ABA Section of
BUSINESS LAW
Practical Resources for the Business Lawyer

Defending Liberty
Pursuing Justice

AMERICAN BAR ASSOCIATION

Section of Business Law
321 North Clark Street
Chicago, Illinois 60610-4714
(312) 988-5588
FAX: (312) 988-5578
e-mail: businesslaw@abanet.org
website: www.ababusinesslaw.org

ASSOCIATION YEAR 2006-2007
CHAIR
Linda Hayman
Four Times Square
New York, NY 10036-6518
CHAIR-ELECT
Charles E. McCallum
900 Fifth Third Center
111 Lyon Street, NW
Suite 900
Grand Rapids, MI 49503-2487
VICE-CHAIR
Karl J. Ege
909 A Street
Tacoma, WA 98402-5111
SECRETARY
Nathaniel L. Doliner
4221 W Boy Scout Boulevard
Suite 1000
Tampa, FL 33607-5765
BUDGET OFFICER
Renie Yoshida Grohl
8300 Fox Hound Run, NE
Warren, OH 44484
IMMEDIATE PAST CHAIR
Hon. Alvin W. Thompson
450 Main Street
Hartford, CT 06103-3022
SECTION DELEGATES TO THE HOUSE OF DELEGATES
Myles V. Lynk
Tempe, AZ
Maury B. Poscover
St. Louis, MO
Hon. Elizabeth S. Stong
Brooklyn, NY
COUNCIL
Lynne B. Barr
Boston, MA
Conrad G. Goodkind
Milwaukee, WI
Hugh H. Makens
Grand Rapids, MI
Rita Ross
Washington, DC
Mike Sigal
Scarsdale, NY
Stanley Keller
Boston, MA
Linda J. Rusch
Spokane, WA
Karol K. Sparks
Chicago, IL
Heidi M. Staudenmaier
Phoenix, AZ
Willard K. Tom
Washington, DC
Arthur N. Field
New York, NY
Kathleen J. Hopkins
Seattle, WA
Mary Ann Jorgenson
Cleveland, OH
Martin E. Lybecker
Washington, DC
Vincent I. Polley
Bloomfield Hills, MI
William H. Clark, Jr.
Philadelphia, PA
Donald W. Glazer
Newton, MA
Stephanie A. Heller
New York, NY
Dixie L. Johnson
Washington, DC
William B. Rosenberg
Montreal, QC

BOARD OF GOVERNORS LIAISON
Don S. De Amicis
Boston, MA

YOUNG LAWYERS DIVISION LIAISONS
S. Kendall Butterworth
Atlanta, GA
Sunil R. Harjani
Chicago, IL

LAW STUDENT DIVISION LIAISON
Jermaine A. Carroll
Provo, UT

SECTION DIRECTOR
Susan Daly
Chicago, IL
(312) 988-6244
suedaly@staff.abanet.org

April 3, 2007

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
2007 APR 16 P 3: 54
RECEIVED
OFFICE OF THE SECRETARY

Nancy M. Morris, Esq.
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0504

Re: Proposed Regulation R (File Number S7-22-06)

Ladies and Gentlemen:

On behalf of the Committees on Federal Regulation of Securities and Banking Law of the Section of Business Law of the American Bar Association (the "Committees"), we are writing to express our views with respect to Proposed Regulation R, issued jointly by the Securities and Exchange Commission ("Commission") and the Board of Governors of the Federal Reserve System ("Board") to implement certain portions of Title II of the Gramm-Leach-Bliley Act of 1999 ("GLB Act").[1] This letter was prepared by a task force of members of the Committees whose names are set forth below, and the members are available to discuss the matters presented herein with the Commission and the Board and their respective Staffs.[2] The comments expressed in this letter are the comments of the Committees only, and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, they do not represent the position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committees on every comment herein.

---

1 Securities Exchange Act Release No. 54946 (December 18, 2006), 71 Fed. Reg. 77522 (December 26, 2006) ("Proposing Release").

2 Each of the members of the task force is in the private sector, and although many of the concerns expressed in our comments are shared by many of our clients -- state- and federally chartered banks, trust companies, thrifts, credit unions, and their affiliated securities firms -- we have sought to provide an independent perspective on the issues raised by Proposed Regulation R.

We wish to preface our comments by noting that we believe Proposed Regulation R goes a long way toward striking an appropriate balance between two important principles: (i) the need for investor protections for persons using banks to effect securities transactions, and (ii) the Congressional mandate in the GLB Act to leave untouched certain preexisting securities activities of the banking industry. Indeed, we commend the Commission and the Board for their collaboration in proposing functional regulations that appropriately provide banks with the ability to conduct their traditional bank securities activities without sacrificing investor protection. Although Proposed Regulation R is still complex, we understand and appreciate (i) the efforts of the Commission and the Board to harmonize traditional bank securities regulations in a manner that is consistent with the investor protection framework of the Securities Exchange Act of 1934 ("Exchange Act") and (ii) the decision to abandon the unnecessarily complicated, overly-detailed rules that comprised Proposed Regulation B.[3] We believe Proposed Regulation R better balances investor protection concerns and business practicalities in a manner that benefits both investors and businesses alike. In particular, we especially applaud the Commission and Board for their decision to include payments made to banks pursuant to Rule 12b-1 Plans[4] in the definition of "relationship compensation" under the trust and fiduciary activities exception and to provide a safe harbor for "sweep" transactions into those money market funds that do not meet the definition of "no load" in applicable NASD rules -- two key problem areas that previously were identified during the comment period on Proposed Regulation B. We appreciate the opportunity to provide comments addressing the remaining areas of Proposed Regulation R that we believe would still benefit from clarification from the Commission and the Board. Given the length of time it has taken to get to Proposed Regulation R, we believe that it is in the public interest for industry participants and legal practitioners to understand fully the intended scope of Proposed Regulation R to avoid inadvertent violations thereof.

---

[3] Securities Exchange Act Release. No. 49879 (June 17, 2004), 69 Fed. Reg. 39682 (June 30, 2004).

[4] Rule 12b-1 Plans are adopted by registered investment companies pursuant to the requirements of Rule 12b-1 under the Investment Company Act of 1940, as amended. 17 C.F.R. § 270.12b-1 (2007). A Rule 12b-1 Plan must be adopted where the payments are "primarily intended" to pay for distribution.

Comments of the Committees

I. Third Party Brokerage Arrangements

A. The Meaning of "Associated Person" for Purposes of Proposed Regulation R

Proposed Regulation R sets forth a variety of limits on the type of fees that may be received by a bank's unregistered employees in connection with securities transactions. In describing certain of these limitations, Proposed Regulation R and the Proposing Release use the term "associated person" or similar language in what we believe may be an inconsistent, or at least ambiguous, manner.

Specifically, we believe the following two proposed rules and statement in the Proposing Release are in need of clarification. First, Rule 701(a)(1)(i)(A), which governs referral fees in connection with institutional or high-net worth referrals, provides that, in order to receive a greater than nominal referral fee, a bank employee must, among other things, not be qualified or otherwise required to be qualified pursuant to the rules of a self-regulatory organization.[5] It is unclear if this language is intended to mean that a bank employee must not be an associated person of a broker-dealer as discussed below, or if it is intended to mean more narrowly that a bank employee must not be required to register as a registered representative. Second, Rule 701(a)(2)(iii) provides that, before the bank employee is paid a greater than nominal referral fee, the bank must provide the broker-dealer with sufficient information to allow the broker-dealer "to determine whether the bank employee is associated with a broker or dealer or is subject to statutory disqualification . . ."[6] These two provisions both reference the required status of bank employees, but each provision uses what appears to be different, or at least potentially different, standards. Finally, the Proposing Release explains that the limits on a bank employee receiving compensation in connection with securities transactions applies only to unregistered bank employees, and the phrase "unregistered employee" in the context of Proposed Regulation R is defined to mean "an employee that [sic] is not an associated person of a broker or dealer and is not qualified pursuant to the rules of a self-regulatory organization."[7]

---

5 Proposed Rule 701(a)(1)(i)(A).

6 Proposed Rule 701(a)(2)(iii).

7 *See* Exchange Act Release No. 54946, 71 Fed. Reg. 77522, at 77524, n. 11.

It is important to understand that the definition of "associated person" in the Exchange Act is quite broad: "associated person of a broker or dealer means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) [of the Exchange Act] (other than paragraph (6) thereof)."[8]

The term "associated person" has been given an expansive interpretation in other contexts. Indeed, due to its facial breadth, the term "associated person" has been the subject of a large body of interpretive guidance and case law. In other contexts, the ambiguity surrounding the scope of the phrase "associated person" has caused significant interpretive difficulties for industry participants and legal practitioners.[9] In light of the potential breadth of this term and the historical uncertainty surrounding its scope, we believe that it would be appropriate for the Commission and the Board to provide additional guidance on who would be an "associated person" for the purposes of Proposed Regulation R.[10] Similarly, we recommend that the Commission and the Board provide additional guidance on the

---

[8] Section 3(a)(18) of the Exchange Act.

[9] For example, the series of no action letters interpreting the scope of the phrase "associated person" in the context of Rule 3a4-1 reflects the complexity and interpretive difficulties faced by industry participants and legal practitioners in interpreting the phrase. *See, e.g.,* Legacy Motors, SEC No-Action Letter (July 31, 1991); St. Paul Federal Bank for Savings, SEC No-Action Letter (October 13, 1988); Chevy Chase Savings Bank, SEC No-Action Letter (December 28, 1986); Old Stone Corporation, SEC No-Action Letter (January 7, 1985).

[10] The Staff of the Commission and the Board have spoken before various groups to explain and discuss Proposed Regulation R. In those contexts, the Commission's Staff has suggested in unofficial remarks that the term "associated person" would be construed more narrowly for purposes of Proposed Regulation R than it would be construed for the broader purposes of other provisions of the Exchange Act. Specifically, it was suggested that the term as used in Proposed Regulation R should be interpreted to include only persons registered with a broker-dealer. *See*, Is *Your Bank Ready for the Bank Broker Rules (aka the Push Out Rules)?*, ABA/ABASA Telephone Briefing (Jan. 17, 2007). If this is the official position of the Commission and the Board, we urge that the Commission and the Board make this clear in the final rule to avoid any potential confusion.

provisions of Proposed Rule 701 discussed above, and in particular clarify the conditions that an employee of a bank must satisfy before receiving greater than nominal referral fees.

B. Imposing a Suitability Requirement on Executing Broker-Dealers

Proposed Regulation R requires banks and broker-dealers to include certain provisions in their written networking agreements that obligate the bank or the broker-dealer to take certain actions.[11] In particular, Proposed Rule 701(a)(3)(ii) provides that the written agreement between a bank and a broker-dealer must require the broker-dealer to perform a suitability or sophistication analysis of the securities transactions being referred to it, depending on whether a referral fee is contingent on the completion of a securities transaction.

In all cases where referral fees are to be paid contingent on completion of a transaction, the written agreement between the parties must require the broker-dealer to conduct a suitability analysis in accordance with the rules of the broker-dealer's applicable self-regulatory organization as if the broker-dealer had recommended the transaction. Significantly, the broker-dealer may rely on any applicable SRO rule or interpretation that provides for an alternative suitability analysis, such as that described in NASD Conduct Rule 2310.[12] While NASD Conduct Rule 2310 only requires broker-dealers to assess the suitability of transactions that they actually recommend, Proposed Rule 701(a)(3)(ii) would require a broker-dealer to make a suitability determination regardless of whether the broker-dealer recommended the transaction. Where the compensation to be paid to the bank employee is not contingent on the transaction, before paying the referral fee the broker-dealer must conduct a sophistication analysis or analyze the suitability of all securities transactions requested by the customer contemporaneously with the referral.[13] If the broker-dealer opts to meet this obligation by conducting a sophistication analysis, it must determine that (1) the customer has the capacity to evaluate the investment risk and make an independent decision(s); and (2) the customer is exercising independent judgment based on the customer's assessment of the risks and opportunities, market factors, and other relevant considerations attendant to that proposed investment.[14]

---

[11] *See* Proposed Rule 710(a)(3).

[12] *See* Exchange Act Release No. 54946, 71 Fed. Reg. 77522, at 77527, n. 50.

[13] Rule 710(a)(3)(ii)(A) and (B).

[14] Exchange Act Release No. 54946, 71 Fed. Reg. 77522, at 77527.

We assume that the Commission and the Board are seeking to protect investors by establishing a process that will cause a registered broker-dealer to assess the suitability of a proposed transaction for an individual investor, but Proposed Regulation R will have the burdensome and potentially unworkable and costly effect of requiring broker-dealers who do not make recommendations to assess the suitability of certain bank customers' transactions. Indeed, many "discount" or "execution-only" broker-dealers deliberately avoid recommending securities transactions to customers in order to avoid having to assess the suitability of their clients' transactions. These broker-dealers may not have the means to begin performing the suitability analyses required by Proposed Regulation R, or may refuse to provide execution services for such persons if they are going to be required to be responsible for suitability assessments of bank customers whose only relationship to the broker-dealer involves the actual execution of transactions. Thus, we are concerned that, as written, Proposed Regulation R will cause "execution-only" broker-dealers to eschew establishing networking arrangements with banks, and bank customers will be deprived of the opportunity to take advantage of their "low-cost" services. In light of this, we urge the Commission and the Board to consider whether any suitability obligation is necessary in the absence of a recommendation by a broker-dealer. As drafted, Regulation R already limits what a referrer can say to a referred customer. Given the current limitations on referring bank employees, it is not necessary to require broker-dealers to assess the suitability of referred transactions they did not recommend.

C. Payments to Employees Other Than Those Making Referrals

Although Proposed Regulation R provides greater clarity on the scope of permissible referral fees that may be paid to an unregistered bank employee who refers customers to affiliated broker-dealers, Proposed Regulation R is silent on whether referral fees may be paid to other employees, such as branch managers or other bank supervisors. We would ask the Commission and the Board to consider whether referral fees earned by a bank or bank employee may be allocated in part to the supervisors of the employee making the actual referrals. In our experience, bank supervisors are often compensated in part on the basis of revenue generated by those whom they supervise; we believe referral fees should continue to be eligible for inclusion in the compensation that may be paid to supervisors. In addition, other bank personnel may have developed banking relationships with the customer before an actual referral is even made, and so should be allowed to be compensated based in part on these prior relationships. We suggest that the Commission and the Board consider clarifying Proposed Regulation R to allow a bank to have the discretion to provide at least a portion of the referral fee to any unregistered bank employee who directly or indirectly assisted with the referral. We believe such allocations are not likely to create an inappropriate "salesman's stake" in bank personnel. Moreover, given the limitations in the definition of incentive compensation in Proposed Rule 700(b)(1)(C) -- which prohibits bonus plans from taking other persons' referrals into

account -- it appears that bank managers and similar employees will not be able to receive any form of compensation for the securities activities of their employees if they are not permitted to share in the referral payments.

II. Trust and Fiduciary Activities

A. Use of Grandfathering Exemptions

Proposed Regulation R permits banks to exclude certain accounts when making the "chiefly compensated" determination, including accounts that have been open for three months or less and accounts that have recently been purchased. Unlike Proposed Regulation B, however, Proposed Regulation R does not exempt any personal or charitable trust accounts from the "chiefly compensated" requirement. As the Commission noted when proposing Regulation B, many banks serve as a fiduciary for pre-existing personal trust accounts and estates that have terms that cannot readily be changed without adverse consequences to the bank and trust beneficiaries.[15] Because we believe banks still need this additional flexibility, we ask that the Commission and the Board consider providing a "safe harbor" for all personal trust accounts and estates and charitable trust accounts opened before the date when Regulation R is finally adopted.

In addition, we suggest that the Commission and the Board consider exempting other accounts from the "chiefly compensated" test, at least for a limited period of time. We believe this is appropriate because the tests to determine compliance with the "chiefly compensated" requirement in Proposed Regulation R are based, at least in part, on operations in the years before the calculation is being made.[16] In other words, a bank's operations in the year before Regulation R's

---

[15] *See* Exchange Act Release. No. 49879, 69 Fed. Reg. 39682, at 39696.

[16] For example, a bank assessing compliance with the "chiefly compensated" requirement on an account-by-account basis under proposed Rule 721(a)(1) would divide the relationship compensation attributable to the account during the immediately preceding two years, translate the resulting quotient for each year into a percentage, and average the percentages of the preceding two years. *See* Exchange Act Release No. 54946, 71 Fed. Reg. 77522, at 77528. Similarly, to assess compliance with the "chiefly compensated" requirement on a bank-wide basis under proposed Rule 722, a bank would divide the relationship compensation attributable to the bank's trust and fiduciary business as a whole during each of the immediately preceding two years by the total compensation attributable to the bank's trust and fiduciary business as a whole during the relevant year, translate the resulting

effective date will affect that bank's ability to comply with Regulation R once it has been finally adopted and its effective date has been established. While the Commission and the Board have taken steps to minimize the impact of prior operations by extending the effective date, the proposed time period may not be sufficient. As a result, we urge the Commission and the Board to consider exempting certain accounts from Regulation R's "chiefly compensated" test for a greater period of time so that a bank can recommend that incoming personal trust accounts and estates and charitable trusts have appropriate compensation arrangements once it knows definitively what "appropriate" is for purposes of Regulation R.

B. Clarify that Examinations for Compliance with Fiduciary Principles Extend to Certain Outsourced Activities

We urge the Commission and the Board to make clear that outsourced trust operations, including acting as liaison between fiduciary customers and a trust officer, can meet the requirement that the trust department or other department must be "regularly examined by bank examiners for compliance with fiduciary principles and standards."[17] Bank regulators have issued guidance that provides bank examiners with a comprehensive approach for ensuring that a bank's outsourced operations are subject to the same risk management and other regulatory oversight as operations conducted within the bank itself.[18] Supervision of outsourced trust operations is properly covered by bank regulators within this scheme.

Proposed Regulation R should not unnecessarily restrict banks' ability to benefit their trust and fiduciary departments by outsourcing operations, provided those operations are examined in accordance with applicable banking regulations. To that end, we ask the Commission and the Board to assure banks that outsourced trust operations can meet the requirement that trust operations be "regularly examined for compliance."

---

quotients into percentages, and average the percentages for each the preceding two years. *See* Exchange Act Release No. 54946, 71 Fed. Reg. 77528, at 77528.

[17] *See* Exchange Act Section 3(a)(4)(B)(ii); Exchange Act Release No. 54946, 71 Fed. Reg. 77522, at 77539.

[18] *See, e.g.*, OCC Bulletin 2001-47, "Third-Party Relationships Risk Management Principles" (Nov. 1, 2001) (the OCC "supports and encourages national banks' use of third parties to take advantage of the many legitimate and safe opportunities to enhance product offerings, improve earnings, and diversify assets and revenues").

III. Safekeeping and Custodial Accounts

A. Permissible Fee Structures Under Proposed Rule 760

Proposed Rule 760(b), which governs securities transactions effected on an accommodation basis, limits the ways in which banks may structure their fees.[19] Proposed Rule 760(a), however, does not provide any limits on banks' fee structures. Thus, it is our understanding that the Commission and the Board have intentionally placed additional limitations on accommodation trades, but that these limitations do not apply to trades executed for employee benefit plan and individual retirement accounts. We request that the Commission and the Board confirm that banks executing orders for employee benefit plan and individual retirement plan accounts under Proposed Rule 760(a) may structure their fees as they see appropriate, subject to other applicable rules and regulations, or, if our understanding is incorrect, that the Commission and the Board provide additional guidance on the range of permissible fee structures under Proposed Rule 760(a).

IV. Other Matters

A. Scope of the Mutual Fund Transfer Agency Provision

As discussed above, Proposed Rule 775 provides that a bank that meets the conditions of an exemption to the definition of "broker" except for the limitation in Section 3(a)(4)(C)(i) of the Exchange Act, which requires banks to direct trades to a registered broker-dealer under certain circumstances, may still rely on an otherwise applicable exemption to the extent it effects transactions in securities issued by an open-end investment company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system and meets certain other requirements. In particular, among other requirements, banks must effect transactions through NSCC or directly with a transfer agent for the open-end company.

We suggest that the Commission and the Board clarify that proposed Rule 775 includes transactions with insurance companies that effectively serve as transfer agents for variable annuity separate accounts, in addition to transactions with Fund Serve or directly with mutual fund transfer agents.

B. Guidance Concerning Dually Registered Employees

While we appreciate guidance from the Commission and the Board on the application of the federal securities laws to banks' securities activities, we ask the

---

[19] *See* Proposed Rule 760(b)(3).

Commission and the Board to consider issuing additional practical guidance on the regulation of dual employees — employees who operate both as registered representatives of broker-dealers and employees of a bank. In particular, we believe both industry participants and legal practitioners could benefit greatly from practical guidance delineating which of the two regulatory schemes will govern dually registered employees' shared activities to avoid uncomfortable jurisdictional discussions that presently arise from time to time. Given the current coordination of the Commission and the Board, we would ask that consideration be given to providing industry participants with clear guidance in areas where the activities of individuals engaged in both securities and banking activity are subject to dual, and sometimes competing, regulation.

Moreover, we believe the potential ambiguities discussed above are exacerbated where, as is common in the banking industry, bank employees are registered with broker-dealers solely in order to receive transaction-based compensation and do not, in practice, engage in traditional brokerage activities. We would ask the Commission and the Board to provide further guidance in this area, and in particular to consider whether these dually registered employees should be subject to all of the supervisory and other regulatory requirements that generally apply to registered representatives of broker-dealers.

C. Process to Seek No-Action Relief

Based on unofficial remarks made by the Staff of the Commission at industry meetings, we understand that the Commission and the Board anticipate handling requests for no-action relief on various aspects of Proposed Regulation R jointly. Given the unique nature of such a process, and for the benefit of legal practitioners and their clients governed by Proposed Regulation R, we would ask that the Commission and the Board provide additional detail about the process and timing of such relief. In particular, we are concerned that relief requiring review by the Staffs of *both* the Commission and the Board could jeopardize the timeliness of such relief, and would welcome additional insight into how the Commission and the Board plan to provide such relief in a timely manner.

* * * *

Once again, we wish to thank the Commission and the Board for this opportunity to comment on Proposed Regulation R. We look forward to working with the Commission and the Board as this rulemaking process moves forward. Members of the Committees are available to discuss these comments. If you believe that such discussions would be helpful, please contact either of the undersigned co-chairs of the drafting committee at 202.663.6000.

Respectfully submitted,

Committee on Federal Regulation of Securities

/s/ Keith F. Higgins

Keith F. Higgins
Chair

Committee on Banking Law

/s/ James E. Scott

James E. Scott
Chair

Drafting Committee:

Brandon Becker, Esq., Co-Chair
Martin E. Lybecker, Esq., Co-Chair
Stuart Kaswell, Esq.
Eugene M. Katz, Esq.
Harold B. Finn, Esq.
Karol K. Sparks, Esq.

cc: Chairman Christopher Cox, Securities and Exchange Commission
Commissioner Paul S. Atkins, Securities and Exchange Commission
Commissioner Roel C. Campos, Securities and Exchange Commission
Commissioner Annette L. Nazareth, Securities and Exchange Commission
Commissioner Kathleen L. Casey, Securities and Exchange Commission
Erik R. Sirri, Securities and Exchange Commission
Robert L.D. Colby, Securities and Exchange Commission
Catherine McGuire, Securities and Exchange Commission
Chairman Ben S. Bernanke, Board of Governors of the Federal Reserve System
Vice Chairman Donald L. Kohn, Board of Governors of the Federal Reserve System
Susan Schmidt Bies, Board of Governors of the Federal Reserve System
Kevin M. Warsh, Board of Governors of the Federal Reserve System
Randall S. Kroszner, Board of Governors of the Federal Reserve System

Frederic S. Mishkin, Board of Governors of the Federal Reserve System
Scott Alvarez, Board of Governors of the Federal Reserve System
Kieran Fallon, Board of Governors of the Federal Reserve System