U.S.TRUST

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March 26, 2007

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Ms. Nancy C. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposed Regulation R
Federal Reserve Docket No. R-1274
SEC Release No. 34-54946; File No. S7-22-06

Dear Ms. Johnson and Ms. Morris:

United States Trust Company, National Association ("U.S. Trust")[1] welcomes the opportunity to comment on proposed Regulation R as recently published[2] jointly by the Board of Governors of the Federal Reserve System (the "Board") and the Securities and Exchange Commission (the "Commission") (the Board and Commission being collectively the "Agencies".) Regulation R would, *inter alia*, interpret certain clauses that exclude banks from the definition of *broker* in Section 3(a)(4) of Securities Exchange Act of 1934 (the "Exchange Act")[3] as modified by the Gramm-Leach-Bliley Act of 1999 (the "GLB Act".)[4]

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[1] United States Trust Company, National Association is a national bank chartered under the laws of the United States and is subject to the supervision of the Office of the Comptroller of Currency. It is a wholly-owned subsidiary of U.S. Trust Corporation ("UST Corp") which, in turn, is a wholly-owned subsidiary of The Charles Schwab Corporation. ("Schwab") In November, 2006, Bank of America Corporation entered an agreement with Schwab to purchase all the stock of UST Corp. This purchase is anticipated to be consummated during the third quarter of 2007.

[2] Federal Reserve Docket No. R-1274, S.E.C. Release No. 34-54946, 71 Fed. Reg. 77522 (December 26, 2006).

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

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I. Background:

As the barriers between the securities and banking industries eroded, Congress enacted the GLB Act which repealed most of the separations that had been mandated by the Glass-Steagall Act.[5] The GLB Act replaced the blanket exclusion for banks from the definition of *broker* in the Exchange Act with a number of functional exceptions (the "broker exceptions").

In 2001, the Commission issued Interim Rules to implement and clarify these broker exceptions,[6] and after receiving extensive comments, published a revised version of these rules as proposed Regulation B[7] in June, 2004. Before proposed Regulation B was adopted in final form, however, Congress enacted the Financial Services Regulatory Relief Act.[8] That statute mandated that Commission and the Board, after consulting with the other Federal bank regulatory agencies, adopt joint rules to implement the broker exceptions. Proposed Regulation R was promulgated in accord with that mandate.[9]

II. U. S. Trust:

U. S. Trust has provided wealth management services since 1853. Although it has a number of institutional clients, U. S. Trust's primary focus has been the needs of affluent individuals and families. To that end, U. S. Trust offers a broad range of services including financial and estate planning, investment management and consulting, trust services, custody and private banking. The nature of U. S. Trust's business makes it particularly interested in proposed Regulation R.

III. Other Comments:

U.S. Trust is aware that the American Bankers Association and The Clearing House Association are each submitting extensive comments on proposed Regulation B. U.S. Trust supports the thrust of those submissions.

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[4] Pub. L. 106--102, 113 Stat. 1338 (1999).

[5] Pub. L. 73—66, ch. 89, 48 Stat. 162 (1933).

[6] S.E.C. Release No. 34-44291, 66 Fed Reg. 27760 (May, 18, 2001).

[7] S.E.C. Release No. 34-49879, 69 Fed. Reg. 39682 (June 30, 2004).

[8] Pub. L. 109--351, 120 Stat. 1966 (2006).

[9] Regulation R would be adopted as Part 218 of Title 12 of the Code of Federal Regulations by the Board and as Part 247 of Title 17 by the Commission.

IV. U. S. Trust Comments:

A. Networking Exception:

Section 3(a)(4)(B)(i) of the Exchange Act[10] authorizes banks to enter arrangements with third-party and affiliated broker-dealers in connection with the provision of brokerage services to bank customers. Such arrangements must satisfy certain conditions, including limitations on the compensation paid to bank employees. In this regard, bank employees cannot receive "incentive compensation" for referring customers to a broker-dealer.[11] However, such employees may receive a "nominal" referral fee, provided that such a fee is not "contingent on whether the referral results in a transaction."

Definition of Transaction:

Section __.700(a) of Regulation R would define "transaction" as including, *inter alia*, "whether an account is opened at a broker or a dealer".[12] Treating the opening of an account as a "transaction" would be an overly expansive interpretation of the term.

Such a view would be inconsistent with both the specific language and overall thrust of Section 3(a)(4) of the Exchange Act which generally defines:

> "a broker as any person engaged in the business of effecting transactions in securities for the account of others."

U. S. Trust believes that it is highly unlikely that Congress used the term "transaction" to refer to two different concepts within the same section of the Exchange Act. In one place the term would refer to a "transaction in securities" while at another place "transaction" would refer to a somewhat amorphous concept that included, *inter alia*, opening an account.

Moreover, the principle *indicium* that differentiates a broker from, e.g., an investment adviser is the receipt of transaction-based compensation. Brokers are brokers because historically they have been paid transaction-based compensation to effect securities transactions. The regulation of broker-dealers in large part is addressed at ameliorating the conflicts that arise between the interests of a broker and his or her customer embedded in this brokerage business model. Such conflicts arise from effecting transactions in securities and not from opening accounts.

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[10] 15 U.S.C. 78c(a)(4)(B)(i).

[11] *Id.* at 78c(a)(4)(B)(i)(VI).

[12] 71 Fed. Reg. at 77544.

Bonus Plans:

Section __.700(b)(1) of Regulation R would define the term "incentive compensation" so that "compensation paid . . . under a bonus or similar plan" that met certain requirements would not be considered prohibited "incentive compensation." The compensation paid under such a bonus plan would have to be:

- "paid on a discretionary basis;"
- "based on multiple factors or variables" that included "significant factors and variables that are not related to securities transactions at the broker-dealer."

U.S. Trust applauds the exclusion of such compensation from term "incentive compensation." This would allow banks to maintain the type of bonus plans that have been traditional in the financial services industry. However, the terms "discretionary" and "related to securities transactions at the broker-dealer" should be clarified.

Many bonus plans established in the financial services industry are structured. Employer financial institutions establish structures and formulas for their bonus plans to avoid arbitrary determinations and to maintain the confidence of their employees in the fairness of the plan. For example, there may be a target bonus percentage or other formula for each class of employees. The extent to which the target is achieved is often a function of the performance of the firm as whole or a division thereof as well as the performance of the employee as an individual. After a good year, employees expect "to be paid." Still, an employee does not have enforceable claim to a bonus under these bonus plans until the bonus is actually paid. The Agencies should indicate that a bonus plan is discretionary within the meaning of Regulation R if the plan does not convey to the employee an enforceable right to a bonus.

The word "related" is by its nature vague. Theoretically, "factors and variables" even tenuously or tangentially associated with "securities transactions" at a broker-dealer could be argued to be "related" to such transactions. U.S. Trust believes that term should be clarified to read "directly related."

Overall Profitability

In addition, under Section __.700(b)(1) of Regulation R the term "incentive compensation" would not include compensation based on "any measure of the overall profitability" of the bank, any of the bank affiliates or an operating unit of either, or, under certain circumstances, a broker-dealer. Again, U.S Trust appreciates the effort that Agencies have made to distinguish between compensation designed specifically to encourage a bank employee to make referrals from compensation based on a broad-based measure of an institution's performance. U.S. Trust would suggest that the basis for compensation not be restricted to "profitability." Other measures of overall performance such as revenues should be available.

Nominal One-Time Cash Fee:

Subject to certain limitations, Section 3(a)(4) of Exchange Act allows unregistered bank employees to receive "a nominal one-time cash fee of a fixed dollar amount" for the referral of a customer to broker-dealer.[13] Section __.700(c) of Regulation R would provide several alternative definitions of "nominal one-time cash fee." One of these alternatives would limit the "nominal fee" to a percentage of annual base salary. Unfortunately, many bank employees receive a majority of their compensation in forms other than base salary. These other forms may include bonuses, incentives for making loans or for gathering deposits etc. In such cases, it would be inappropriate to use base salary as a factor in the calculation of what should be considered a "nominal fee." U.S Trust suggests that total compensation be used instead.

B. High Net Worth Customers:

Section __.701 of Regulation R would allow banks to pay enhanced referral fees to bank employees for referring high net worth customers to a broker-dealer. Such referral fees would not be limited to a "nominal" amount and could be contingent on the consummation of a securities transaction. U.S. Trust greatly appreciates the Agencies' willingness to allow such enhanced referral fees. However, U.S. Trust has several concerns.

Definition of High Net Worth Customer:

The primary issue for U. S. Trust is the level of wealth necessary to qualify as high net worth customer. Section __.701(c)(1) of Regulation R would require that an individual have a net worth of at least $5,000,000 not counting the individual's equity in his or her principal residence. This requirement is excessive. U. S. Trust concurs with the view that an individual with substantial assets is more likely to understand the relationship between the bank and its employees and the broker-dealer and to grasp that a bank employee has an interest in making a successful referral. However, U. S. Trust believes that an investor would acquire that level of sophistication long before he or she acquired $5,000,000.

A bank's referral of an individual to a broker-dealer entails a relatively low level of risk The individual is, after all, being referred to a broker-dealer that is subject to regulation by the Commission and a Self Regulatory Organization. In contrast, the level of risk taken by an individual who invests in a private equity fund or hedge fund is of a different order of magnitude. Such funds are unregistered private pools of capital. The private equity funds typically require the investor to lock up his or her investment for a decade or more. Hedge funds generally avail themselves of leverage and require lockups, albeit for lesser periods.

[13] 15 U.S.C. 78c(a)(4)(B)(i)(VI).

Yet, the Commission currently has rules that permit a natural person having a net worth of $1,000,000 to invest in private equity or hedge funds[14] and has only recently proposed raising that limit to $2,500,000 for individual investors in hedge funds.[15]

Under Section __.701 of Regulation R, the sophisticated customer would be specifically informed that the bank employee making the referral might receive an enhanced referral fee contingent on the customer's entering into a securities transaction. U. S. Trust believes that this is an added reason why an individual with a net worth of $1,000,000 should qualify an individual as a high net worth customer. Such an investor would not only have experience with substantial assets but also have the information needed to evaluate the economic interests of the bank employee.

Statutory Disqualification:

Section __.701(a)(3) of Regulation R would mandate that a written agreement between the bank and the broker-dealer provide, *inter alia*, that the bank and the broker-dealer determine that the referring bank employee not be subject to statutory disqualification under the Exchange Act. This determination should not be the obligation or responsibility of the bank. Because of the complexities associated with determining whether a person is statutorily disqualified, this determination should instead be the responsibility of the broker-dealer who should be familiar with the Exchange Act and the level of diligence needed.

Ordinary Course of Duties for the Bank:

Section __.701(a)(1)(ii) of Regulation R would require that the high net worth customer be "encountered . . . in ordinary course of the [bank] employee's assigned duties for the bank." U. S. Trust is concerned that this language could be interpreted as implying that the encounter must take place at specific locations or specific times.

Bank employees involved in sales and marketing functions are expected to cultivate current and prospective customers and to educate these persons about the bank's products or services wherever and whenever they encounter such current and prospective customers. Even bank employees not involved in sales and marketing functions are encouraged to assist in developing the bank's customer base at all times. These encounters occur in social settings and at civic functions or charitable events. Bankers meet customers at wakes and weddings and at alumni reunions and golf tournaments. Such encounters are all "in ordinary course of the employee's assigned duties."

[14] 17 C.F.R. §§ 230.215(e) and 230.501(a)(5).

[15] Prop. 17 C.F.R. §§ 230.216(a) and 230.509(a) *set forth in* S.E.C. Release No. 33-8766; IA-2576, 72 Fed Reg. 400, 414 and 416 (January 4, 2007).

C. Trust and Fiduciary Activities:

Under Section 3(a)(4)(ii) of Exchange Act, a bank can effect securities transactions in connection with providing trust or fiduciary services, and nevertheless, be excluded from the definition of "broker" as long as certain conditions are satisfied. The purpose of this exception is to allow banks to continue to engage in the types of trust and fiduciary activities that they have engaged in for many years.[16]

Chiefly Compensated:

To qualify for the exclusion for trust and fiduciary activities, a bank must be "chiefly compensated" for such activities by "relationship compensation."[17] The method of calculating "chiefly compensated" in former Proposed Regulation B engendered a significant amount of controversy. A salient issue was that Proposed Regulation B would have effectively required the calculation to be made on an account-by-account basis.

In contrast, Regulation R represents a very significant improvement. Section __.721 of Regulation R would retain the "account-by-account" method for measuring compliance with the "chiefly compensated" standard. On the other hand, Section __.722 would allow the calculation to be made on an aggregate basis. A difference would remain. To be "chiefly compensated" under the "account-by-account" method, "relationship compensation" would have to be greater than fifty percent of total compensation. Under the aggregate method, "relationship compensation" would have to be greater than seventy percent of total compensation.

In its comments on former Proposed Regulation B, U.S. Trust vehemently asserted that "the 'account-by-account' method for measuring compliance with the 'chiefly compensated' test [was] neither mandated nor supported by either the statutory language or legislative history of the GLB Act." Moreover, it would be would be unreasonable to infer that Congress wished to impose such a difficult and complex methodology. U.S. Trust still believes that the aggregate method should be the standard method for measuring compliance and that that test should be satisfied where "relationship compensation" is greater than fifty percent of total compensation.

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[16] *See* Conf. Rep. 106-434 106th Cong. 1st Sess. at 164 (1999).

[17] Section 3(a)(4)(B)(ii)(I) requires that a bank be "chiefly compensated" for its fiduciary activities:

> "on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers, or any combination of such fees."

Former Proposed Regulation B would have characterized this type of compensation as "relationship compensation." Prop. 17 C.F.R. § 242.724(h) *at* 69 Fed. Reg. 39735. Regulation R would use the same term. Prop. ___. § 242.721(a)(4) *at* 71 Fed. Reg. 77546.

That being said, U.S. Trust recognizes that the aggregate test for compliance set forth in Section __.722 is a very meaningful enhancement. When combined with the redefinition of "relationship compensation," which is discussed below, the aggregate test will provide a workable method for the vast majority of banks. Accordingly, U.S Trust wishes to express its appreciation to the Agencies for their efforts in resolving one of the more contentious issues.

Relationship Compensation:

Proposed Regulation B would have excluded many fees received by banks from mutual funds from the definition of "relationship compensation" even though such fees were based on "a percentage of assets under management." This narrow definition also gave rise to considerable adverse comment.

Section __.721(a)(4) of Regulation R would redefine "relationship compensation" in line with the definition set forth at Section 3(a)(4)(B)(ii)(I) of the Exchange Act.[18] Among other things, shareholder servicing fees, "Rule 12b-1" fees and other fees paid by investment companies that were based on assets under management would be included in "relationship compensation." The revised definition represents a significant advance, and again, U.S Trust appreciates the efforts of the Agencies.

D. Safekeeping and Custody Exception:

Section __.760 of Regulation R would allow banks, subject to certain conditions, to accept orders for securities transactions from custodial customers.

Investment Advice or Research

Among the conditions imposed on a bank's accepting orders, Section __.760(b)(6) of Regulation R would restrict a bank from providing investment advice or research to, making recommendations to or soliciting securities transactions from a custody account. This restriction on providing investment advice or research is to some extent ameliorated allowing banks to cross-market investment management services by providing sales advertisements and sales literature.

Still, the restriction on providing investment advice or research is far too broadly worded. Banks promote their investment advisory services in a number of ways, many of which could be considered providing investment advice or research. Websites, sales literature, newsletters and other publications that are available both to clients and to the general public may set forth the bank's views on the economy and on the different segments of the market. In some of these publications individual securities are mentioned and discussed. In many other cases, bank officers are interviewed by the financial press, and their investment views appear in both broadcast and print media. Transcripts of interviews or reprints of written articles based on such interviews are often disseminated by banks. All of the above could be

[18] 15 U.S.C. 78c(a)(4)(B)(ii)(I).

considered prohibited investment advice or research. If that were the case, banks would be precluded from providing to their custody clients that which they routinely provide to the general public. The restrictions on providing investment advice or research should be limited to a prohibition on recommending or soliciting individual securities transactions.

Carrying Broker Activities:

The safekeeping and custody exception does not apply if:

> "the bank, in connection with such activities, acts in the United States as a carrying broker (as such term, and different formulations thereof, are used in section 15(c)(3) of [the Exchange Act] and the rules and regulations thereunder) for any broker or dealer, unless such carrying broker activities are engaged in with respect to government securities."[19]

Proposed Regulation R does not define "carrying broker" for purposes of this provision. The GLB Act defines "carrying broker" in terms of Section 15(c)(3) of the Exchange Act.[20] In this regard, Section 15(c)(3) and the Commission's rules issued thereunder establish higher net capital standards for a broker that "carries customer or broker or dealer accounts and receives or holds funds or securities for those persons."[21] This provision distinguishes between "carrying brokers" and so-called "introducing brokers" which do not carry customer accounts.

U.S. Trust believes that the point of the prohibiting a bank from acting as a "carrying broker" was to prevent broker-dealers that were functioning as "carrying brokers" from circumventing the applicable net capital standards. Accordingly, the Agencies should define the "carrying broker" provision in light of the financial responsibility requirements for

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[19] 15 U.S.C. 78c(a)(4)(B)(ii)(II).

[20] 15 U.S.C. 78o(c)(3) which provides in relevant part:

> No broker or dealer (other than a government securities broker or government securities dealer, except a registered broker or dealer) shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale, of any security (other than an exempted security (except a government security) or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits and credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers. *Id.* at 78o(c)(3)(A).

[21] 17 C.F.R. § 240.15c3-1(a)(2)(i).

"carrying brokers." A custodian bank should not be deemed a "carrying broker" so long as it is not enabling broker-dealer to avoid the capital requirements that would be applicable to such "carrying brokers."

In conclusion, U. S. Trust appreciates the opportunity to express its views on proposed Regulation R and hopes the comments contained in this letter are helpful. If you have any questions on the above, please contact the undersigned by telephone at (212) 852-1367 or by E-mail at john_sullivan@ustrust.com.

Very truly yours,

John B. Sullivan