Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Ave. NW
Washington, D.C. 20551
Re: Docket No. R-1274

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549
Re: File No. S7-22-06

Dear Ms. Johnson and Ms. Morris:

Re: Definitions of Terms and Exemptions Relating to the “Broker” Exceptions for Banks. FRB Docket No. R-1274. SEC File No. S7-22-06.

Dear Sir or Madam:

The Financial Services Roundtable[1] appreciates this opportunity to comment on the joint notice of proposed rulemaking (NPR) to implement certain exemptions for banks and thrift institutions from the definition of “broker” under Section 3(a)(4) of the Securities Exchange Act of 1934.

Under the Gramm-Leach-Bliley Act (GLBA),[2] the long standing broad exemption for banks from the broker-dealer registration requirements of the Securities and Exchange Act of 1934 was replaced with specific exemptions based on the type of activity involved or the capacity in which the bank is acting. The legislative history of GLBA indicates that the blanket exemption was deleted in light of the other provisions in GLBA that enhanced the ability of banking organizations to engage in securities transactions, and the desire to regulate these newly permissible activities under the doctrine of “functional regulation.” However, the legislative history also makes it very clear that Congress added the more specific exemptions in order to permit banks to continue to

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1 The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, investment products and services to the American consumer. Roundtable member companies provide fuel for America’s economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue, and 2.1 million jobs.

2 Public Law 106-102, 113 Stat. 1338 (1999).

offer traditional securities services without the need to register as a broker or dealer.[3] As explained in the Senate report:[4]

> The Committee does not believe that an extensive "push-out" of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years...

This NPR implements the activity specific exemptions in four major areas: (i) third party networking arrangements; (ii) trust and fiduciary activities; (iii) sweep activities; and (iv) safekeeping and custody activities. The overriding purposes for the NPR are to accommodate the business practices of banks and protect investors.

The Roundtable believes that this NPR represents a significant improvement over prior proposals to implement the GLBA broker-dealer amendments, and commends all of the agencies that have been involved in this effort. However, we believe that there are several areas in which the proposal could be improved, as set forth below.

I. Third Party Networking

A. Nominal One-Time Cash Fee

Third party networking refers to arrangements in which a bank employee refers a bank customer to a registered broker-dealer in exchange for a fee or other form of compensation. GLBA authorizes banks to enter into these programs with registered broker-dealers, if certain conditions are met, and so long as the bank employee making the referral does not receive "incentive compensation for any brokerage transaction."[5] While the term "incentive compensation" is not defined in the statute, GLBA provides a safe harbor for a "nominal one-time cash fee of a fixed dollar amount" if the fee is not contingent on whether the referral results in a transaction.

Under the proposal, a payment will be considered a "nominal one-time cash fee of a fixed dollar amount" if the payment does note exceed:

1. Twice the average hourly wage for the job family that includes the employee;
2. One-thousandth of the average annual base salary established for the job family;
3. Twice the employee's actual base hourly salary; or

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[3] See, e.g. S. Rep. No. 106-44 at 10; H.R. Rep. No. 106-434 at 164 (Conference Report).

[4] The Committee report goes on to describe numerous other traditional banking services that should not be "pushed out" into a registered broker or dealer, including custodial, safekeeping and clearing plans for IRAs, dividend reinvestment plans, employee benefit plans and private placement.

[5] Section 3(a) (4) (B) (i) of the Securities Exchange Act of 1934, as added by GLBA § 201.

4. Twenty-five dollars, adjusted for inflation beginning in 2012.

The Roundtable appreciates that the proposal provides a range of alternative methods for determining the amount of a "nominal" cash referral fee. However, we are concerned that the proposal does not reflect the fact that, as in other industries that rely on building customer relationships, financial institutions typically reward relationship officers and employees commissions, bonuses and other measures of success. Thus, for most employees, the base salary is just that, a base upon which significant additional compensation is expected. The proposal mistakenly relies on base salary or hourly wage for determining if a payment is nominal, when these amounts are often a fraction of the actual compensation earned by bank officers and employees. We suggest that the NPR use the employee's *actual* total income for the prior year or prior quarter as a more relevant measure of whether the referral fee is "nominal" from the perspective of the employee.

B. <u>Exemption for Institutional and High Net Worth Customers</u>

1. <u>Eligibility Criteria</u>

The NPR proposes to permit the payment of a referral fee, of any size, if an employee refers certain institutional or high net worth individuals to an affiliated broker-dealer. The exemption is based on the realization that these customers have the sophistication to independently evaluate the relationship between the bank, the employee, and the broker-dealer. The proposal defines an "institutional" customer as a corporation, trust, or other entity that is not an individual that has at least $10 million in investments, or $40 million in assets; or $25 million in assets if the referral is for investment banking services (underwriting a securities issuance, financial adviser in a merger, providing venture capital, etc.).

The NPR defines a "high net worth" individual customer as an individual who has at least $5 million in net worth (excluding primary residence and associated mortgage). In computing the $5 million threshold, 50 percent of the assets held jointly with a spouse may be included in the customer's net worth, and 100 percent of the assets of a spouse held as "community property" (in states recognizing that form of ownership) are also included. If both spouses are acting together, the assets of both individuals may be combined, regardless of the form of ownership.

As a preliminary matter, the Roundtable is very concerned that the NPR singles out "spouses" for special treatment and ignores that two or more individuals, whether or not legally married, may hold assets jointly. For example, it is not uncommon for domestic partners, individuals related by blood or marriage, and others to hold assets jointly. It has also become more common for individuals to place assets in a "living trust" or other legal structure designed to avoid the costs of probate. The final regulation should take into account the various ways in which the property may be held, and should not be limited to "spouses."

Second, the Roundtable believes that the investment and asset size limits for both individuals and business entities are unnecessarily high. In this regard we note that in 1979 the SEC codified the concept of "accredited investors" as persons that due to their financial sophistication and ability to fend for themselves do not require the protections of registration under the Federal securities laws.[6] Currently, the SEC regulations define accredited investors to include individuals with a net worth in excess of $1 million *or* with income in excess of $200,000 for the preceding two years and expected current year.[7] Business entities and other non-natural entities are included if they have more than $5 million in assets.[8] If these tests are sufficient for determining a class of investors who are sophisticated and knowledgeable to the point that they do not need the protection of registration under the Securities Act, these investors arguably should be viewed as capable of understanding that a bank employee may have a financial interest by referring them to an affiliated broker-dealer. We therefore recommend that the agencies lower the threshold tests for high net worth individuals and institutional investors, so that these thresholds are more consistent the accredited investor definition.

2. Procedural and Other Requirements

The NPR also includes an extensive list of procedural and other requirements that must be met under this exemption. The bank and the affiliated broker-dealer must enter into a written agreement pursuant to which the bank *and* the broker-dealer must determine that the bank employee is not subject to certain statutory disqualifications, and the broker-dealer must determine that the customer qualifies for the exemption. The agreement must require the broker-dealer to perform a suitability or sophistication analysis of the transaction or customer. The bank must provide written disclosures to the customer of the name of the broker-dealer and the fact that the employee participates in a compensation plan that may result in a payment for the referral or transaction. The referral fee may be a dollar amount based on a fixed percentage of revenues received by the broker-dealer for investment banking services, or it may be a predetermined dollar amount. However, the fee may not be based on revenue generated by a transaction with the customer, the amount of securities purchased or sold, or the number of referrals made.

We believe that many of these conditions and limitations are inconsistent with the principle behind the exemption. As a fundamental matter, this exemption is grounded on the fact that sophisticated customers know full well that sales are generated by referrals, and that referrals are incented through the payment of compensation. This is a common understanding throughout our economy. It is simply inefficient and wasteful to impose numerous restrictions on the ability of bank employees to refer sophisticated customers to affiliated service providers. The Roundtable understands the need to assure that customer

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[6] See SEC Release No. 33-6180 (Jan. 17, 1980). Companies selling securities in non-public transactions only to accredited investors are exempt from Securities Act registration.

[7] 17 CFR 230.501. Assets held jointly with a spouse are combined when determining net worth. If joint income is used, the level is raised from $200,000 to $300,000.

[8] Id.

is in fact sophisticated, as that term will be defined in the final regulation, and that certain basic disclosures should be made. The Roundtable also recognizes that certain individuals, due to criminal or other violations, should not be involved in any way in securities transactions. However, rather than prescribing the terms that must be included in written agreements between the bank and broker-dealer, detailed disclosure requirements, and limitations on the types of fees that may be paid, and numerous other business practices, we would urge the agencies to provide the industry the flexibility to develop their own methods and rules for achieving the goals described above, subject to supervisory approval. This will allow each banking organization to meet the regulatory obligations through the most efficient methods and procedures for that organization, while maintaining the ability of the agencies to assure that these obligations are met.

II. Trust and Fiduciary Activities

The GLBA exempts bank securities activities conducted in a trustee capacity, or conducted in a fiduciary capacity in a trust department or other area of the bank that is regularly examined for compliance with fiduciary principles.[9] The bank may not publicly solicit brokerage business other than the fact that it conducts securities transactions in conjunction with advertising its trust services. The bank must direct trades through a registered broker-dealer for execution, or effect the trade through a cross-trade within the banking organization. And finally, the bank must be "chiefly compensated" for such transactions, consistent with fiduciary principles and standards, based on an administration or annual fee, a percentage of assets under management fee, a flat or capped per order fee that is not in excess of actual costs, or combination of these fees.[10] The NPR uses the term "relationship compensation" to refer to these fees.

Under the NPR, a bank will meet the "chiefly compensated" standard if 50 percent or more of the compensation for each trust or fiduciary account is derived from relationship compensation fees. Alternatively, a bank will meet the chiefly compensated test if 70 percent or more of its compensation from all trust and fiduciary accounts on a bank-wide basis are derived from relationship compensation.

The NPR goes on to define relationship compensation to include such items as administration fees; fees paid for services; account maintenance charges; annual fees; and fees based on the amount of assets under management. The proposal specifically states that Rule 12b-1 fees are included as relationship compensation.

The proposal permits financial institutions to comply with the chiefly compensated test either on an account by account basis, or if the aggregate relationship compensation for the bank's trust and fiduciary business is at least 70 percent of its total trust and fiduciary compensation. In either the account-by-account or bank-wide computation, the bank may exclude a trust or fiduciary account open for less than 3

[9] Section 3(a) (4) (B) (ii).

[10] Id.

months, and accounts acquired as part of an acquisition, merger, or consolidation (for 12 months after the acquisition).

Under the account-by-account approach, the proposal permits a bank to transfer an account (or the securities in the account) to a registered broker-dealer within 3 months after the end of the year that the account that fails to meet the “chiefly compensated” test.

Also under the account-by-account method, the proposal permits a bank to exclude up to 1 percent of the total number of trust or fiduciary accounts held by the bank or 500 accounts, whichever is less. The de minis exclusion may not be utilized two years in a row.

The Roundtable believes that this proposal is significantly improved over prior proposals, in particular in permitting the necessary flexibility in computing the “chiefly compensated” standard. Additional improvement could be made if the definition of “relationship compensation” was further enlarged to include other forms of compensation that are based on the fiduciary relationship and not on security transactions. For example, fees based on the performance of an investment portfolio are not related to sales, but instead are based on the success of investments that are already in the fiduciary account. We believe that these and other compensation not dependent on sales be included as relationship fees. We also urge that the proposal should also permit the computation of the chiefly compensated standard either on the bank level, or for an entire banking organization. This additional flexibility would permit a bank holding company or savings and loan holding company the option of calculating the chiefly compensated ratio on a consolidated basis for all of the depository institutions within the company.

Finally, we would ask that the Agencies make clear that where a bank serves as trustee for individual retirement accounts (IRA), the securities assets of which are held at a clearing broker, the bank need not comply with the trust and fiduciary exception. This issue is very important to our members who do not have trust departments, but are permitted under rules of the Internal Revenue Service and their authorizing statutes to serve as trustees for IRA accounts.[11] Because the securities held in these accounts are sold through the bank’s affiliated broker-dealer and the securities assets are held at a clearing broker, a bank, serving as a trustee under these circumstances, should not be considered to be effectuating transactions in securities. Alternatively, we would ask that the agencies clarify that such banks 1) do not need trust departments to take advantage of the trustee exception or 2) are not acting in a trustee or fiduciary capacity for purposes of the safekeeping and custody exception.

[11] To convert these accounts to IRA custodial accounts and, thus, excepted under the statute, would be extremely burdensome as it would require a bank to resubmit all plans to the IRS; the IRS to assign a new plan number to the bank, and then the bank to contact all customers IRA trust customers to request that they readopt the new IRA plans.

III. Investment Company Securities

Under the NPR proposal, a bank that otherwise meets the conditions for an exemption from broker registration may effect transactions in certain investment company securities[12] without going through a broker-dealer.[13] The proposal would permit such transactions to be executed through the National Securities Clearing Corporation Mutual Fund Services or directly with a transfer agent acting for the mutual fund. The Roundtable supports this proposal, but notes that many defined contribution pension plans offer investments in annuities as well as mutual funds. We therefore urge that the exemption should include annuities as well as open-end mutual fund companies.

IV. Bank Service Provider

For many smaller banks and thrifts the only practical method for engaging in securities transactions that are permissible under the proposal is through the use of a service provider that can perform back office functions. Often, that service provider is itself a bank. We believe that the use of a bank service provider should not change the relationship or effect of the transaction any more than the use of a separate department within the bank to handle back office functions. Thus, if the primary bank is relying on the custodial relationship exemption, the fact that this primary bank using a second bank to engage in back office activities, including placing of transactions with a broker-dealer, should not trigger compensation restrictions on either institution.

V. Dual Employees

The Roundtable is also concerned that the application of NASD Rule 3040 to dual depository institution and broker-dealer employees will undermine the benefits of the proposed joint SEC-Federal Reserve regulation and the intent of Congress as envisioned in Title II of GLBA.

The NASD Rule 3040 provides that NASD registered representatives who engage in covered securities activities outside of their employment with a member firm must comply with NASD imposed notice, approval, record retention, and supervision requirements. The rule is intended to make sure that investors receive the benefits of the supervision that is provided by a member firm, and thus avoid potential consumer abuses.

The concerns of the NASD may be relevant if the registered representative is associated with an unregulated entity. However, the rule creates an unnecessary regulatory burden, and in many cases will effectively prevent, the use of dual employees

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[12] The securities must be issued by open-end mutual funds that are neither traded on a national securities exchange nor through the facilities of a national securities association or an inter-dealer quotation system.

[13] Under GLBA, banks relying on the trust and fiduciary, employee benefit and stock reinvestment plan, certain issuer plans, and custodial-safekeeping exemption are required to use registered broker-dealers for execution of trades.

by banking organizations that are subject to extensive Federal supervision and regulatory controls. Unlike non-regulated entities, banks and thrifts are subject to intensive regulatory scrutiny, including scrutiny over securities related activities. Bank trust departments are required to comply with stringent fiduciary standards, and are examined by specialized fiduciary examiners. Application of NASD's rule 3040 is simply unnecessary in the case of banking institution dual employees.

Moreover, both the proposed SEC-Federal Reserve regulation and Title II of GLBA are intended to permit banks to continue to conduct traditional securities activities within the bank, whether as part of the institution's trust department, or elsewhere as provided in the legislation. The NASD regulation effectively prevents banks to continue to use dual employees for this purpose, creating a significant roadblock to the fulfillment of this Congressional directive.

We therefore urge the SEC and Federal Reserve Board, as well as the other banking agencies, to encourage the NASD to exempt bank and thrift dual employees from the scope of Rule 3040.

VI. Conclusion

The Roundtable believes that this proposal represents a significant step forward in implementing Title II of GLBA, and represents thoughtful consideration of many complex issues. However, we note that there are several areas in which further modifications should be made in order to assure that the goals of GLBA are accomplished. If you have any questions please feel free to contact me or Irving Daniels at 202-289-4322.

Sincerely,

Richard M. Whiting

Rich Whiting
Executive Director and General Counsel