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March 26, 2007

Electronic Submission

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

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

Re: Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks; File No. S7-22-06; Docket No. R-1274; 71 Federal Register 77522, December 26, 2006;

Re: Exemptions for Banks Under Section 3(a)(5) of the Securities Exchange Act of 1934 and Related Rules; File No. S7-23-06; 71 Federal Register 77550, December 26, 2006.

Dear Ms. Morris and Ms. Johnson:

The American Bankers Association (ABA)[1] and its affiliate, the ABA Securities Association (ABASA),[2] appreciate the opportunity to comment on the proposed Regulation R jointly issued by the Securities and Exchange Commission (Commission) and the Board of Governors of the Federal Reserve System (Board) (hereinafter referred collectively as "Agencies") to implement certain exceptions for banks from the definition of the term "broker" under Section 3(a)(4), of the Securities Exchange Act of 1934 (Exchange Act), as amended by the Gramm-Leach-Bliley Act (GLBA). The ABA also takes this opportunity to offer comments on the Commission's related proposal to exempt banks, under certain

[1] The ABA, on behalf of the more than two million men and women working in US banks, represents every category of banking institution in this rapidly changing industry. The ABA membership includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks, making it the largest banking trade association in the country.

[2] ABASA is a separately chartered affiliate of the ABA representing those holding company members of the ABA actively engaged in capital markets, investment banking and broker-dealer activities.

conditions, from the definition of dealer under Section 3(a)(5) of the Exchange Act.

OVERVIEW

As directed by the Financial Services Regulatory Relief Act of 2006,[3] the Agencies have issued for comment Regulation R which includes proposed rules to implement the broker exceptions for banks[4] provided under GLBA, as well as various related exemptions. As currently contemplated by the proposal, banks will be required to come into compliance with Regulation R on the first day of their first fiscal year commencing after June 30, 2008. Banks with fiscal years that coincide with the calendar year will be required to be in compliance with the regulation no later than January 1, 2009.

At the outset, we would like to commend the leadership of both Agencies for their dedicated and collaborative efforts in issuing this proposal. We believe that Regulation R is a much improved proposal and, subject to certain comments we discuss below, workable for our membership. We particularly wish to commend the Agencies on those provisions of Regulation R that address bank trust and fiduciary activities and safekeeping and custodial services. While we take issue with some of the legal bases for the regulation's requirements, we believe that these provisions, for the most part, have been structured in such a manner that the ability of banks to continue to engage in traditional banking activities will be facilitated, much as the Congress intended when it passed GLBA.[5]

With respect to third-party brokerage arrangements or "networking" provisions of GLBA and proposed Regulation R, we note that all businesses set performance goals and objectives for their employees, and banks are no different in setting employee performance objectives that encourage employees to grow assets and revenue for their institution and its shareholders. We believe that the Agencies have achieved appropriate balance by not interfering with the banking industry's ability to offer employee bonus compensation that encourages employees to grow the business and, at the same time, complies with the prohibition on paying transaction-based compensation to unlicensed bank employees. Moreover, while we appreciate the Agencies' attempt to provide an exemption for referrals of sophisticated customers, unfortunately, we do not think that in this case the same balance has been achieved. As we outline below, we

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

[4] Section 401 of the Financial Services Regulatory Relief amended the definition of "bank" in Section 3(a) (6) of the Exchange Act to include any Federal savings association or other savings association the deposits of which are insured by the FDIC. Accordingly, we use the term 'banks" in this letter to include commercial banks, trust companies, savings banks, and savings associations.

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

believe much can be done to fashion a "sophisticated customer" exemption that is less proscriptive than that contained in the proposal.

The Need for Legal Certainty Regarding Dual Bank Broker-Dealer Employees

We have previously stated that the banking industry needs legal certainty, and that legal uncertainty brought on by the lack of final rules has been very costly for the industry. Much of what the Agencies have proposed, we submit, will provide that certainty once adopted with the revisions we have suggested below. Unfortunately, the proposal fails to resolve a very important and outstanding issue associated with persons employed concurrently by banks and broker-dealers (dual employees). As we have previously explained, under the "functional regulation" approach adopted under GLBA, the use of dual employees has become vital to the implementation of the business model of a diversified financial institution in a manner consistent with GLBA and the differing requirements of the functional regulators, while consolidating in one relationship manager the delivery of several types of financial services and products to customers.

Since August of 2001, we have had a request before the NASD seeking affirmation that NASD Rule 3040[6] does not apply to these dual employees. Understandably, the NASD has not responded to our request while the rules implementing the broker "push-out" provisions of GLBA were not yet final. Until the NASD is able to respond to our request for clarification, our members are extremely reluctant to register bank employees without full knowledge of what dual licensing entails. In fact, this lack of legal certainty has caused many of our members to de-license their bank employees.

From comments made by the staff of the Agencies, we understand that the Agencies have begun to consider the various issues associated with dual employees. This is a very positive development and we encourage the Agencies, working with the NASD, to resolve the issues sufficiently in advance of the eventual effective date for compliance with Regulation R. A sufficient lead time is necessary in order for banks to determine the appropriate dual employee program to establish at their institution that both meets the individual bank's needs and complies with NASD's position on our interpretive request. We also strongly encourage the NASD to meet again with industry representatives before responding to our request for clarification. Much has transpired in the intervening years and all parties would benefit from prior consultation.

[6] Rule 3040 requires registered representatives involved in securities transactions outside of their employment and member firms to comply with certain notice, approval, record retention, and supervision requirements. Specifically, registered representatives must provide written notice to the employer member firm describing, in detail, each transaction it proposes to execute outside of the member firm, i.e., in a bank. The employer member firm is frequently required to pre-approve the transaction and monitor and supervise the employee's participation to the same extent as if the transaction were executed on behalf of the member firm itself. Moreover, duplicate books and records must be maintained at the member firm.

Guidance with Respect to the Other GLBA Exceptions

The Agencies have asked whether it would be useful or appropriate to adopt rules implementing the other exceptions to broker registration provided by GLBA or providing further related exemptions. While we do not, at this time, believe that further guidance on the actual terms of the statutory exceptions or additional exemptions are required,[7] it would be helpful if the Agencies were to confirm the informal advice given previously by the staff of the Agencies that the statutory exceptions and the proposed exemptions in Regulation R are not mutually exclusive,[8] and that activities that are excepted or exempted under one provision may also be excepted or exempted under another provision of the Exchange Act, GLBA or Regulation R. For example, the referral fee and bonus plan limitations contained in proposed Rules 700 and 701 would not apply if a bank employee were to refer a customer to the bank's money market mutual fund, as proposed to be permitted under Rule 741, or its government securities trading desk to effect transactions in exempt securities. Similarly, compensation received by a bank for effecting transactions in exempt securities or money market mutual funds on behalf of trust and fiduciary accounts need not be included in the "chiefly compensated" calculations required under proposed Rules 721 and 722. Income earned on stand-alone custody accounts could, but need not, be included in the "chiefly compensated" calculation. While the custody business is generally conducted within bank trust and fiduciary department, banks should be able to rely on the GLBA custody exception or the proposed aforementioned money market mutual fund exemption should it make good business sense to do so.

Future Regulatory Action

Before we turn to our specific comments on the proposal, we note that the Agencies have stated that any future changes or additions to Regulation R or future regulations implementing GLBA's other statutory broker exceptions will be adopted jointly by the Commission and the Board in accordance with the joint rulemaking provisions in Section 101(b) of the Financial Services Regulatory Relief Act. We strongly support continued joint rulemaking between the Commission and the Board and consultation with the other bank regulators, as required under this Act.[9] We also believe that the Agencies should coordinate on issuing interpretive guidance regarding the broker provisions of GLBA. It would

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[7] By our comments, we certainly do not suggest the Agencies' willingness to review and consider additional regulations raised during the comment period should be limited.

[8] The sole exception to this proposition is proposed Rule 760 which provides that trust and fiduciary accounts may not take advantage of the custodial order-taking exemptions. We note that with certain off-shore corporate trust programs, the bank has separate custodial and trust indenture agreements with the same client. For the reasons discussed below, we do not believe these accounts should be required to be analyzed under either the GLBA or Regulation R framework. In any event, Rule 760's prohibition on order-taking should not apply to accounts such as these where there is a stand-alone custodial agreement.

[9] GLBA also requires the bank regulators to consult with the Commission in connection with establishing recordkeeping requirements for the broker-dealer exceptions.

be most counterproductive for the Board and the Commission each unilaterally to issue conflicting interpretive guidance.

Finally, we request that the Board and the Commission reach some common understanding, possibly through a Memorandum of Understanding, that they will consult each other in connection with the institution of any enforcement actions, including administrative cease and desist orders, involving GLBA and related regulatory issues, particularly when such action may involve new interpretations of these provisions.[10]

DISCUSSION

1. NETWORKING EXCEPTION

The networking exception of GLBA permits bank employees to provide support services to third-party and affiliated broker-dealers in connection with the sale of securities to bank customers. In order to qualify for the exception, the networking services must satisfy a number of conditions, including, to the extent practicable, physical separation of brokerage and routine banking services, compliance with certain advertising conditions and various disclosure provisions, and a limitation on bank employee compensation associated with securities referrals.[11] Proposed Rule 700 defines several terms used in GLBA that place conditions on bank employee compensation.

A. Referral Fees

GLBA provides that unregistered bank employees may receive compensation for the referral of customers to broker-dealer firms if the compensation is "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 [brokerage] transaction." Proposed Rule 700 alternatively defines the statutory term "nominal one-time cash fee of a fixed dollar amount," in terms of either multiples of base hourly wages or fractions of annual base salaries for the referring employee's job family, twice the employee's actual base hourly wage, or

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[10] For example, in a Commission order instituting administrative cease-and-desist proceedings, making findings and imposing remedial sanctions against Dunham Trust Company, Dunham & Associates Securities, Inc., and certain affiliated person and entities, the Commission made a certain conclusory statement that "revocable trusts are generally not established for fiduciary purposes." While we may not disagree with the Commission's ultimate actions in this particular factual situation, we disagree with the unfortunate dicta, as it is contrary to the long standing common and state law recognition of a trustee's high level of fiduciary duty owed to both revocable and irrevocable trusts. We are concerned that similar mischaracterizations of bank fiduciary activities might be made in the context of enforcing GLBA, the Exchange Act and/or provisions of Regulation R, if adopted without consultation with the relevant banking regulators. *See* www.sec.gov/litigation/admin/2006/33-8740.pdf

[11] Section 3(a)(4)(B)(i), 15 USC 78c(a)(4)(B)(i).

$25.[12] Moreover, the proposal provides that the flat $25 referral fee could be adjusted for inflation.

While we are supportive of giving banking organizations the ability to structure referral fee programs in a manner that best suits their particular institutions' business models and geographic location, we are concerned that defining "nominal one-time cash fee" by reference to base hourly or annual salaries severely disadvantages those employees who receive most of their compensation in the form of contingent compensation based on sales or referrals of non-securities products. In order to encourage employees to market non-securities products and/or accounts, banks frequently pay personnel such as mortgage brokers, syndicated lenders, private bankers and trust sales persons, to name just a few, relatively low base salaries partnered with high contingent compensation. For example, it is not uncommon for mortgage brokers to receive two-thirds of their compensation in the form of contingent compensation. Under the proposal, these employees would not have the same opportunity as "salary only" employees to receive comparable fees and, in fact, might receive a lesser fee for referring relatively more sophisticated customers[13] to a third-party or affiliated broker-dealer than branch customer service personnel who may refer retail customers to brokerage firms.

We recommend that the proposal be revised to permit another alternative measure of "nominal one-time cash fee" based on total hourly or annual compensation for the referring employee, so long as that portion of the individual's compensation that is based on securities transaction referrals is not included in total hourly or annual compensation. Under this formulation, bank employees could be paid a nominal referral fee that is twice their total hourly wage or 1/1000th of their total annual compensation consisting of their base salary and non-securities contingent compensation paid. This alternative will give banks additional flexibility to establish referral programs that best meet the needs of their various business units and, at the same time, insure that the fee is small in relation to the employee's overall compensation. By "backing-out" securities transaction referral fees, the Agencies can be assured that bank employees have not been unduly motivated to sell securities to bank customers.

We also recommend that the Agencies provide further flexibility by allowing referral fees to be paid in non-cash form, such as points.[14] Many banks

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[12] We continue to question the need to define "nominal" as banks and brokerage firms, for the past 12 years, have operated under bank regulatory and Commission guidance requiring retail referral fees to be "nominal" without further numerical definition.

[13] We recognize that these employees may receive higher referral fees, under proposed Rule 701, for referring certain high net worth and institutional customers to a broker-dealer. That said, as discussed below, many sophisticated customers will not be able to satisfy the exceedingly high standard set out in the proposal.

[14] Of course, the prohibition on paying referral fees in non-cash forms does not prohibit broker-dealers and banks from using non-cash promotions, e.g., pizza parties, coffee cups and other nominal gifts, to introduce branch employees to new products and services offered by the bank's broker-dealer partner.

establish point programs as an administrative convenience to reduce the frequency of cash payments to employees. We believe a non-cash program can be properly structured so as to meet the GLBA statutory conditions that the referral fee be nominal, one-time, paid in cash and not tied to the success of a securities transaction if the points awarded under the program merely serve as an interim step between the referral and the cash referral payment. For example, a points program that awards a point for each referral and then subsequently converts the points to cash after some total points hurdle is met, e.g., 25 points converted to $25, could, we believe, be appropriately structured to satisfy the aforementioned statutory conditions.

We are pleased that the narrative portion of the proposing release confirms that the "one-time" requirement is a one-time per referral, not per customer. This position is supported by a plain reading of GLBA and, importantly, eliminates the need for banks to keep detailed records to track the identity of the customers referred.

It is also quite helpful that the Agencies have clarified that banks may condition the payment of a referral fee on whether a customer contacts or keeps an appointment with a broker-dealer as a result of a referral or whether the customer meets objective, base-line qualification criteria such as minimum asset, net worth, or income requirements. This provision appropriately recognizes that banks should not have to compensate employees for referrals that can never, under any reasonable fact pattern, result in a securities transaction. We are particularly pleased that marginal tax bracket was added to the list of qualification criteria as we previously requested.

The definition of "referral" provides that a bank employee must direct a bank customer to the broker-dealer partner. We suggest that referral also encompass potential customers. It is not uncommon for a potential customer seeking financial services to approach the bank. After discerning the particular needs of the potential customer, the bank employee may refer the potential customer to its broker-dealer partner. The bank employee should be compensated for that referral despite the fact that the party referred was not, at the time, a bank customer.

B. Bonus Plans

Many banks have bonus plans that set performance goals or objectives for their employees. These performance-based metrics are intended to provide incentives for employees to grow the overall profitability of the clients' relationships with the financial services company as a whole, taking into account the bank holding company and its various affiliates and subsidiaries through which different parts of its business are operated. Objectives can be established on, for example, an individual basis, a team or group basis, a branch basis, department-wide basis, line-of-business basis or an entity-wide basis. Further, it is not uncommon to find a variety of performance objectives, some of which could be expressed in terms of asset gathering, i.e., new or increased business brought into the unit or referred to other units or affiliates. For example, it would not be unusual for a bank's institutional line of business to set objectives that involve new or increased business with a wide variety of other department and affiliate products to such customers, such as treasury and cash management services, loan syndication, derivatives products, employee benefit, incremental credit, mergers and acquisition advisory services and securities underwriting.

Typically, payments under bonus plans are paid on a discretionary basis to employees, often with no mandatory criteria on how that discretion should be exercised. However, part of the decision may be based upon whether certain objective and subjective performance goals have been met. The bonuses are usually paid out on a periodic basis, e.g., quarterly or annually, not on a transaction-by-transaction basis. The pool of money made available to pay bonuses is generally established by senior executives, and may be based on the overall financial performance (expressed in any number of ways, such as income, revenue, return on capital) of the bank or bank holding company or the profitability of one or more business units, among other factors. Once the bonus pool is established, senior management then allocates the pool to various business units, based on the overall performance of that unit, among other factors. Business unit heads then, in turn, award employees bonuses based on their assessment of the individual employee's overall performance, which may include his or her role in handling multiple client relationships and may be based upon multiple performance factors. These performance factors may be both objective, as discussed above, and subjective, such as measuring the employee's ability to be a team player and satisfactorily maintaining compliance goals. This process can be extremely flexible, with the criteria changing periodically (for example from year-to-year). Indeed, specific performance factors and goals are often discussed and agreed-to between employees and their superiors on a periodic basis.

While we continue to maintain that the Congress, in enacting the networking exception in GLBA, intended only to prohibit the payment of traditional brokerage commissions, not bonuses, to bank employees, we are pleased that the Agencies have defined the term "incentive compensation" in such a manner that it should not interfere with traditional bonus plans in financial services firms. Specifically, proposed Rule 700(b)(1) would permit bonus plans that are paid on a discretionary basis and are based on multiple factors and variables that include significant factors and variables that are not related to securities transactions at the broker-dealer, and do not include securities referrals as a factor or variable in setting the employee's compensation.[15] Consequently, balanced, discretionary bonus plans, similar to those described above, that measure the revenue generated by, or the profitability of, a customer relationship would satisfy the Rule's requirements because the plan measures significant factors and variables that are not related to securities transactions. This would be true despite the fact that the bonus plan measured significant other factors and variables that are securities related, such as revenues derived from securities

[15] Proposed Rule 700(b) (1) would also preclude bonus plans structured to reward employees for referrals made by other persons.

underwriting and brokerage services provided by the broker-dealer that may have been initially generated by a bank employee referral.

Proposed Rule 700(b)(2) makes clear that banks may also pay bonuses to individuals based on the financial performance of the bank, bank holding company, a bank holding company affiliate or operating unit, or, under certain circumstances, a broker-dealer. We believe that this language adequately captures those bank incentive plans that pay bonuses based on the financial performance of branches, divisions or geographic or operational units, as well as those plans that pay bonuses based on the general profitability of the bank or its affiliates. We encourage the Agencies to carry this notion forward, however, and allow banks to pay bonuses, under certain circumstances, to individuals based on the financial performance of a branch, division, or geographic or operational unit of a broker-dealer. Non-bank affiliated brokerage firms pay bonuses in such a manner, and we see no reason why banks affiliated with broker-dealers should not have the same flexibility.

C. Institutional Referral Exemption

Proposed Rule 701 would allow banks that meet all the other conditions of the networking exception to pay referral fees to bank employees for referring high net worth or institutional customers to a broker-dealer partner in a different manner. These referral fees need not be nominal and may be contingent on the success of a sale. As stated above, while the Agencies' willingness to allow such referral fees to be paid under certain circumstances is reasonable, the proposed rule itself is proscriptive and burdensome.

A scaled-down, much more simplified exemption can be structured so as to ensure that sophisticated investors have the appropriate information necessary to understand and evaluate the relationship between the bank, its employees and its broker-dealer partners and any resulting securities transactions. We would submit that defining the appropriate categories of sophisticated customers and providing those customers with clear and conspicuous disclosures outlining the relationship between the bank and the broker-dealer partner and the fact that the referring bank employee may receive an enhanced fee which could be contingent on the customer entering into a securities transaction should be sufficient. This is especially true when one considers that the un-licensed bank employee is only making a referral and that the SEC and the self-regulatory authorities have oversight and enforcement authority over securities transactions that take place at the broker-dealer.

All practical issues associated with building a due diligence and compliance model for a sophisticated customer referral program should be resolved through agreement between the bank and the broker-dealer partner, rather than being mandated through regulation. For example, which entity should be allocated responsibility for ensuring that the referring bank employee is not statutorily disqualified as that term is used under the Exchange Act, should not be mandated by rule, as the Agencies proposed to do in Rule 701, but rather should be determined by contractual agreement between the parties, all of which are cognizant of the practical difficulties associated with performing these analyses. Similarly, responsibility for determining customer qualification should be allocated through this agreement.

(1) High Net Worth and Institutional Customer Definitions

The notion that a sophisticated investor needs less protection than a retail investor has long been a basic tenet of the federal securities laws.[16] We do, however, take issue with the extremely high net-worth hurdle – $5 million – for natural persons to qualify as high net worth customers, as it does not appear to be rationally related in any way to the level of risk the customer is assuming in leaving the confines of the banking world for that of the broker-dealer. Specifically, the Commission's current rules permit natural persons having a net worth of $1 million to invest in private equity funds[17] and has recently proposed that these same investors must have a net worth of $2.5 million dollars to invest in hedge funds. Surely if the Commission believes that these net worth levels are appropriate for individuals to have the requisite sophistication to invest in unregistered private pools of capital, then the net worth requirement as a measure of client sophistication should be significantly less for that client to understand the relationship between the bank and its broker-dealer partner. This is especially true when one considers that the proposed Rule would also require that the sophisticated customer be informed that the bank employee that made the referral could receive an enhanced referral fee that might be contingent on the success of that customer entering into a securities transaction with the broker-dealer partner. At most, a natural person should only need $1 million in net worth to demonstrate that he or she has the requisite sophistication to understand the disclosures regarding the relationship between the bank and its broker-dealer partner and the fact that the bank employee may be entitled to receive compensation based on the success of the referral. [18]

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[16] *See* SEC Regulation D, 17 CFR 230.501(a)(1) (defining "accredited investor"); SEC Rule 144A Securities, 17 CFR 230.144A(a) (defining "qualified institutional buyer"); SEC Rule 15a-6, 17 CFR 240.15a-6(b)(7) (defining "U.S. institutional investor"); Section 2(a)(51) of the Investment Company Act of 1940, 15 USC 80a-2(51) (defining "qualified purchaser").

[17] Moreover, a natural person investing in private equity funds is able to include all assets jointly held in his or her net worth calculation, whereas proposed Rule 701would permit only one-half of jointly held assets to be included in the net worth determination. Also, no other high net worth customer definition, that we are aware of, requires the primary residence and all associated liabilities to be excluded from the net worth determination.

[18] Should the Agencies determine not to adopt our recommendation, discussed below, that, for purposes of this referral fee rule, institutions are, by definition, sophisticated and need not satisfy some further asset or other similar threshold,, we would then suggest that where a settlor of a revocable trust meets the Rule's net worth requirement for natural persons, then the trust itself should be deemed to be a qualifying institutional investor under the Rule. It makes no sense to distinguish between the two based on whether the investor is investing in his or her individual capacity or through a trust vehicle. This is especially true when one considers that the settlor will frequently have the benefit of the corporate fiduciary's investment expertise.

With respect to corporate and other institutional investors, there is simply no need for a numerical measure of sophistication. By definition, these institutions, whether they be pension plans, private equity pools, or corporations have the requisite sophistication to understand the relationship between the bank, the broker-dealer and the referring bank employee.

Should the Agencies disagree with our position, we would suggest that the numerical measure for corporate and other institutional customers be revised. The dollar hurdle for institutional customers is simply too high to be of much practical use to many bank customer referrals. For example, many municipal authorities, such as fire and school districts, will have difficulty in even satisfying the $25 million hurdle for investment banking services, let alone the higher thresholds[19] for brokerage, portfolio management, and other similar services offered by the broker-dealer. Many municipalities have in-house experts or access to financial advisors to guide their investment and capital markets decisions. These experts have the requisite skills to understand the relationship between the bank and the broker-dealer and the fact that the referring bank employee will be compensated if the municipality enters into a securities transaction with the broker-dealer. Similarly, charities with in-house experts or access to financial advisors are capable of understanding these relationships. Consequently, it is our belief that where a municipality or charity has the requisite investment expertise to understand the relationship between the bank, the referring bank employee and the broker-dealer, there is simply no need to overlay a high net worth or asset requirement on that institutional investor.

With respect to corporations and other institutional investors, we would suggest that the Agencies include "revenue" as a measure of sophistication, in addition to assets or investments. While it may be appropriate to measure sophistication for employee benefit plans according to assets under management, it does not make sense to measure corporations in this way. Banks generally distinguish small business from larger middle market customers according to the company's annual revenue. A reasonable measure of sophistication for an employee benefit plan or other similar institutional investor would be $5-$10 million in assets under management, while a corporation's sophistication would be measured at $5-$10 million in annual revenue. The institutional customer definition should also include newly formed joint ventures or subsidiaries that do not yet have the requisite revenue volume, so long as the controlling owners of the venture or subsidiary meet the institutional customer definition themselves.

It would be most inappropriate if the proposal's definition of high net worth and institutional customer were to default to the definition of "qualified investor" contained in GLBA. That definition requires significantly higher investment thresholds for natural persons, municipalities and corporations than

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[19] Proposed Rule 701 defines "institutional customer" for purposes of services other than investment banking services as "any corporation, partnership, limited liability company, trust or other non-natural person that has at least $10 million in investments, or $40 million in assets."

those proposed here because the Congress determined that customers investing, through the bank and not a broker-dealer, in loan participations, equity swaps, or asset-backed securities should be of significant means so as to not need the protections offered by the broker-dealer sales practice rules. This is not the situation here at hand, as high net worth and institutional customers referred to a broker-dealer will engage in securities transactions through the broker-dealer and thus be entitled to receive all the protections offered by those rules.

Finally, while we support the proposal's requirement that high net worth and institutional customers receive disclosures regarding the relationship between the bank and its broker-dealer partner and the fact that the bank employee may earn compensation based on the success of the referral, it makes more sense to require those disclosures to be made at or prior to the time a securities transaction is effected. From a practical standpoint, a customer is more likely to focus on these disclosures at the time he or she is in the process of authorizing a securities transaction, then when he or she is being referred to a broker-dealer partner. Consequently, we would urge the Agencies to revise proposed Rule 701(a)(2)(i) to provide that the required disclosures are to be made at or prior to the time a securities transaction is effected.

(2) Customer Qualification

We are also troubled by the proposal's two different temporal standards for qualifying a customer as an institutional or high net worth customer. All customers should be qualified at or before the referral fee is actually paid; not prior to or at the time of the referral. As now structured, the proposal will result in needless inefficiency because high net worth customers qualified at the time of the initial referral, may not qualify, due to a variety of circumstances, at the time the account is opened or the securities transaction is effected. By contrast, broker-dealers performing their "know your customer" and, if applicable under self-regulatory rules, suitability responsibilities will be able to ensure that the customer is qualified as a high net worth investor at the time they effect the securities transaction on the customer's behalf which, of course, will be before any referral fee is paid to the bank employee.

The requirement to qualify the high net worth customer at the time of referral is also troubling for other reasons. First, because broker-dealers have certain recordkeeping obligations that require them to gather detailed information about clients and their investment objections, we are concerned that any unlicensed bank employee gathering this same detailed information may be viewed by the self-regulatory organizations as functioning in more than a clerical or ministerial capacity vis-à-vis that client[20] and, thus, be required to be licensed.

[20] We note that GLBA specifically granted to bank employees the ability to handle customer funds or securities and describe in general terms the types of investment vehicles available through the networking arrangement. See Section 3(a)(4)(B)(i)(V), 15 USC 78c(a)(4)(B)(i)(V). It did not give unlicensed bank employees the ability to perform suitability analyses on "to be referred" customers.

Second, qualifying the customer at the time a referral fee is actually paid will eliminate much of the need for banks to avail themselves of the good faith compliance and correction provision of proposed Rule 701(a)(2)(iv), which provides that a bank will not be considered to be a broker if it makes a reasonable effort to reclaim the portion of a referral fee paid in error to a bank employee because the customer did not qualify as a high net worth investor. Qualifying the high net worth individual shortly before the referral fee is paid will lessen the likelihood that banks will have to reclaim referral fee compensation already paid to the bank employee.[21] Accordingly, we request that the proposal be revised so that high net worth customers are required to be qualified at or around the time the referral is paid; not prior to or at the time of the referral.

In addition, proposed Rule 701 conditions the exemption from paying nominal referral fees for high net worth and institutional customer referrals on the existence of a written agreement between the bank and the broker-dealer that provides, among other things, that in any case where the payment of a referral fee to a bank employee is contingent on the completion of a securities transaction, the broker-dealer must perform a suitability analysis regarding the securities transaction at issue. We strongly object to this requirement. Suitability analyses should only be required in accordance with the rules of the self-regulatory organizations (SROs) and those rules do not require performance of suitability analyses on unsolicited transactions. Yet, this proposal would require the broker-dealer to do just that. A rule developed to implement broker provisions of GLBA should not be used as a back-door attempt to expand existing suitability responsibilities established under SRO rules.

(3) Bank Employee Requirements

As part of their assigned duties, bank employees are expected to educate current and prospective customers about products or services offered by both bank and non-bank affiliates wherever and whenever they encounter current or prospective customers. Bank employees involved in sales and marketing functions are also often expected to maintain a high profile in their local communities. As a result, bank employees frequently encounter current and prospective clients at social functions, such as charitable fundraisers and other philanthropic events, school functions, and sporting events. It is our understanding that employee referrals of current and prospective customers encountered in the ordinary course of that employee performing his or her assigned duties, even if those duties take place beyond the four walls of the banking institution, would be entitled to receive an enhanced referral fee for any high net worth and institutional referrals that satisfied the other conditions of proposed Rule 701.

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[21] This reclamation process could quickly become difficult to administer, especially if the bank and the employee were following a compliance program organized and implemented in good faith. At a minimum, the rule should provide a safe harbor period after which money received by the employee is "safe" from reclamation.

Proposed Rule 701(a)(3) mandates that a written agreement between the bank and the broker-dealer provide, among things, that the bank <u>and</u> the broker-dealer determine that the referring bank employee is not subject to statutory disqualification under the Exchange Act. As discussed above, and because of the technical complexities associated with determining whether a person is statutorily disqualified,[22] we think that it would be more appropriate for the responsibility for making this determination be allocated between the broker-dealer and the bank based on which entity is best suited to perform the analysis. We also believe that it is inefficient to have both entities incur the time and expense to perform this analysis as the proposed Rule now provides.

2. TRUST AND FIDUCIARY EXCEPTION

Under GLBA, a bank can effect securities transactions in connection with providing trust or fiduciary services and remain exempt from registration as a broker as long as four basic conditions are satisfied. First, the bank cannot publicly solicit brokerage business, other than by advertising that it effects transactions in securities as part of its overall advertising of its general trust business. Second, the bank's compensation for effecting transactions in securities must consist chiefly of an administration or annual fee; a percentage of assets under management; a flat or capped per order processing fee that does not exceed the cost of executing the securities transaction for trust or fiduciary customers, or a combination of such fees. Third, the bank would have to direct all trades of publicly traded domestic securities to a registered broker-dealer. And fourth, the bank must effect the transactions in a department that is regularly examined by bank examiners for compliance with fiduciary principles and standards.

The purpose of this exception is to continue to allow banks to engage in the types of trust and fiduciary activities they have engaged in for many years, even if a substantial portion of those activities generate fees that would otherwise trigger broker registration requirements.[23] In providing this exception, the Congress recognized that where banks conduct securities transactions in their fiduciary capacity, they are subject to an entirely separate scheme of bank fiduciary regulation.[24] Of course, the "chiefly compensated" language, along with the requirements of separate broker-dealer execution of securities trades and the prohibition on brokerage advertising, ensures that the trust exception may not be used simply to transfer a full-scale securities brokerage operation into a bank trust department to evade Commission regulation.

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[22] A statutory disqualification analysis requires, among other things, review of Court opinions and regulatory agency orders, in addition to a review of the CRD system maintained by the NASD.

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

[24] We ask the Agencies to acknowledge that under Exchange Act Section 3(a)(4) "fiduciary capacity" includes acting "in any other similar capacity," such as a conservator. The Commission previously noted this and other capacities as eligible fiduciary capacities. *See* 66 <u>Fed. Reg</u>. 27760, 27772 (May 18, 2001).

Chief among our concerns with respect to the two prior proposals for implementing the broker provisions of GLBA were the positions taken with respect to calculating "chiefly compensated." Specifically, the prior proposals would have required the banks to analyze compensation received from customers on an account-by-account basis. Requiring banks to analyze compensation received from each trust and fiduciary account would have created enormous systems and personnel issues for our members, especially when one considers the fact that over 1,827 banks serve as trustees or fiduciaries to over 19 million accounts.[25]

We were also concerned that the earlier proposals did not consider fees received by banks from mutual funds as one of the enumerated types of compensation permitted under GLBA. Many banks, at the direction of or with the consent of, their trust clients, have structured their compensation in such a manner that the bank receives a significant portion of its compensation directly from the mutual fund organization. And for many banks, particularly those with significant employee benefit and corporate trust business lines, the previous characterizations of these fees as not one of the statutorily permitted fees would have prevented many banks from satisfying the statutorily mandated "chiefly compensated" test.

We, therefore, support the general approach in the Agencies' proposal in that the Agencies have taken several steps to reduce significantly the burdens and expenses associated with complying with the trust and fiduciary exception's "chiefly compensated" requirement. Of particular note is the fact that the Agencies now propose in Rule 721 to include fees permitted by Rule 12b-1 of the Investment Company Act and other similar types of fees paid by investment companies within the meaning of fees based on assets under management, and therefore permitted by GLBA. And while we continue to question whether GLBA actually requires banks to calculate "chiefly compensated" on an account-by-account basis, we are pleased that the Agencies have provided what appears to be a very workable bank-wide exemption that will not require banks to perform an account-by-account analysis of their compensation, although as pointed out below, it would be useful if that exemption could be applied on a "line of business" basis.

We do have the following comments to make with respect to the definitional provisions of proposed Rule 721 and the bank-wide exemption requirements of proposed Rule 722.

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[25] FDIC Quarterly Banking Profile Table VIII-A (4th Quarter 2006), http://www2.fdic.gov/qbp/2006dec/qbp.pdf.

A. Relationship Compensation

Relationship compensation is defined as including all of the fees enumerated in GLBA.[26] Proposed Rule 721 clarifies that administrative fees include fees paid for personal services, tax preparation, or real estate settlement, and that asset under management fees include various fees paid by investment companies, including 12b-1 fees. We would submit that this revised definition of relationship compensation is a very significant improvement over earlier proposals that would not have considered 12b-1 and other similar fees paid by investment companies for personal service, shareholder maintenance or administrative services to be relationship compensation.

As the Agencies are aware, banks offer their trust and fiduciary clients the ability to invest in an array of investments, including registered investment companies and other pooled funds exempt from registration under the Investment Company Act. Many of these products, such as bank collective funds,[27] are executed on the National Securities Clearing Corporation's Mutual Fund Services (NSCC) platform and, as a result, it is not uncommon for clients to move back and forth between registered mutual funds and bank collective funds. Banks are frequently compensated for their services through fees paid, not by the funds themselves, but by the funds' service providers, including the administrator, primary distributor, investment adviser, or transfer agent. We assume that the phrase "including without limitation" when used to discuss fees received as a percentage of assets under management in proposed rule 721(a)(4)(iii) would include these fees but would request that the Agencies make clear that current industry practices wherein fees may be paid by a registered investment company, a pooled fund exempt from registration under the Investment Company Act or anyone of its service providers, are acceptable as relationship compensation.[28]

The definition of relationship compensation, specifically assets under management fees, should also cover certain other fees that banks receive in connection with servicing trust and fiduciary accounts. For example, custody fees may be charged separately from the trustee fee and are generally based on assets under management.

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[26] Relationship compensation includes an administrative fee, an annual fee, a fee based on assets under management, and a flat or capped per order processing fee that is equal to not more than the cost incurred by the bank in connection with executing securities transactions for trust or fiduciary accounts.

[27] Collective funds for employee benefit plans are exempt from registration under the Securities Act of 1933 Section 3(a)(2) (15 USC Section 77c (a)(2)); Rule 132, 17 CFR 230.132; and the Investment Company Act Section 3(c)(11) (15 USC 80a-3 (c)(11)).

[28] Revising paragraph (a)(4) of proposed Rule 721 to provide that "[*r*}*elationship compensation* means any compensation, regardless of which entity pays, that a bank receives that consists of:…." would help to clarify this issue.

Fees earned in connection with securities lending activities should also be considered assets under management fees. With respect to securities lending activities, banks generally share, with their trust and fiduciary clients, the income earned on reinvestment of the cash collateral posted by the securities borrower as part of the lending compensation arrangement. Banks may also charge related securities lending service fees. Fees earned in connection with the securities lending transactions are not inconsequential, frequently exceeding 30% of a bank's overall trust and fiduciary compensation. We note that the list of fees qualifying as "assets under management" is "without limitation"[29] and believe that the portion of the income or compensation earned on the cash collateral associated with securities lending transactions and related serviced fees could properly be classified as an "assets under management" fee.

We similarly believe that performance-based fees should be considered permissible. Performance-based fees are very common and important in aligning the goals of the trust or fiduciary client with those of the bank. By measuring the growth of assets under management during a given period relative to some standard benchmark or measure of the market, such as the S&P 500 Index, these types of fees are, in essence another variation of a flat fee imposed on assets under management. At no time does the number of transactions affect the fee and, in fact, the investments could remain static throughout the year and still beat a standard measure of market performance.

We note that the Congress has permitted registered investment advisers to charge advisory clients fees for performance measured against a standard benchmark or measure of the market. *See* Section 205(b)(2)(B) of the Investment Advisers Act, 15 U.S.C. 80b-5. So, too, has the Department of Labor permitted performance fees in several ERISA Advisory Opinions.[30] Permissible relationship compensation for bank fiduciaries, subject to extensive regulation and oversight, should, at a minimum, be as broad as that permitted for registered investment advisers and pension plan service providers.

Relationship compensation also includes "annual fees," examples of which include fees paid for <u>measuring</u> a manager or a portfolio's performance against a benchmark and compliance reporting. This latter type of service requires the bank to compare the assets held in a portfolio with the investment manager's guidelines and notify the client if the guidelines are violated. These fees are assessed periodically and are not priced as a percentage of assets under management.

Settlement fees are fees earned in directed trust accounts on trades placed with a broker-dealer by an outside investment manager. These fees are assessed for the administrative services necessary to settle the transaction, not to execute

[29] *See* proposed Rule 721(a)(4)(iii).

[30] U.S. Department of Labor Advisory Opinion No. 89-28A (Sept. 25, 1989); U.S. Department of Labor Advisory Opinion 86-21A (Aug. 29, 1986); U.S. Department of Labor Advisory Opinion 86-20A (Aug. 29, 1986).

the transaction that has already been performed by the broker-dealer. While these fees are frequently set as a flat per order processing fee, they should be distinguished from the statutory limits placed on flat per order processing fees associated with executing securities transactions. This fee should be properly characterized as an administrative fee. We would note that settlement fees are permissible under the custodial exception, as well as the proposed order-taking exemption.[31]

We also presume that disbursement fees, wire transfer fees and other similar types of fees should also be classified as administrative fees, and, therefore, relationship compensation. Similar to some of the fees listed as administration fees in proposed Rule 721, these fees frequently have nothing to do with securities transactions. Disbursement fees can include fees for distributions to participants in employee benefit plans or personal trust beneficiaries. Wire transfer fees, fees for recording income payments (interest and dividends) and the myriad of other services that are necessary to service fiduciary accounts should be considered "without limitation," administrative fees.

We understand that the Agencies have taken the position that monies earned by the trust department for providing services to affiliated or unaffiliated companies, e.g., mutual fund and other pooled fund custodial services, is neither total or relationship compensation and, thus, is exempt from the chiefly compensated test. We agree with this position as the monies are not earned on an account-by-account basis but rather by the trust and fiduciary department as a whole. Soft dollar credits are similarly exempt, as are credits received from the commercial side of the bank for monies deposited. Deposit credits are not included in fiduciary revenue under Schedule RC-T to the Call Report.

B. Foreign Branches

We would urge the Agencies to exempt fees earned on trust and fiduciary accounts held in a foreign branch of a US bank from the chiefly compensated calculation, either under the statutory exception or the bank-wide exemption in proposed Rule 722. It would be difficult for such a branch to distinguish revenue earned on foreign branch activities involving non-US persons, from revenue earned on activities involving US persons. Considered alone, activities with non-US persons would not trigger the Exchange Act's broker registration requirements. Therefore, we believe that revenues from these activities should not be included in the chiefly compensated calculation.

As a general matter, when choosing to do business with a branch of a US bank located outside of the US, non-US persons would not expect the branch to be subject to Exchange Act regulation. And it is not realistic to expect the US bank to include all revenue earned by the foreign branch in the bank's overall chiefly compensated calculation, as compensation for accounts of foreign

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[31] *See* proposed Rule 760.

fiduciary clients may be structured, as the foreign market dictates, in a manner that would not satisfy the bank-wide exemption. Revenues generated from activities that do not trigger U.S. jurisdictional means should not be included in a calculation required by an otherwise inapplicable law.

Other significant administrative difficulties also argue against including these revenues in the chiefly compensated calculation, including the fact that business is conducted in the various currencies of that region, and that foreign branch systems and other associated infrastructure are not set up in a manner necessary to provide the information required under the calculation. Consequently, we strongly urge the Agencies to exempt revenues earned in foreign branches from the trust and fiduciary exception's chiefly compensated test.[32]

C. Two-Year Rolling Average

We understand that calculation of "chiefly compensated," whether performed on an account-by-account basis or on a bank wide basis, requires averaging the percentages obtained for each of the two immediately preceding years. We further understand that compliance with proposed Regulation R will not be required until the first fiscal year beginning after June 30, 2008 and, thus, for those banks whose fiscal year coincides with the calendar year, compliance will not be required until January 1, 2009. Once compliance is required, only then will a bank be required to start collecting the requisite data to perform the two-year rolling average calculation.

Common sense would seem to dictate that this calculation should only be required to be performed once a year, not on a rolling basis and that the yearly calculation need only be performed once the relevant information necessary for the calculation is available. For example, if a bank's reports on relationship to total compensation are available January 31st for a bank with a fiscal year that coincides with the calendar year that bank would be required to perform the calculation on an annual basis on or about January 31st. So that the requisite systems can be developed in a timely and least burdensome manner, we request confirmation of our understanding.

D. Bank-Wide Exemption

As noted above, we credit the Agencies with developing a workable bank-wide exemption that will not require banks to perform an account-by-account analysis of their compensation. However, large institutions may operate different lines of business – all within the trust department of the bank—in different geographic locations using different operating and reporting platforms. For example, private banking and corporate trust divisions would all be within a bank's "trust department," but would typically be managed separately, be located

[32] We also reserve the right to approach the Agencies regarding other situations involving foreign branches which may deserve appropriate statutory and/or regulatory exemptive relief.

in different locations (possibly even different cities), and use different management reporting systems. While the operations of the various lines of business within a trust department will all roll up into the trust department's operating results, it may be more difficult to aggregate the kind of detailed MIS data needed to calculate conformance with the bank-wide exception.

Accordingly, we suggest that the agencies consider permitting banks to apply the bank-wide exemption on a "line of business" basis, where there is an identifiable department, unit or division of the bank organized and operated on an ongoing basis for business reasons with similar types of accounts. This would allow the bank to calculate conformance with the bank-wide exemption among a small number of well-defined business units, or use the bank-wide exemption for one or two large business units while using the account-by-account basis for smaller or less complex units.

Similar flexibility should be given to allow those banking organizations that choose to perform the bank-wide calculation on a holding company basis. A strict reading of proposed Rule 721 would suggest that the calculations may only be performed on a bank entity level basis. It may make more sense for some organizations that have, for example, more than one banking institution subsidiary, to perform this calculation on an enterprise-wide basis. Flexibility to analyze chiefly compensated on holding company basis should similarly extend to any line of business analysis.

E. Other

Questions have arisen among our members regarding the ratio of relationship to total compensation. Under the account-by-account formulation proposed in Rule 721 (a)(1), all compensation to be measured is based on what is attributable to trust and fiduciary "accounts." The bank-wide exemption of proposed Rule 722(a)(2) provides, however, that compensation is to be measured for the bank's trust and fiduciary business. With respect to the bank-wide exemption, we assume that the Agencies contemplated that bank trust and fiduciary departments will add up all relationship compensation received for each trust and fiduciary account and that number would form the numerator, while the denominator – total compensation – would consist of all compensation received for those trust and fiduciary accounts. We request clarification of our understanding.[33]

[33] We also suggest that Rule 722(c) read: "Yearly bank-wide compensation percentage. For purposes of this section, a bank's yearly bank-wide compensation percentage for a year shall equal the relationship compensation attributable to trust and fiduciary *accounts for which the bank is relying on the trust and fiduciary exemption and maintained as part of the bank's trust and fiduciary business* as a whole during the year divided by the total compensation attributable to *trust and fiduciary accounts for which the bank is relying on the trust and fiduciary exemption and maintained as part of* the bank's trust and fiduciary business as a whole during that year, with the quotient expressed as a percentage." [Emphasis added to show suggested changes.]

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 those of our members that do not have trust powers and, thus, cannot satisfy that aspect of the exception that requires the bank to be regularly examined by bank examiners for compliance with fiduciary principles and standards, yet are permitted under rules of the Internal Revenue Service to serve as trustee for IRA accounts.[34] 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.

3. SAFEKEEPING AND CUSTODY EXCEPTION

GLBA excepts from broker registration various activities conducted by banks in connection with safekeeping and custody services. These services, long provided by banks as part of their customary banking activities, are defined as: (1) providing safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers; (2) facilitating the transfer of funds or securities as custodian or clearing agency, in connection with the clearance and settlement of its customer transactions in securities; (3) effecting securities lending or borrowing transactions with or on behalf of customers in connection with providing safekeeping, custody and clearing activities; (4) investing cash collateral pledged in connection with securities lending or borrowing transactions; holding securities pledged by a customer to another person (e.g., to the bank as collateral for an extension of credit or other secured transaction), or securities subject to purchase or resale agreement for a customer, or facilitating the pledging or transfer for such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; or (5) serving as custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.

Proposed Rule 760 would allow banks, subject to certain conditions, to accept orders for securities transactions from custodial customers. While we continue to question the need for this exemption, as the Congress clearly contemplated providing banks, under the statute,[35] with the ability to continue to

[34] To convert these accounts to IRA custodial accounts and, thus, except them 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 IRA trust customers to request that they readopt the new IRA plans.

[35] Order-taking is permitted as it has long been recognized as a customary banking activity. Further support for the notion that order-taking is permitted under the statute can be found in GLBA. For example, Section 3(a)(4)(C) of the Exchange Act directs banks and trust companies conducting securities transaction under the auspices of the safekeeping and custody exception to transmit certain publicly-traded security buy or sell orders to a registered broker-dealer for

provide order-taking services for custodial clients, we believe the scope of the proposed exemption is very much improved from earlier proposals that would have allowed order-taking for a narrow universe of employee benefit plans and certain "qualified investor" customers.

We note that the narrative portion of the release makes quite clear that a bank that is engaged in non-order taking custodial services need not rely on the exemption provided by proposed Rule 760. These services are excepted under the statute itself.

The proposal distinguishes order-taking services provided to employee benefit plans and similar accounts from order-taking services provided as an accommodation to all other custodial clients. More restrictive conditions attach to the latter.

A. <u>Employee Benefit Plans, Individual Retirement and Similar Accounts</u>

We are quite pleased that the definition of "employee benefit account" and "individual retirement account or similar account" includes the full panoply of employee benefit plans that a bank custodial department might typically service. These plans include not only the traditional defined benefit and defined contribution plans, but also church plans, rabbi and secular trusts, deferred compensation plans, and supplemental or mirror plans, to name just a few. We are equally pleased to see that traditional and Roth IRAs, as well as health savings accounts, medical savings accounts, and education savings accounts are also included within the exemption. We had previously suggested this change as banks organize and operate their employee benefit business without distinction as to whether the plans are qualified under applicable Internal Revenue Code (IRC) provisions or not. Also the "without limitation" language in paragraph (g)(3) of the exemption makes clear that banks, satisfying the conditions of the exemption, may provide order taking services for any other employee benefit plans not listed. Because the Congress frequently revises those provisions of the IRC governing tax-favored savings accounts, we would suggest that some sort of similar language allowing for successor plans be added to paragraph (g)(4). For example, the Administration, in its latest Budget submission to the Congress, has suggested that the Congress amend the IRC to provide for lifetime savings accounts (LSAs), retirement savings accounts (RSAs), and employer retirement savings accounts (ERSAs). These tax-favored accounts would replace many of the accounts described in paragraph (g)(4). Similarly, we would suggest that banks be able to provide order-taking services for escrow, issuing and paying agent, tender agent, and agent for disbursement accounts, or any similar non-trust and fiduciary account for which the bank holds securities in custody, regardless of the name of

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execution. If banks were not taking orders from custodial customers, there would be no need for any legislative requirement to direct the transaction to a registered broker-dealer, as the instruction to DVP/RVP securities would come from the customer's broker-dealer in the first instance.

the account, and that the less restrictive conditions of proposed Rule 760(a) attach to these accounts.[36]

As the Agencies recognize, it is not uncommon for bank trust departments to outsource various aspects of their business, including their custodial services to third-parties.[37] A bank providing custodial services to a third-party bank trust department should, we would submit, be able to provide order-taking services to those institutions under the same conditions as banks that serve as custodians to employee benefit plans and similar accounts. In this situation, the bank providing custodial services is a service provider to the outsourcing bank, not the beneficial owners, and, as such, does not interface with the beneficial owners. The Agencies should provide that, in those situations, where a bank serves as custodian for a third-party or affiliated bank trust department or trust company, there is no need for the more restrictive conditions, particularly the bank fee limitations of proposed Rule 760(b)(3), associated with accommodation trades, as it is the banking organization, not the individual investor, that is placing the order with the custodian bank.

The employee compensation restrictions appear workable, especially as they do not prohibit a bank employee from receiving compensation that recognizes the employee for his efforts in selling the bank's custodial services,[38] as well as bonuses and referrals permitted under proposed Rules 700 and 701. The exemption also properly recognizes that some banks function as non-fiduciary and non-custodial administrators and recordkeepers for employee benefit plans and provides for an exemption for these banks.

One of the conditions imposed on administrator and recordkeeper order taking is that they must not execute a cross-trade with or for the employee benefit plan. The Agencies justify this prohibition by stating that executing cross-trades involves setting prices for securities transactions. We disagree most strongly with this statement.

GLBA specifically prohibits banks from executing certain securities transactions on behalf of trust, fiduciary and custodial clients. Execution must be done by a broker-dealer. But, as noted in the proposing release, the Act makes clear that certain cross trades do not constitute execution of securities transactions. Specifically, the statutory exception for cross trades requires that: (1) it be made by the bank or between the bank and an affiliated fiduciary; and (2) it not be in contravention of fiduciary principles established under applicable state

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[36] A bank providing non-order taking custodial services for these accounts need only rely on the statutory exception, the money market mutual fund exemption provided in proposed Rule 741, if applicable, or any other GLBA exception or proposed Regulation R exemption.

[37] *See* fn 76 at 71 Fed. Reg. 77522, 77529 (December 26, 2006).

[38] The release makes clear that this compensation may be based either on the customer establishing a custodial account with the bank or on the total amount of assets in the account at opening.

or federal law. By excepting these cross-trading activities from the GLBA securities execution requirement, the Congress not only recognized the traditional securities role banks have undertaken with respect to their trust and custodial clients, but also by implication, that cross-trading does not constitute securities transaction execution and all that that term entails.[39] As a result, cross-trading does not involve setting prices for securities transactions. Our position is further supported by the Commission's own Rule 17a-7[40] under the Investment Company Act, which permits cross-trades between affiliated mutual funds subject to certain conditions, such as the use of reported prices. The adopting release should eliminate this condition and make clear that cross-trading as permitted under GLBA and fiduciary principles established under DOL guidance, the Investment Company Act or other applicable law does not involve setting prices for securities transactions.

B. Accommodation Orders

For all non-employee benefit plan and tax-favored accounts, proposed Rule 760(b) would exempt from broker registration any bank that accepts securities orders for custodial accounts only as an accommodation to that customer. To ensure that the bank only accepts accommodation orders, the federal banking agencies plan to issue examiner guidance describing the types of policies, procedures, and systems that the bank should have in place. Accommodation orders would be subject to the same restrictions that apply for order-taking activities engaged in on behalf of employee benefit plan and tax-favored accounts. Additional restrictions would also apply, two of which we discuss below.

The proposal would place restrictions on the fees banks could earn for providing order-taking services. Appropriately, the bank fee restrictions do not restrict a bank from charging the client a fee for providing the order-taking service that varies based on the type of security purchased or sold. It is not uncommon for a bank to vary fees charged based on whether the security is foreign or domestic, or publicly-traded.[41]

In addition, the proposal limits the ability of banks to provide investment advice or research to, make recommendations to, or solicit securities transactions from, the account. This limitation is properly tempered to allow banks to cross-market investment management services, including sharing examples of investment research prepared by the trust department for trust and fiduciary

[39] Certain cross-trading is also allowed for ERISA fiduciary accounts. U.S. Dep't of Labor, Prohibited Transaction Exemption 2002-12 (Feb. 12, 2002); *See also* Section 611(g) of The Pension Protection Act, Pub. L. No. 109-280.

[40] 17 CFR 270.17a-7.

[41] Consistent with the optionality feature of the GLBA exceptions and most of the Regulation R exemptions, the fee restrictions would not apply to those banks that come within the GLBA safekeeping and custodial exception.

customers. The ability to cross-market these services is very important to the banking industry and proposed Rule 760 should explicitly provide that cross-marketing is permitted. Moreover, providing custodial customers with an array of investments, e.g., mutual funds, from which to choose would not constitute investment advice or recommendations.

We do have some compliance concerns with this provision that warrant the Agencies' attention. Many customers have separate trust and safekeeping/custody accounts. Surely, a bank cannot be found to have violated the proposal's limitation on providing investment advice or research, if a customer receives investment research or general newsletters containing financial advice, in his trust customer capacity, and then chooses to act upon that research or advice through his or her custodial account. We request confirmation of our understanding.

C. Carrying Broker Activities

GLBA's 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." Proposed Regulation R does not address the meaning of the term "carrying broker" for the purposes of this provision. We request that the Agencies commit in the Final Rule not to adopt or adhere to any separate or joint interpretation of GLBA's "carrying broker" provision, until and unless they jointly issue notice, and provide an opportunity to comment, on a proposed joint interpretation.

In particular, we note that the Commission had previously proposed to interpret "carrying broker" in an overly broad and impractical manner in Regulation B.[42] As provided by the Financial Services Regulatory Relief Act, that interpretation will be nullified upon the Agencies adoption of Regulation R. The Commission's interpretation of GLBA's "carrying broker" provision was highly objectionable and unworkable for the industry because it failed to take into account that customers obtain brokerage and custody services from the same or affiliated institutions in order to enjoy the cost-savings and improved service that result from close coordination of the two functions. In this regard, bank custodians and their affiliated brokers have an overlapping customer base, and share many of the same back-office functions. Because brokers and custodians require many of the same systems for their operations, systems that already exist inside many bank custodians, it would have been wasteful and inefficient to force brokers to build duplicate systems and to compel customers to use unaffiliated custodians to avoid the bank's loss of the safekeeping and custody exception.

[42] *See* Release No. 34-49879, 69 Fed. Reg. 39682, 39711-13 (June 30, 2004).

Such a result would have undermined the principal purposes of GLBA, among which are "increased efficiency for financial services providers, and more choices and lower costs for consumers."[43] At the time of GLBA, the Congress recognized that "[a]s the various sectors of financial services converge, providers of financial services are seeking to serve customers better by combining those sectors in one organization."[44] In enacting GLBA, the Congress accordingly sought to repeal "existing statutes [that] create impediments and inefficiencies for the affiliations occurring in the marketplace."[45] Moreover, the Board's interpretations clearly recognize the synergies between banks and affiliated broker-dealers. This recognition was most recently acknowledged by the Board staff a few months ago in a letter to E*Trade Bank.[46]

In sum, the Congress clearly did not intend the "carrying broker" provision to thwart the goals of eliminating artificial barriers and inefficiencies between banks and affiliated financial service providers. The Board's interpretations in analogous contexts are mindful of the same concerns. We request that the Agencies commit in the Final Rule not to adopt or adhere to any separate or joint interpretations of GLBA's "carrying broker" provision, until and unless they jointly issue notice, and provide an opportunity to comment, on a proposed joint interpretation.

4. SECURITIES LENDING EXEMPTION

In recognition that it is no longer uncommon for a customer to divide custody and securities lending management between two entities, proposed Rule 772 provides an exemption for securities lending services when the bank is NOT also performing custodial services for the customer. We would strongly encourage the Agencies to affirm explicitly in the final rule's preamble that the requirements under the exemption for securities lending activities conducted as agent in the non-custodial context do not apply to the securities lending management activities of custodians. There has been some confusion due to the use of the term "agent" in proposed Rule 772 that has led some to believe that banks acting in a custodial capacity must also follow the exemption when conducting securities lending services for the same customer. We believe that footnote 115 of the release makes it perfectly clear that this is not the case but

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[43] S. Rep. No. 106-44 at 6 (1999).
[44] *Id.* at 4.

[45] *Id.* at 5.

[46] *See e.g.,* Letter to John A. Buchman, General Counsel, E*Trade Bank, from Robert deV. Frierson, Deputy Secretary of the Board (Oct. 24, 2006), at 11-12 (noting that the Board has granted exemptions from § 23A for securities-borrowing and securities-lending activities between bank and an affiliate); *see also id.* ("Granting the exemptions would benefit the public because cost and operational efficiencies would result from Bank's maintaining Clearing as a subsidiary. ETFC has stated that it would be able to pass on a portion of those savings to customers in the form of lower brokerage commissions, higher yields on deposit products, additional product innovation, or enhanced product functionality and customer service.").

would suggest that this statement be contained in a preamble to Rule 772 in order to quash any further confusion.

5. BROKER-DEALER EXECUTION

To qualify for the trust and fiduciary and custody exemptions, GLBA requires trades conducted under these exemptions to be directed to a registered broker-dealer for execution. However, because securities of most mutual funds are neither traded on a national securities exchange nor through the facilities of a national securities association or an inter-dealer quotation system, Rule 775 permits these trades to be effected either through the NSCC or directly through the mutual fund's transfer agent, provided that: (1) the shares are distributed by a registered broker-dealer, and (2) the sales charge is limited to what the broker-dealer could charge under applicable regulations.[47] We are appreciative of the fact that the Agencies recognize the realities of the distribution system for mutual fund shares and have crafted Rule 775 accordingly.

We have, however, recently become aware of an additional situation in which distribution is not accomplished through registered broker-dealers. The purchase and sale of variable annuities that are held in insurance company separate accounts is often accomplished directly with the issuing insurance company. In such situations, it is the insurance company that maintains policy-holder records, acting, in effect, as the transfer agent for the variable annuities it issues. Alternatively, settlement may be accomplished through settlement services offered by NSCC to insurance companies. We recommend that the agencies expand the scope of Rule 775 to include variable annuities.

Variable annuities and mutual funds are the only permissible investments for defined contribution plans established under section 403(b) of the Internal Revenue Code by tax-exempt nonprofit employers. The annuity component under such plans is intended to provide lifetime income for plan participants. Absent an expanded scope of Rule 775, transactions in variable annuities under such plans would have to be routed through a registered broker-dealer, thus raising transaction costs. We believe that the broader scope of Rule 775 is warranted

6. MONEY MARKET MUTUAL FUND EXEMPTION

We support the Agencies' proposal to exempt banks effecting transactions in money market mutual funds from broker registration. We believe the proposal will allow banks to continue to offer customers the ability to sweep excess cash from deposit or custodial accounts into money market funds on a daily basis.

[47] As discussed above, many, but not all, collective funds for employee benefit plans are traded on the NSCC platform. However, as exempted securities, shares in collective investment funds are not subject to the GLBA's broker-dealer execution requirements or the exemption provided by proposed Rule 775.

This exemption is important as bank customers continue to look for products and services that allow them to manage their daily liquidity needs.

We would, however, request that the prospectus delivery requirements contained in proposed in Rule 741(a)(2)(ii) be revised to conform with current industry practices, namely that the prospectus should be required to be delivered prior to or at the time of purchase, not at the time of customer authorization to enter into the transaction.

7. REGULATION S

The Agencies have proposed an exemption from broker registration that would permit US banks and US branches and agencies of foreign banks to sell Regulation S qualified securities to non-US persons.[48] Regulation S specifies the requirements for an offer or sale of securities to be deemed to occur outside the United States and therefore not subject to Securities Act registration requirements and permits the sale of newly issued off-shore securities and re-sales of off-shore securities from a non-US person to a non-US person.

We fully support the proposed exemption for the reasons identified by the Agencies, namely that non-US persons typically do not rely on the protections of the US securities laws when purchasing Regulation S securities from US banks and that non-US persons can generally purchase the same securities from banks located outside of the United States and would not have the protections of the US securities laws when purchasing these securities off-shore.

We also wish to be associated with the comments submitted by the Institute of International Bankers (IIB) regarding the Regulation S exemptions from broker and dealer registration, particularly its request that the Agencies clarify that the definition of "eligible security" in proposed rule 771 does not prohibit a Bank from selling securities that are being or have been issued by an affiliate. We further note that the IIB's request for clarification that compensation for a transaction that qualifies under the Regulation S exemption when effected by a bank acting in a fiduciary capacity should not be included within the "chiefly compensated" calculation under the trust and fiduciary exception or the bank-wide exemption of proposed Rule 722 is consistent with comments we have made elsewhere in this letter.

8. AMENDMENTS TO BANK DEALER EXEMPTIONS

In conjunction with the proposed bank exemptions from the definition of "broker" under GLBA, the Commission is proposing to amend certain provisions of its 2003 final rule implementing the bank "dealer" exemptions of GLBA. In this connection, we recommend that the Commission adopt an additional

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[48] A complementary exemption from dealer registration is also proposed. *See* proposed Rule 3a5-2, Rel. No. 34-54947, 71 Fed. Reg. 77550, 77555-56 (December 26, 2006).

exemption from the definition of "dealer" under the Exchange Act solely to permit banks to enter into repurchase and reverse repurchase transactions (collectively referred to as "repos") in debt securities, e.g., corporate debt, that are not "exempted securities" under section 3(a)(12) of the Act. We believe that such an exemption for repo transactions in non-exempt securities is warranted because it would further the fundamental principle of functional regulation embodied in GLBA by treating repos as what they, in fact, are—traditional bank financing activities.

Repos functionally serve the same financing purposes as cash loans for which securities are pledged as collateral. For example, in both instances, the lender—party that originally owns the securities—retains the beneficial ownership of the securities, including the right to any income thereon. Repos are used by market intermediaries and investors to finance their own securities positions or to finance the securities position of others. For example, banks may use repos to extend credit to customers, to finance extensions of credit to customers, or to finance their own fixed income portfolios. However, because in repo transactions ownership of the securities is actually transferred, the Commission views this activity as a "dealer" function.

One of the primary goals of GLBA was to provide exemptions from the definitions of "broker" and "dealer" to enable banks to continue to offer the traditional banking products and services that they had long provided to their customers. We believe that providing financing through repo transactions is such a service.

Given that repo transactions are the functional equivalent of secured loans—clearly a traditional bank product—it could be argued that banks may continue to provide this service by transforming repo transactions into secured loans. However, doing so would cause banks to lose significant risk mitigation benefits derived from the repo structure. For example, the non-defaulting party in a repo may have substantially better rights under the Bankruptcy Code than a creditor whose loan is secured by exactly the same securities.[49] In other cases, governing documents may permit an investor to enter into repo transactions, but not secured loans.

Both the securities markets and investors would be served by adopting an exemption permitting banks to engage in repo transactions in non-exempt securities. Under the current dealer exemption, banks may engage in repo transactions on government securities or other exempted securities without registering as dealers under the Act,[50] and we can see no reason why a change in

[49] Under the Bankruptcy Code, transactions that qualify as "repurchase agreements" or "securities contracts" are not subject to certain provisions, such as the automatic stay, that may impair a creditor's rights.

[50] Under the current rules, banks are exempt from dealer registration when they buy and sell certain securities, including "exempted securities." "Exempted securities" include government securities, municipal securities, and interests or participations in common or collective trust funds.

the underlying collateral should necessitate dealer registration. Rather, we believe the dealer registration requirement would unduly disrupt participants in this market with no concomitant benefit—in effect elevating form over substance.

Accordingly, we believe that such an exemption for repo transactions is warranted because it would effectuate functional regulation by recognizing repos as traditional bank financing products.

CONCLUSION

In conclusion, the ABA and ABASA appreciate the dedicated and collaborative efforts of the Agencies and their staff in issuing this improved proposal that has clearly responded to many of the concerns raised by the banking industry. Overall, we believe that with the revisions we have suggested herein, Regulation R should be workable for our membership. We are also encouraged by the Agencies' pledge of continued collaboration on future regulatory actions and believe that collaboration should be expanded to include enforcement actions involving new interpretations of GLBA and Regulation R. Finally, we strongly urge the Agencies to address, in a timely manner, the dual employee issue that we have previously raised and renew in this letter.

Sincerely yours,

Sarah A. Miller

Thus, banks may freely engage in repo and reverse repo transactions that involve exempted securities without registering as dealers.