NASAA

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April 13, 2007

Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090

Via e- mail to: rule-comments@sec.gov

Re: File No. S7-22-06, Proposed Regulation R

Dear Secretary Morris:

The North American Securities Administrators Association ("NASAA")1 respectfully submits the following comments regarding proposed Regulation R promulgated under the Gramm-Leach-Bliley Act ("GLBA") and jointly proposed by the Federal Reserve Board ("Board") and the Securities and Exchange Commission (the "Commission"). Regulation R is the third in a series of attempts to define exceptions for banks, savings associations, and savings banks with regard to the term "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934 ("Exchange Act") as amended by the GLBA. It is the direct result of the Financial Services Regulatory Relief Act of 2006, which in part, directed the Commission and the Board to jointly adopt a single set of rules to implement these exceptions.

In our letter dated September 8, 2004, commenting on proposed Regulation B, the immediate predecessor to Regulation R, NASAA made certain observations concerning the legislative history of the GLBA, to wit:

> Throughout the legislative development of the GLBA, including congressional testimony and other participation in the legislative process, NASAA advocated for the concept of "functional regulation," whereby regulation would be carried out pursuant to function rather than structure. Ultimately, functional regulation became the foundation upon which the GLBA was built.2 In particular, Congress sought to establish functional regulation of bank securities activities.3 Congress noted that "the limitations on bank securities activities have eroded as a result of administrative actions by Federal banking regulators. The rationale for the exemptions in the Federal securities laws that apply to banks is, thus no longer

1 The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA's members are securities agencies responsible for grass-roots investor protection and efficient capital formation.

2 See Joint Explanatory Statement of the Committee of Conference, contained in H. Rept. 106-434, at p. 151.

3 *Id* at 163. *See also* H. Rept. 106-74, part 3, at p. 162.

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> sound, given the extensive and increasing securities activities in which banks are engaging." (H. Rept. 106-74, Part 3, Financial Services Act of 1999 [to accompy H.R. 10], June 15, 1999, pp. 113-14). Consequently, the GLBA replaced the blanket exemption from securities regulation with a set of narrow exceptions for banks engaged in broker activities.
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> In formulating the system of functional regulation, Congress realized that banks may have to change the ways in which they carry out securities activities and "push out" certain activities to licensed broker-dealers.[4] Thus, the litmus test for Regulation B should not be whether the regulation causes banks to change the way they do business, but whether the regulation carries out Congressionally mandated functional regulation.

NASAA generally supported Regulation B and believed that it promoted functional regulation consistent with the Congressional intent expressed in the GLBA. While the same may be said for parts of Regulation R, NASAA believes that it is less consistent with the Congressional intent expressed in the GBLA than was Regulation B in several instances, and may erode investor protection by relegating regulation of core securities activities to agencies other than the Commission.

It is noted that several other commentators, including certain members of the U.S. Congress, indicated that it was their belief that Regulation B was "fundamentally inconsistent with Congressional intent"[5] and that the Commission had failed to take into consideration the negative impact that Regulation B would have had on "the ability of banks and savings associations to continue to provide traditional banking services"[6]It is NASAA's position that merely because banks may have previously been allowed to conduct certain securities activities without registration; that fact alone does not make such activities "traditional banking services."

The activities exempted under Regulation R constitute core securities functions, and allowing banks to conduct those activities will undermine the integrity of the investor protections that have been so arduously developed over the past several decades. We believe that Regulation R represents a significant shift in favor of the banking industry from previous proposals at the potential expense of investor protection. Accordingly, NASAA offers the following comments regarding Regulation R.

Networking Exception

The networking exception in GLBA expresses the Congressional intent to ban all forms of incentive compensation except for the very limited instance of a referral – and then, such

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4 For example, Senate Report 106-44 expressly addresses the "push out" issue in its "Cost Estimate" section. At page 49, the Report states: "A substantial number of banks that currently handle securities activities have a broker-dealer affiliate so that the incremental cost of complying with SEC regulation would involve moving non-exempt activities to such an affiliate *and would not be significant.*" (Emphasis added.)

5 Letter dated March 4, 2005 from Jim Bunning, Michael Enzi, Tim Johnson, Debbie Stabenow, Thomas Carper, Michael Crapo, Robert Bennett, Wayne Allard, Rick Santorum, Chuck Hagel, Elizabeth Dole, Charles Schumer, John Sununu, and Mell Martinez, Members of Congress.

6 Letter dated October 14, 2004 from Michael G. Oxley, et al., House Committee on Financial Services, U.S. House of Representatives.

compensation is limited to "a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction."[7]

A. Separation of the Bank/BD Function

The entirety of the so-called networking exception is based on a concept of *separation* between the banking functions and broker-dealer investment functions in order to promote investor protection.[8] Not only must there be physical separation between bank and investment employees, there are also advertising restrictions and even affirmative disclosure obligations. As cited above, Congress also included a provision banning all incentive compensation, except under very limited circumstances for making referrals.

Recent regulatory action has shown that both broker-dealers and banks have failed to monitor the activities of on-premises broker-dealers in a way that eviscerates the congressionally mandated separation discussed above.[9] In these regulatory actions, there was an impermissible blurring of the bank and broker-dealer functions. In one such case, a broker-dealer consented to sanctions in response to a complaint by the Massachusetts Securities Division that alleged the bank broker-dealer operated "in a manner that obscured the broker dealer-bank distinction, thereby misleading investors as to the risks associated with investing in non-Bank products."[10] This misconduct was harmful to retail investors, as indicated by the NASD's subsequent action against the broker-dealer affiliate of Citizens Bank, in which it announced: "This bank-affiliated firm missed the mark with regard to several important requirements, including some that impacted retirees – an especially vulnerable group for whom NASD rules, the federal securities laws, and the telemarketing laws provide valuable protections."[11]

Similarly, an agreement between the Massachusetts Securities Division and another bank-channel broker-dealer also pointed to the blurring of two businesses and included a remedial measure that the broker-dealer would, "[m]onitor and provide ongoing training as to the sales of variable annuities on the premises of depository institutions, including the additional written and oral disclosures required to be made to those customers investing funds previously held in a depository institution."[12] Likewise, the Commission has found that both a bank and its affiliated broker-dealer, "engaged in activities that blurred the distinction between the bank and the brokerage firm and their respective products.[13]

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7 15 U.S.C. § 78c(a)(4)(B)(i)(VI).

8 *See* 15 U.S.C. § 78c(a)(4); *cf.* NASD Rule 2350.

9*See CCO Investment Services Corp.*, NASD News Release, *NASD Fines Citizens Bank Affiliate, CCO Investment Services Corp., $850,000 For Supervisory, Recordkeeping, Telemarketing, Other Violations – Firm Failed to Implement Procedures Relating to Variable Annuity Sales to Elderly*, (Oct. 16, 2006) (available at <http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_017657>); *Citizens Inv. Servs. Corp.*, Consent Order, Docket Nos. E-2004-0050, E-2005-0004, E-2005-0140 (Mass. Sec. Div. 2005) (respondent sanctioned in part for variable annuity sales practice abuses and failures to supervise conduct on bank premises); *Banc of Am. Inv. Servs, Inc.*, Memo of Understanding, Docket No. E-2005-0060 (Mass. Sec. Div. 2005) (where broker-dealer offered rescission to variable annuity customers based in part on investigation into investment practices on bank premises); *In the matter of Nationssecurities & Nationsbank*, Admin. Proc. File No. 3-9596, Rel. No. 7532, 1998 SEC LEXIS 833 (May 4, 1998).

10 *Citizens Inv. Servs. Corp.*, Consent Order, Docket Nos. E-2004-0050, E-2005-0004, E-2005-0140 (Mass. Sec. Div. 2005).

11*CCO Investment Services Corp.*, NASD News Release, *NASD Fines Citizens Bank Affiliate, CCO Investment Services Corp., $850,000 For Supervisory, Recordkeeping, Telemarketing, Other Violations – Firm Failed to Implement Procedures Relating to Variable Annuity Sales to Elderly*, (Oct. 16, 2006).

12 *Banc of Am. Inv. Servs, Inc.*, Memo of Understanding, Docket No. E-2005-0060 (Mass. Sec. Div. 2005).

13 *In the matter of Nationssecurities & Nationsbank*, Admin. Proc. File No. 3-9596, Rel. No. 7532, 1998 SEC LEXIS 833 (May 4, 1998).

Each of these regulatory actions creates an administrative record demonstrating the serious consequences that can result from the breakdown of the separation that GLBA requires. Regulation R's provisions concerning networking arrangements between banks and broker-dealers should, therefore, be read in light of GLBA's focus on separation and overarching theme of functional regulation, all of which were designed by Congress to promote investor protection.

B. Proposed Definition of "Incentive Compensation"

Regulation R would allow certain types of bonuses to be paid to bank employees based, in part, on the overall profitability of the broker-dealer affiliate by defining "incentive compensation" so as to exclude those bonuses. However, bonuses are incentive-based by their very nature. We recommend that Regulation R remain faithful to the letter and spirit of GLBA by banning all incentive compensation except for the nominal, one-time cash payments expressly provided for in the statute. Significantly, even the Commission has acknowledged that bonuses are inherently incentive by nature.[14]

It is inconsistent with investor protection to allows banks to tie employee bonuses to broker-dealer profitability because they may be economically significant in relation to an employee's overall compensation package and may encourage the employee to make referrals regardless of suitability considerations. Such bonuses create the precise conflict of interest GLBA was designed to prevent. The administrative record cited above indicates that bank-affiliated broker-dealers have impermissibly blurred the distinction to the detriment of retail investors. Moreover, the Massachusetts Securities Division complaint against Citizens Investment Services, Inc. alleged that both referral compensation and periodic bonuses are inherently incentive compensation. Bonuses, like all incentive compensation, have the real potential of creating a bank culture where investor protection takes a back seat to sales efforts and meeting quota-like benchmarks to increase one's take-home pay.

C. Exemption for Payment of More than a Nominal Fee for Referring Institutional Customers and High Net Worth Customers

Regulation R contains a new exemption that did not appear in either the Interim Rules or Regulation B. Essentially, this new exemption allows a bank to pay an employee a fee for referring an institutional or high net worth customer to a broker-dealer. The fee, however, is greater than a "nominal" amount and can be contingent on whether the referral results in a transaction at the broker-dealer. The release proposing Regulation R explains the intent of this exemption by stating that:

> The purpose of the proposed exemption and its conditions is to recognize that sizable institutions and high net worth individuals, when provided appropriate information, are more likely to be able to understand and evaluate the relationship between the bank and its employees and its broker-dealer partner and any resulting securities transaction with the broker-dealer.

14 Bank Broker-Dealer Final Rules, Rel. 34-44291, 66 Fed. Reg. 27760 (May 18, 2001) ("While bonuses sometimes fall within the category of a one-time payment, by their very nature they are incentive compensation").

This justification appears to contradict GLBA's theme of functional regulation and essentially gives unregistered bank employees a salesman's stake in the broker-dealer's securities transaction. Indeed, Regulation R would allow a payment to be made "based on a fixed percentage of the total dollar amount of assets placed in an account with the broker-dealer." Clearly this could potentially result in significant income to the unregistered bank employee.

Regardless of whether high net worth individuals and institutions are better able to assess the relationship with the bank and the broker-dealer, Congress expressly limited incentive compensation to a referral fee that is a "nominal," "one-time cash fee," "of a fixed dollar amount," that is "not contingent on whether the referral results in a transaction."[15] As such, we believe this exemption should be removed in light of the separation demanded by the networking exception. Otherwise, Regulation R – as currently proposed – has the potential of creating enormous incentives for unregistered bank employees to refer customers to the broker-dealer.[16] The significance of the compensation involved may also result in such employees impermissibly engaging in salesman's tactics or investment advice since their paycheck could depend on the size of the ultimate investment.[17] We are urged not to worry about this based on the theory that the wealthy invariably possess the sophistication not to be unduly influenced by bank employees unqualified to give investment advice, but if that is the case, one must ask why banks and broker-dealers seek the ability to pay unlimited compensation to persons unlikely to exercise significant influence.

D. Proposed Definition of "Nominal One-Time Cash Fee of a Fixed Dollar Amount"

The provision in GLBA prohibiting the payment of incentive compensation to bank employees for referring customers to a broker-dealer contains a narrow exception allowing "a one-time cash fee of a fixed dollar amount," provided the payment is not contingent on whether the referral results in a transaction. Although the statute does not define "nominal," it is a term used in common parlance, making a dictionary a logical starting point for determining its reach. As defined in Webster's II New Riverside University Dictionary, "nominal" means "existing in name only and not in reality" or alternatively, "small" or "trifling." Clearly, the intent behind the exception was not to create a significant incentive to make a referral, or the exception would swallow the rule.

15NASAA recognizes that the Federal Regulators have relied on the "General Exemptive Authority" provided at § 36 of the Securities Exchange Act of 1934. However, we question whether the SEC's departure from Congress' express language in GLBA in this instance is an appropriate exercise of its § 36 authority – which requires such exemption to be "necessary or appropriate in the public interest, and is consistent with the protection of investors." *See* 15 U.S.C. § 78mm.

16 NASAA recognizes that § 701(a)(1)(i)(B) of Reg R requires that the bank employee be "[p]redominantly engaged in banking activities, other than making referrals to a broker or dealer", however, that does not sufficiently address the salesman's stake created by this exemption.

17 Proposed Reg R also states that while compensation in this context may not vary based on revenue generated by the customer with the broker-dealer, "these restrictions do not prevent a referral fee from being paid…based on a fixed percentage of the total dollar amount of assets placed in an account with the broker or dealer. Additionally, these restrictions do not prevent a referral fee from being based on the total dollar amount of assets maintained by the customer with the broker or dealer…." While unclear, this suggests the possibility that the referring bank employee could be entitled to compensation on an ongoing basis, determined for instance, by the amount of assets under management. If that is indeed the intent, it creates an incentive for the bank employee to provide ongoing investment advice to the customer, which heightens the concern that an unqualified person may exercise significant influence over decisions made in the brokerage account. If that is not the intent, the Federal Regulators should clarify with unambiguous language.

In implementing the above exception, Regulation R would define "a nominal one-time cash fee" to allow the payment of twice the employee's actual base hourly wage for each referral. The drafters of the proposed regulation do not, however, offer any empirical support for their conclusion that such a payment is nominal or that it would not constitute a significant incentive. Rather, they simply assume such to be the case.

Although we too must base our judgment on applying our life experiences to the plain meaning of "nominal," we have trouble with the notion that an additional two hours of pay is trifling. This is especially true for salaried employees who, since they will be paid their salaries in any event, have no reason not to try to earn extra money by inducing even the most unsuitable of candidates to utilize the investment services of the firm with which their bank has a networking arrangement. If, in the course of a week, an employee is able to persuade only two customers to make an appointment with the broker-dealer, the employee will earn an extra half-day's salary. That may be trifling when compared to a Goldman Sachs bonus, but we suspect it is not so viewed by many bank employees. For them, an extra two hours of pay for each success is likely to provide significant encouragement, and thus, we believe the proposed definition goes beyond both the letter and spirit of the underlying law.

Trust and Fiduciary Account Exception

As we previously discussed in our comment letters dated July 16, 2001 and September 8, 2004, the Trust and Fiduciary Account Exception is perhaps the most complex of the exclusions from the definition of "broker" added by the GLBA. This exception allows a bank, under certain conditions, to effect securities transactions in a trustee or fiduciary capacity without requiring registration. The number of conditions placed on this exclusion reflects the Congressional intent that it be narrow in scope.18 Otherwise, banks could use this exclusion to conduct full brokerage activities under the guise of a "private banking" or other similar program. Of course, such activity would be inconsistent with functional regulation and contrary to Congressional intent.19

As was stated in our previous comment letters, NASAA believes that the provisions of Regulation B regarding "chiefly compensated" properly defined arrangements within the trust and fiduciary activities exclusion. By comparing "relationship compensation" and "sales compensation," those provisions ensured that traditional trust activities would remain in the bank, while activities in which the bank had a "salesman's stake" would be pushed out.20 NASAA was not opposed to the provisions in Regulation B that expanded the definition of "relationship compensation" because it did not appear that they would compromise investor protection. The same cannot be said of the expansions in the definition of "relationship compensation" included in Regulation R because the "salesman's stake", which was intended by Congress to be "pushed out" of the bank, is specifically included in the calculation of whether a bank meets the requisite threshold of "relationship compensation" in order to be excluded from the definition of "broker".

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18 H. Rept. 106-434 at p.163 ("The Conferees retained certain limited exemptions…").
19 See H. Rept. No. 106-74, part 3, at p. 164.
20 Congress intended that activities in which there is a "salesman's stake" be "pushed out." See H. Rept. 106-74, part 3, at p. 164.

The inclusion of 12b-1 fees in the calculation of compensation defined as “relationship income” is troubling. The established concept of 12b-1 fees is clearly one of distribution costs, which under any reasonable definition includes marketing and sales compensation to brokers and others selling fund shares. To include these fees in the computation of “relationship income” strains the ordinary and traditional meaning of the term, and will undoubtedly significantly expand the number of banks that can meet the requirements for the exclusion from the definition of “broker”. Additionally, by allowing the inclusion of 12b-1 fees, it is likely that more banks will be able to meet the 70% threshold, thereby allowing the computation of “relationship compensation” versus “sales compensation” to be made on a bank-wide basis, as opposed to an account-by-account basis. Of course, by allowing the bank-wide computation, individual instances in which the chief compensation is not “relationship income” will be overlooked or undetected. We continue to maintain that anything less than an account-by-account calculation creates the potential for a bank to use the trust and fiduciary activities exemption to conduct brokerage activities outside the securities laws through a “private banking” or similar program. Whether the calculation is made on an account-by-account basis or a bank-wide basis, banks should be required to separately calculate the amount of the “relationship income” attributable to 12b-1 fees so that regulators can determine the percentage of compensation derived from such fees.

Likewise, the ability of banks to exclude certain types of accounts from the calculation under the “chiefly compensated” tests will artificially enlarge the number of banks meeting the requirements of the exclusion in the definition, and lends itself to the potential for manipulation in calculating “relationship income.”

Bank Custody Exception

As addressed in NASAA’s previous comment letter, NASAA believes that Congress did not intend for the safekeeping and custody activities exception to allow banks to engage in broader securities activities.21 The terms “custody” or “related administrative services” do not include the acceptance of orders from investors to purchase or sell securities. Order acceptance is a fundamental broker-dealer activity, and to allow order acceptance within the bank custody activities exception is inconsistent with functional regulation. These activities are not merely “limited and incidental” to traditional banking functions, but rather are activities engaged in with the intent and purpose of independently generating profit, contrary to Congressional intent.22 The primary charge of banks is safety and soundness and for this reason it is somewhat disconcerting that banks are venturing into activities involving securities lending and borrowing. This area of broker-dealer business is one traditionally separate from banking activities and should remain a function of entities in the securities business that are registered and subject to the authority of securities regulators and rules applicable to broker-dealers.

It is understandable that banks want to engage in the highly profitable business of lending and borrowing securities. However, the complexities and recent attention given to the lending business, an area concerning which NASAA has recently provided comment, suggests that further attention is needed in this area to better protect the investing public.23 Accordingly,

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21 Letter from Ralph A. Lambiase, Pres., NASAA, to Jonathan Katz, Secretary, SEC, *Proposed Regulation B* (Sep. 8, 2004).
22 H. Rept. 106-74, part 3, at p. 168.
23 Letter from Joseph P. Borg, Pres., NASAA, to Nancy M. Morris, Secretary, SEC, Comments on Amendments to Regulation SHO (Oct. 4, 2006).

NASAA feels this service should not be carved out for an exemption, but rather should be "pushed out" to a traditional broker-dealer. Similarly, we continue to believe that bank employees should not be directly or indirectly compensated through 12b-1 fees or any other fees related to transactions other than the statutorily permitted nominal one-time cash referral fee of a fixed dollar amount specified in the GLBA.

If such activities are allowed, particular attention should be given to ensure that appropriate disclosure is provided to clients and approval is secured prior to engaging in this business.

NASAA continues to prefer the concept in the Interim Rules that provided banks with two exemptions—one for small banks and one for all banks. Both exemptions are consistent with functional regulation in that they contain solicitation, compensation, and staffing limits designed to allow banks acting as a custodian to engage in a small number of accommodation trades that do not amount to large scale brokerage activity without the investor protections under federal securities laws. While we believe that Regulation B may have gone too far in the expansion of the definition of small banks and might have resulted in more large-scale brokerage activity than was contemplated under the GLBA, Regulation R indisputably does so. In addition to investor protection issues, Congress has also expressed its concern that certain exemptions have created a disparity between competitors in the financial services marketplace by permitting banks to engage in securities activities without being subject to the same regulatory requirements that apply to broker-dealers. 24 This disparity is even more pronounced under Regulation R.

Sweep Accounts Exception

In light of the GLBA's use of "no- load" in the statutory sweep accounts exception, we maintain that adoption of the NASD's definition of "no- load," as was used in Regulation B, is the logical and appropriate way to clarify this exception. We agree with the Commission's previously stated position that investors have come to rely upon as denoting not more than minimal 12b-1 fees, and not carrying front-end or deferred sales charges. The allowance of "loaded" funds, i.e., funds charging in excess of 25 basis points in 12b-1 fees per annum or carrying a front-end or deferred sales charge, is not consistent with GLBA's use of the term "no-load". Therefore, we do not support the Regulation R amendments because they are inconsistent with common industry and investor understanding. Merely providing the customer with a prospectus and prohibiting a bank from characterizing a fund as "no-load" when it is not does not justify the departure from the clear language mandated in the GBLA.

Conclusion

NASAA appreciates the opportunity to comment on Regulation R. We believe that investors purchasing securities through banks, savings and loans, credit unions, and thrift institutions are entitled to receive the same protections afforded to them as when they purchase securities through broker-dealers. The regulations governing broker-dealers have evolved over many years of experience and countless transactions in securities, resulting in a high degree of integrity in the market and a practical investor protection regulatory regime that is not unduly burdensome. We believe that the different type of regulation typically employed in reviewing bank activities,

24 See H. Rept. 106-74, Part 3, pp. 113-14.

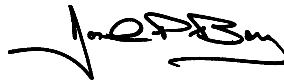
i.e., one that emphasizes safety and soundness as opposed to the more stringent emphasis on sales practices typically employed in the regulation of broker-dealers, may operate to deprive investors of those protections.

If banks are allowed to conduct activities normally associated with broker-dealers, and bank employees allowed to be compensated by fees different than the one-time nominal fees mandated by Congress, problems involving sales practice abuses should be expected. These problems are likely to go undetected and unresolved under the typical "safety and soundness" analysis employed by most bank regulators. Consequently, while supporting limited portions of Regulation R, NASAA believes that the regulation requires strengthening if investor protection is not to suffer. In the same way that bank regulators have recently deemed it ill-advised for large retailers to enter into the retail banking business and conduct traditional banking activities, it should likewise be deemed unwise to allow banks to engage in those core functions that are fundamental to the securities broker-dealer arena.

In general, although parts of the proposed regulation promote functional regulation as intended by the GLBA, significant portions appear to run counter to Congressional intent. As a result, and because we question whether investors will be adequately protected under Regulation R, NASAA does not support the regulation in its present form.

Please do not hesitate to contact either Matthew J. Neubert, chair of the NASAA Broker-Dealer Section at (602) 542-0605, or John E. Moore, Jr., chair of the NASAA Market and Regulatory Policy and Review Project Group at (501) 324-8686, if you have any questions or would like additional information.

Sincerely,



Joseph P. Borg
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