." These exceptions permit the payment of a higher than "nominal" referral that may be a contingent payment. An "institutional customer" is any corporation, partnership, limited liability company, trust, or other non-natural person that has 1) $10 million in investments, 2) $20 million in revenues, or 3) $15 million in revenues if the bank employee refers the customer for investment banking services. "High net worth" customers are natural persons, who either individually or with his or her spouse, have at least $5 million in net worth. The net worth computation excludes the person's primary residence and associated liabilities. The definition includes inter vivos or living trusts of which the settlor is a natural person that satisfies the net worth requirements.

Under this exception, the bank must have a reasonable basis to believe that the customer qualifies as institutional or high net worth customer. In addition, the bank must provide the institutional and high net worth customers with written or oral disclosures at the time of, or prior to, the referral. These disclosures notify

the prospective customer that the bank employee may receive a referral fee of more than a nominal amount and payment of the fee may be contingent on whether the referral results in a securities transaction.

As an additional customer protection measure when the referral fee is contingent, the broker/dealer must perform a suitability analysis on the prospective transaction as if a recommendation to purchase/sell that security had been made. If the fee is more than nominal, but not contingent, the broke/dealer may satisfy certain qualification requirements or conduct a suitability analysis.

Trust and Fiduciary Activities

This exception allows a bank to continue to conduct securities transactions in a trustee or fiduciary capacity without registering as a broker/dealer. These transactions may be conducted in the bank's trust department or other department regularly examined by bank examiners for compliance with fiduciary principles and standard. The bank must be "chiefly compensated" for these transactions consistent with fiduciary principles and standards on the basis of "relationship compensation."

Relationship compensation includes:

- an administration or annual fee;
- a percentage of assets under management including 12b-1 fees;
- a flat or capped order processing fee that does not exceed the cost the bank incurs in executing those securities transactions; or
- any combination of such fees.

Regulation R defines what constitutes "chiefly compensated." A bank may satisfy this requirement on an account-by-account basis or bank-wide basis. Both tests involve a two year rolling average comparison.

The account-by-account test requires the relationship compensation to be greater than 50 percent of total compensation for each trust or fiduciary account. The bank may also satisfy this test if the average relationship compensation received from all trust and fiduciary accounts is greater than 70 percent of total compensation from those accounts.

Banks must direct the trades associated with the trust and fiduciary exception to a registered broker-dealer for execution. Banks may not publicly solicit brokerage business, except for advertising that they complete securities transactions in conjunction with its trust activities.

Sweep Accounts and Transactions in Money Market Funds

Under the "sweep exception" contained in the Exchange Act banks may invest or re-invest customer deposits into a no-load fund that holds itself out as a money market fund. Regulation R clarifies the definition of "no-load" and "money market fund" for purposes of the "sweep exception." A fund satisfies the definition of "no-load" if it is not subject to a sales charge or deferred sales charge and the annual charges do not exceed 25 basis points. The rule outlines the charges included in this calculation. Regulation R defines a money market fund as an open-end investment company registered under the Investment Company Act of 1940.

Safekeeping and Custody Activities

The "custody and safekeeping exception" of the Exchange Act allows banks to provide customers with specified custodial and safekeeping services without being subject to the broker/dealer registration requirements. Regulation R permits banks to continue to provide safekeeping and custodial services to employee benefit plan accounts, individual retirement accounts (IRAs), or similar accounts subject to certain conditions. In addition to employee compensation restrictions and other restrictions, banks relying on this exemption must not advertise that it accepts orders for securities transactions for employee benefit accounts, IRAs, or similar accounts, except as part of advertising for other custodial and safekeeping services.

The exemption allows banks to continue accept securities orders on an accommodation basis for customers that do not hold employee benefit accounts, IRAs, or similar accounts. The activities are subject to employee compensation

restrictions, fee limits, advertising and sales literature restrictions, investment advice and recommendation restrictions and other conditions.

Other Exemptions

Regulation R contains a series of additional exemptions permitting banks to engage in the following activities subject to certain conditions without registering as broker-dealer or pushing those activities out of the bank to a registered broker-dealer. Those exemptions apply to the following:

- Regulation S transactions with non-U.S. persons and registered broker/dealers;
- Non-custodial securities lending transactions;
- Transactions involving mutual funds, variable annuity contracts, and variable life insurance products; and
- Certain transactions involving a company's securities for its employee benefit plans and participants.

Temporary and Permanent Exemption for Contracts Entered Into by Banks from Being Considered Void or Voidable

Regulation R provides the banks with an exemption from liability under Section 29 of the Exchange Act. Under this exemption, contracts entered into before March 31, 2009 will not be considered void or voidable because the bank did not register with the SEC as broker/dealer. Certain qualification requirements must be met for the exemption to be applicable.

FINRA Requests Comment on Proposed Amendments to OTC Trade Reporting Requirements for Equity Securities

On September 28, 2007, in Regulatory Notice 07-46, FINRA stated that the current trade reporting rules are confusing. This causes a delay in reporting the transactions and, sometimes, duplication of trade reports. FINRA is seeking to create a simpler, uniform trade reporting rule structure to improve the timeliness and accuracy of this data. Specifically, FINRA is seeking comments on two proposals, the first being Trade Reporting Structure and the second related to Linking, Both proposals would amend the equity over-the-counter (OTC) trade reporting requirements.

Trade Reporting Structure Proposal

This proposal will simplify and update the current market maker-based trade reporting structure and is seeking comment on alternative structures. One approach FINRA is considering is a sell-side reporting structure -- where the sell-side to a transaction between member firms would always have the trade-reporting obligation. A second approach FINRA is considering is an executing broker reporting structure, where the broker executing the trade between member firms would always have the trade-reporting obligation.

Linking Proposal

This proposal will require firms to provide information to link related reports when both a tape and non-tape report are submitted to FINRA for the same overall transaction. A possible approach would require firms to link tape and non-tape reports that are submitted to FINRA for the same overall transaction.

Comments must be received on or before November 12, 2007.

FINRA Proposes Amendments to the Functionality of the NASD/NYSE Trade Reporting Facility

On September 21, 2007, the SEC published for comment FINRA's proposed rule change on the functionality of the NASD/NYSE trade reporting facility.

The changes will permit participants to submit trades to the NASD/NYSE TRF for submission to the National Securities Clearing Corporation (NSCC) for clearance and settlement.

The proposed changes will:

- Amend Rules 6130E(a) and 6140E to reflect a change in the functionality of the NASD/NYSE TRF to permit Participants to submit trades to the NASD/NYSE TRF for submission to the NSCC for clearance and settlement.
- Amend Rules 4632E(e)(3)(B) and 6130E(f) to include references to "clearing" and "clearing-only" reports; and Rule 6160E to refer to trades that have been treated as locked-in "and sent to DTCC."
- Provide members with another mechanism for clearing trades that they report to FINRA and will ensure consistency in the trade reporting rules relating to the TRFs, to the extent practicable.

FINRA has filed the proposed rule change for immediate effectiveness and requested a waiver of the 30-day operative delay. FINRA proposed that the rule change be operative on September 19, 2007.

SEC Approves FINRA Proposed Rule Change to the Reporting of Foreign Equity Securities to the Order Audit Trail System

On September 28, 2007, the SEC approved FINRA's proposed rule change relating to the reporting of order information for foreign equity securities to the Order Audit Trail System (OATS).

Beginning on February 4, 2008, members will be required to record and report order information regarding all OTC equity securities.

The amendments will:

- Exclude certain orders and transactions in foreign equity securities from the OATS recording and reporting requirements -- members will only have to record and report order information regarding foreign equity securities only in instances where any resulting execution is subject to the transaction reporting requirements in Rule 6620. Members will not be required to record and submit information to FINRA for orders in a foreign equity security that do not result in a trade report to FINRA.
- Permit firms to use Form T to report required OATS information instead for reporting through the firm's normal OATS reporting channels in instances where a firm has a reporting obligation in a foreign equity security, but does not have a U.S. symbol assigned to it at the time of the trade.

The rule will become effective on February 4, 2008.

SEC Published for Comment Interpretive Rule Under the Advisers Act Affecting Broker-Dealers

On September 24, 2007, the SEC published for comment an interpretive rule that would address the application of the Investment Advisers Act of 1940 to certain activities of broker-dealers.

The proposal would reinstate three interpretive provisions of a rule which was vacated by a recent court opinion:

- The first provision would clarify that a broker-dealer that exercises investment discretion with respect to an account or charges a separate fee, or separately contracts, for advisory services provides investment advice that is not "solely incidental to" its business as a broker-dealer.
- The second provision would clarify that a broker-dealer does not receive special compensation within the meaning of section 202(a)(11)(C) of the Advisers Act solely because it charges a commission for discount brokerage services that is less than it charges for full-service brokerage.
- The third provision would clarify that a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subjects it to the Advisers Act.

Comments should be received on or before November 2, 2007.

FinCEN Issues Notice to Registered MSBs

On October 10, 2007 the Financial Crimes Enforcement Network (FinCEN) issued a notice to registered money services businesses (MSBs) concerning the registration renewal deadline.

FinCEN reminded MSBs of the obligation to renew registration by December 31 every two years after the initial registration period.

If registration was last renewed in 2005, then in order to continue to operate as an MSB, registration must be renewed by December 31, 2007.

If initial registration was on any day in 2006, then registration must be renewed by December 31, 2007 -- to renew at the end of the initial registration period.

FinCen posted an MSB Registration Renewal Calculator on www.msb.gov to aide in determining renewal requirements.

FinCEN Issues Suggestions for Addressing Common Errors Noted in SARs

On October 10, 2007, FinCEN issued some suggestions for addressing common errors noted in the filing of suspicious activity reports (SAR).

FinCEN identified three areas where financial institutions should concentrate their efforts to ensure that information contained in a SAR is complete.

SAR Narratives

SAR narratives should describe why the activity or transaction is unusual for the customer, taking into consideration the types of products and services offered by your industry and the nature and typical activities of similar customers and explain why the transaction is suspicious.

Reponses in Fields of Critical Value
In SAR forms, examiners use fields of critical value (marked by an asterisk) to track activity and follow-up leads provided in SARs. FinCEN also uses the information to develop analytical products that are distributed to law enforcement, regulators and other intelligence agencies -- therefore the quality of the information is extremely important.

Identifying the Category and Character of Suspicious Activity
It is important to indicate the possible characterizations of the suspicious activity and their descriptions.

SARs are an important tool in combating financial crimes. When completed correctly, the forms provide its users with important information that can be used to analyze broad sets of data and to apprehend suspected criminals and terrorists. This also helps financial institutions maintain a picture of the identified, suspicious transactions flowing through them, which may be of use for AML program risk mitigation purposes.

In addition to the specific guidance listed above, FinCEN provides the following general suggestions to help reduce incomplete and/or incorrect SARs:

- Sign up for BSA E-filing;
- Provide staff and preparers with training on recognizing suspicious activity and avoiding SAR filing errors;
- Provide preparers with examples of accurate and complete SAR filings with "John Doe" data in the fields;
- Ensure that preparers know the company EIN, address, telephone number, contact office, etc. for the Reporting Business and Contract for Assistance fields;
- Provide preparers with the instructions for completing the form currently in use;
- Provide preparers with the FinCEN Regulatory Helpline number; and
- Implement a second review to ensure accuracy and completeness.

Agencies Propose Joint Rule on Unlawful Internet Gambling Enforcement Act

On October 1, 2007, the agencies announced the release of a joint proposed rule to implement the Unlawful Internet Gambling Enforcement Act. The Act prohibits gambling businesses from accepting payments in connection with unlawful Internet gambling, including payments made through credit cards, electronic funds transfers, and checks.

The proposed rule would:

- Require U.S. financial firms that participate in designated payment systems to have policies and procedures that are reasonably designed to prevent payments being made to gambling businesses in connection with unlawful Internet gambling; and
- Provide examples of policies and procedures.

The proposed rule defines unlawful Internet gambling as the making of a bet or wager that involves use of the Internet and that is unlawful under any applicable federal or state law in the jurisdiction where the bet or wager is made.

Comments should be received on or before December 12, 2007.

Comptroller Dugan Urges Federal Reserve to Allow Consumers to Opt Out of Higher Credit Card Rates

On September 27, 2007, the Comptroller of the Currency urged the Federal Reserve Board (FRB) to allow consumers the opportunity to "opt out" of certain credit card rate increases in a speech to the Financial Services Roundtable.

The FRB is considering a change to its Truth in Lending rules -- the change would allow the consumer to avoid the credit card rate increase by paying off the card balance or moving it to another card. Mr. Dugan does not believe that this would provide a meaningful choice for some consumers. Some consumers may have balances that are too large to pay off or they may not have another card to roll the balance.

The Comptroller states, "The practical reality is that the consumer would get stuck paying the higher rate on the full amount of his or her outstanding balance, because there would be no realistic alternative."

"But the opt-out would allow the consumer to keep the balance outstanding on the card at the old rate, with a requirement to pay off that balance or roll it over to another card within a reasonable period," stated Mr. Dugan.

Mr. Dugan noted in his speech that the primary focus of regulation has been on providing consumers with meaningful notice of the costs and terms of the card, while leaving lenders free to set costs and terms.

"The underlying theory of this approach to regulation is a familiar one: if consumers are provided adequate information about products, they will choose the ones they want and like best, and banks will compete to innovate to structure these products, without government interference, to best meet that demand," the Comptroller said.

Mr. Dugan concluded, "My take on all this is that there is plainly a state of disequilibrium when it comes to consumer protection for credit cards, and the system needs fixing."

Comptroller Dugan Urges Improved Underwriting Standards on Third Party Loans

On October 8, 2007, the Comptroller of the Currency urged banks to strengthen their underwriting standards for loans sold to third party investors.

"I am here to say that banks need to strengthen their underwriting standards so that they move back towards the fundamental principle of maintaining a reasonable expectation that loans will be repaid, even if the loans are to be sold to third parties -- and that goes for mortgage loans, leveraged loans, or any other syndicated credit," Mr. Dugan stated.

The OCC has taken several steps to address these issues. Mr. Dugan said that where subprime and nontraditional mortgage loans are originated for sale to the secondary market, "our examiners expect banks to use their guidance as their benchmark in not ceding underwriting standards to the third party purchasers of loans -- they can deviate, but only so long as the risk differences are manageable."

"We have asked our large bank examiners to encourage agent banks to underwrite funding commitments in a manner that is reasonably consistent with the standards they would use if holding the loan on their own books," Mr. Dugan said. "We have asked our examiners to review with banks the expectations we have set forth in existing supervisory guidance. We want

examiners to communicate areas of noncompliance to bank management and, if appropriate, to cite them as Matters Requiring Attention in exam reports to achieve improvement in underwriting standards and risk management practices."

FINRA Announces the Advertising Regulation Electronic Files

On September 27, 2007, FINRA announced Advertising Regulation Electronic Files (AREF), a web-based application that enables FINRA member firms to file communications with the public law for review by FINRA's Advertising Regulation Department.

Effective on October 29, 2007, firms are required to provide further regulatory data about each AREF submission. The new data will help the Advertising Regulation Department to prioritize submissions. The AREF will also be enhanced to enable firms to provide additional information, such as rankings back up data, to cover letters when they initially upload communications for review.

Additional Information

If you would like additional information about the topics discussed in this newsletter, or about PwC's Financial Services Regulatory Advisory Services, please call:

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