

# UPDATE

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## News of Developments in the Financial Sector and Related Areas

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#### *Check 21 Act*

The *Check Clearing for the 21st Century Act* (the "Check 21 Act") will become effective on October 28, 2004. The Check 21 Act facilitates check truncation by creating a new negotiable instrument called a *substitute check*, which will permit banks to truncate original checks, to process check information electronically and to deliver substitute checks to banks that want to continue receiving paper checks. A substitute check will be the legal equivalent of the original check and will include all the information contained on the original check. Once the Check 21 Act becomes effective, all banks must be prepared to handle substitute checks. The Check 21 Act requires banks to provide their customers with a notice that describes substitutes checks and the rights of customers when they receive substitute checks. This notice must be sent to customers who receive original or substitute checks once the Check 21 Act becomes effective. Model notices to customers are contained in Regulation CC promulgated by the Federal Reserve Board. Although the Check 21 Act does not require banks to accept checks in electronic form and does not require banks to use the new authority granted by the law to create substitute checks, banks will have to be prepared to handle substitute checks at a minimum. Prior to the Check 21 Act

becoming effective, clearing paper checks was basically an inexpensive process on a per-check basis. However, with the passage of the new law, the clearing of paper checks will become more costly as the volume of the clearing of paper declines, resulting in more banks converting to electronic methods through agreements with third party providers in order to control their costs. It will be interesting to see the responses once bank customers begin receiving image statements with miniature reproductions of their written checks.

#### *Securities Activities of Banks*

The Securities and Exchange Commission ("SEC") has proposed Regulation B to implement provisions of the Gramm-Leach-Bliley Act ("GLB Act") that delineate the securities activities banks may engage in without registering as brokers. The GLB Act replaced the exception of banks from the definitions of *broker* and *dealer* with eleven functional exceptions. Regulation B will define some of the statutory terms used in the eleven exceptions. Probably one of the most important exceptions for banks is the statutory third-party brokerage (networking) exception which allows banks to partner with broker-dealers in offering their customers a wide range of financial services, including securities brokerage. Under this exception, a broker-dealer offers brokerage services to bank customers and shares the compensation with the bank. The exception also allows unregistered bank employees to receive incentive compensation in the form of a "nominal one-time cash fee of a fixed dollar amount" for referring bank customers to the broker-dealer. Regulation B defines nominal compensation to be a fee not exceeding (i) a flat \$25; (ii) the employee's base hourly rate of pay; or (iii) \$15 adjusted for inflation from 1999. Another exemption would apply to

trust and fiduciary activities of banks and permits a bank to assess its compliance on an aggregate, rather than on an account-by-account, basis using a proportion of 9 to 1 as the ratio for relationship to sales compensation when calculating how much compensation is received from "relationship activities" such as annual fees versus referral fees. If 90% of compensation comes from relationship activities, registration would not be required. Regulation B would also provide certain exceptions for banks acting as a custodian permitting them to engage in securities transactions while holding funds and securities relating to those transactions. Under the small bank custody exemption, registration would not be required in those situations where annual revenue was \$100,000 or less from securities transactions, the bank has less than \$500 million in assets, the bank is not part of a bank holding company with more than \$1 billion in consolidated assets and other specified criteria. It is expected that once Regulation B becomes effective, banks will be given a period of time to comply. Information on Regulation B is available on the web site of the SEC at [www.sec.gov](http://www.sec.gov).

### ***Cases, Releases and Rulings***

The Securities and Exchange Commission has released a report entitled *Report on Transactions in Municipal Securities* which provides information on spreads, trading volume and the variation in prices received or paid by customers purchasing the same municipal security on the same day. The report estimates the size of the spreads paid by customers on fixed coupon bonds, *i.e.*, the difference between the average price that customers paid for a municipal security and the average price they received when selling it, for various trade sizes and securities with different characteristics. Depending on the size of the trade and the characteristics of the security, the report found that the cost to the customer of purchasing and reselling a fixed coupon municipal security during the sample

period covered by the report was a bit less than 2% of the principal amount of the security. The report is available on the website of the SEC at [www.sec.gov](http://www.sec.gov).

*Traffic Control Service, Inc. v. United Rentals Northwest, Inc.*, No. 40798, is an interesting recent decision by the Nevada Supreme Court which held that a noncompetition agreement signed by an employee was not assignable by the employer. In this case, the employee signed a noncompetition agreement in exchange for \$10,000 and, as a condition of employment, agreed that if he was terminated he was barred from dealing in the business activity of his employer within 60 miles of the employer's location for one year. Two years after signing the agreement, the company that was the employer was sold to another company. The Court held that since the noncompete clause did not contain any assignment provision in it, that the covenant was not assignable without separate consideration and consent of the employee.

The Securities and Exchange Commission and the National Association of Securities Dealers, Inc. have released a joint staff report entitled *Joint SEC/NASD Staff Report on Examination Findings Regarding Broker-Dealer Sales of Variable Annuity Insurance Products* in connection with their examinations of broker-dealer sales of variable annuities and variable life insurance. The report identifies both "sound" and "weak" broker-dealer practices in the areas of sales suitability, disclosure, supervision, training and records maintenance. In connection with the report, the SEC issued an alert to remind investors that variable annuities are not suitable for all consumers, especially investors who need the money in the short term or who borrow against their home mortgage in order to purchase a variable annuity or variable life insurance product. Both the report and the alert is available on the website of the SEC at [www.sec.gov](http://www.sec.gov).