Bank
Insurance &
Securities
Association

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
2007 MAR 26 P 12: 01
RECEIVED
OFFICE OF THE SECRETARY

March 22, 2007

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

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Proposed Regulation R; FRB Docket No. R-1274; SEC File No. S7-22-06

Dear Ms. Johnson and Ms. Morris:

The Bank Insurance and Securities Association ("BISA") welcomes the opportunity to comment on the Board of Governors of the Federal Reserve System's ("FRB") and the Securities and Exchange Commission's ("SEC") Proposed Regulation R,[1] on behalf of BISA's bank and broker-dealer members.[2]

BISA appreciates the FRB's and the SEC's hard work in providing financial institutions with guidance on the application of various broker exceptions contained in Title II of the Gramm-Leach-Bliley Act ("GLBA"). BISA also thanks the FRB and SEC staffs for devoting significant amounts of time and other resources to working with BISA and other trade associations in order to promote a dialogue between the agencies and the financial services industry. That dialogue, which we hope will continue, has proven to be a valuable tool in fostering communications between the agencies and the industry.

[1] *See* Securities Exchange Act Release No. 54946 (December 18, 2006) (Proposing Regulation R).

[2] BISA is the largest association representing financial institutions in selling securities and insurance in the bank distribution channel. Its 400 institutional members are a cross section of banks, thrifts, credit unions and the various businesses that support their products and services. BISA has members in all 50 states, and its publications are distributed to 22,000 institutions and persons throughout the United States and North America.

303 West Lancaster Ave., Suite 1C • Wayne, Pennsylvania • 19087-3938
Phone: 610.989.9047 • Fax: 610.989.9102 • e-mail: BISA@BISA.org • web site: www.BISAnet.org

## I. Summary of BISA's Position

As a threshold matter, BISA generally supports the agencies' joint proposal to implement the bank exceptions from the definition of "broker" found in Section 3(a)(4)(B) of the Securities Exchange Act of 1934 ("Exchange Act"). BISA is concerned, however, that in the agencies' proposed application of Exchange Act Section 3(a)(4)(B)(i) (the "Networking Exception"), the ability of banks to compensate their unregistered employees is more limited than that permitted in prior FRB statements[3] and SEC staff no-action letters,[4] as well as in self-regulatory organization rules,[5] and is more limited than that contemplated by GLBA. BISA also believes that the proposed prohibition of non-cash referral fees is unlikely to result in additional investor protections and may have unintended, undesirable results.

In addition, although BISA supports the agencies' proposal to permit higher than nominal fees for the referral of institutional customers to a broker-dealer, we believe the standard for who may be considered a "high net worth customer" under the proposal sets too high a threshold. While we applaud the concept of an institutional networking exemption generally, we believe the current proposal imposes unnecessary, often duplicative obligations on banks and broker-dealers participating in such arrangements. BISA therefore requests that the agencies reconsider their proposed application of the Networking Exception to bank compensation practices as discussed below.

## II. Application of Networking Exception to Bank Bonus Programs

BISA is concerned that in attempting to define "incentive compensation" for purposes of the Exchange Act, the agencies may have unduly restricted the ability of banks to determine discretionary employee bonuses in a manner that goes beyond limitations contemplated by GLBA. The Networking Exception in GLBA prohibits "incentive compensation" to unregistered bank employees "for any brokerage transaction" unless such employees are duly registered

---

[3] The framework for banking practices under networking arrangements is proscribed primarily by the Interagency Statement on Retail Sales of Nondeposit Investment Products. *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *Interagency Statement on Retail Sales of Nondeposit Investment Products* (February 15, 1994) ("Interagency Statement").

[4] *See e.g., Chubb Securities Corp.* (November 24, 1993) ("*Chubb*"). The letters provided thrifts and credit unions with a means to compete with commercial banks in making securities brokerage services available to their customers. *Id.*

[5] *See e.g.*, NASD Rule 2350, which governs broker-dealer activities on the premises of a financial institution. The SEC approved Rule 2350 in Securities Exchange Act Release No. 34294 (November 4, 1997).

associated persons of a broker-dealer.[6] Proposed Regulation R would generally define "incentive compensation" as compensation that is intended to encourage a bank employee to refer potential customers to a broker-dealer or give a bank employee an interest in the success of a securities transaction at a broker-dealer.[7] Under the proposal, in determining employee bonuses, a bank may take into account the profits of the bank (including the holding company), a bank affiliate or operating unit, or the profits of a broker-dealer, provided that broker-dealer profits is one of many factors or variables considered, including significant factors or variables unrelated to the profitability of the broker-dealer.[8]

BISA does not believe GLBA was intended to limit a bank's ability to determine *bona fide* bonuses under the narrow set of conditions proposed. We instead believe that a bank should be able to take into account the revenue the bank earns from all activities, including at the branch or division level in determining discretionary bonuses, including where a component of such revenue is attributable to broker-dealer securities transactions (*i.e.*, not necessarily broker-dealer profits).[9] We believe further, that banks should be able to consider assets gathered by the bank and the broker-dealer with which it networks, including at the branch or division level, in determining discretionary bonuses, as long as the bank provides equal weighting to assets custodied by the bank as it does to assets custodied by the broker-dealer (either directly or

---

6 *See* Exchange Act Section 3(a)(4)(B)(i)(VI).

7 *See* Securities Exchange Act Release No. 54946 (December 18, 2006) at Section II.A.3.

8 *See Id.*

9 In this regard we also request that the agencies clarify that under the current proposal the ability to take into account the profits of a bank operating unit in determining employee bonuses would also permit banks to take into account the revenues received from a broker-dealer in connection with transactions for customers associated with a specific bank branch or other operating unit. Under the proposal, incentive compensation does not include compensation paid by a bank under a bonus or similar plan that is: (i) Paid on a discretionary basis; and (ii) Based on multiple factors or variables and: (A) Those factors or variables include significant factors or variables that are not related to securities transactions at the broker or dealer; (B) A referral made by an employee is not a factor or variable in determining the employee's compensation under the plan; and (C) The employee's compensation is not determined by reference to referrals made by any other person. The proposed rule states further that it should not be construed to prevent a bank from compensating an officer, director or employee on the basis of any measure of the overall profitability of (i) the bank, either on a stand-alone or consolidated basis; (ii) any of the bank's affiliates (other than a broker-dealer) or operating units; or (3) a broker-dealer if, such profitability is only one of multiple factors used to determine the compensation of the bank employee; and significant other factors not related to the profitability of the broker-dealer are used in determining the employee's bonus. *See* Securities Exchange Act Release No. 54946 (December 18, 2006).

though its clearing broker). We therefore request that the agencies revise Regulation R to expressly permit banks to determine discretionary bonuses for unregistered bank employees based in part on either revenues earned by the bank that are attributable to the branch or division in which that employee works or assets gathered by the bank that are attributable to the branch or division where the employee works. Under the revenue test, revenues received from a broker-dealer would be one of multiple factors or variables used to determine the bonus amount, including significant factors or variables unrelated to the broker-dealer's securities activities. Under the assets gathered test, the bank would be required to give the same weight to assets held at the broker-dealer as it does to assets held at the bank. Neither of these tests should cause a bank employee to determine where to refer customers based on the expectation that he or she is likely to receive a different level of compensation based on that decision.

BISA also requests that the agencies clarify that nominal one-time cash fees of a fixed dollar amount may be paid to unlicensed supervisory bank employees in connection with referrals by other bank employees whom they supervise, directly or indirectly. The current proposal appears to contemplate the payment of referral fees solely to non-supervisory employees making referrals, but BISA is not aware of any such limitation in the statutory language of GLBA, nor of any patterns of abusive behavior on the part of supervisory bank employees.

## III. Proposed Prohibition of Non-Cash Referral Fees

BISA disagrees with the agencies' decision to prohibit the payment of non-cash referral fees to unregistered bank employees. We believe instead that non-cash referral fees should be expressly permitted, provided they are nominal in amount and meet the requirements for a one-time payment of a fixed dollar amount. The SEC previously was comfortable with permitting non-cash referral fees, provided the other statutory conditions for referral fees were met.[10] We therefore suggest that the agencies amend proposed Regulation R to permit banks to pay their unregistered employees referral fees in a form other than cash, including through a point system.

Many banking organizations currently rely on point systems to reward employees for referrals, rather than relying solely on immediate cash compensation. Point systems provide the banks with additional flexibility in rewarding their employees for referrals, without providing the "salesman's stake" GLBA intended to avoid. Points are also sometimes used in contests aimed at developing teamwork. Moreover, the points given for brokerage referrals are typically only a small part of a larger program under which bank employees receive points for referrals of customers for banking products also. As long as the amount of points received for a securities referral does not exceed the amount of points the employee receives for the referral of a comparable banking product (*e.g.*, a CD), the non-cash fee should not provide undue incentive for the employee to promote securities products over banking products. Moreover, if banks are

[10] *See e.g.*, Securities Exchange Act Release No. 49879 (June 17, 2004)(proposing Regulation B).

not permitted to provide non-cash fees for referrals to a broker-dealer, banks may be forced to bifurcate their incentive programs to the detriment of the bank customers as well as the bank employees.[11] BISA therefore requests that the agencies permit banks to reward their unregistered employees with non-cash referral fees, provided that the value of the non-cash award is nominal, doesn't exceed the reward for comparable banking products, and meets the one-time and fixed dollar amount requirements of Exchange Act Section 3(a)(4)(B)(i)(VI).

In the event that the agencies determine to prohibit non-cash referral fees upon adoption of Regulation R, BISA requests that the agencies clarify that banks and broker-dealers may continue to provide unregistered bank employees with non-cash compensation in the form of meals and entertainment, provided such compensation is not provided in reference to referrals made by bank employees and is limited in value in some way (*e.g.,* under $200 per calendar year). BISA is concerned that without this clarification, the current proposal may be read to prohibit the provision of non-cash compensation to unregistered bank employees, even where such compensation is not intended to reward the employees for securities referrals.

## IV. Institutional Networking

BISA generally supports the agencies' proposal to permit higher than nominal referral fees for institutional and high net worth customers. BISA believes, however, that the $5 million minimum net worth requirement for high net worth individuals is higher than necessary to achieve investor protection and is inconsistent with current bank practices. Banks typically treat customers with $1 million or more in liquid assets as high net worth customers, eligible for bank programs limited to such customers.[12] As long as such customers are informed that the referring bank employee may receive a higher than nominal referral fee, and is informed of the contingencies, if any, on which such fee would be based (*e.g.,* account opening, securities transactions occurring), the customers should be able to assess for themselves whether following up on the referral with the broker-dealer is in the customer's best interest.

BISA also notes that the proposed institutional networking exemption requires the bank <u>and</u> the broker-dealer to each make certain determinations that should reasonably be required of only one or the other, but not both parties to the arrangement. For example, under the current proposal, both the bank and the broker-dealer must independently determine that a customer is a high net

---

[11] For example, where a bank employee participates in a point program for referral of multiple bank products and a cash-only program for referral of securities products, an employee interested in obtaining a reward for meeting a specific point total may have an incentive to promote a bank product over a securities products, even where the sale of a securities product might have been in the best interest of the customer.

[12] BISA notes that $1 million is the SEC's standard for "accredited investor" status, which permits individuals to invest in private offerings under Regulation D.

worth customer before the referral fee is paid.[13] Each of the parties must also determine that the bank employee making the referral is not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act and is not qualified or required to be qualified (i.e., registered) under self-regulatory organization rules. Although broker-dealers may have ready access to certain information on the employee's qualification and statutory disqualification status (*i.e.,* through the CRD system), it is not clear how banks can easily obtain this information. BISA therefore believes that it should be adequate for the parties to contractually allocate between them the determination of whether the customer is a high net worth customer and whether the referring bank employee is qualified (or required to be qualified) under self-regulatory organization rules or subject to a statutory disqualification. Requiring both parties to do so seems to us redundant and therefore unnecessary.

* * * * *

BISA appreciates the FRB's and SEC's consideration of its comments on Proposed Regulation R. We also would welcome a continuing dialogue with the FRB and SEC staffs on the important matters raised by GLBA, including matters not raised in the Proposing Release.[14] If either agency has any questions relating to BISA's comments or would otherwise like to discuss them further, please contact either John F. Hartigan, General Counsel of BISA, at 213.612.2630, Kathleen W. Collins, BISA's Washington Counsel, at 202.739.5642 or Jack P. Drogin at 202.739.5380.

Sincerely,

/s/ Richard D. Starr

Richard D. Starr
Director – Government Relations

---

[13] In the event the broker-dealer determines that an individual is not a high net worth customer, it must inform the bank of this determination. BISA is concerned that this may raise privacy issues that are not fully addressed in exceptions in GLBA and privacy regulations thereunder, or in state privacy laws or regulations, or contemplated in the agencies' proposal.

[14] For example, BISA is interested in discussing the application of NASD Rule 3040 to dual bank/broker-dealer employees.