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

Dear Ms. Morris and Ms. Johnson:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the proposed Regulation R jointly issued by the Securities and Exchange Commission (the "Commission") and the Board of Governors of the Federal Reserve System (the "Board") (collectively, the "Agencies"). Through Regulation R, the Agencies will implement the Gramm Leach Bliley Act ("GLBA") exceptions for banks[2] from the definition of "broker" within Section 3(a)(4) of the Securities Exchange Act of 1934 (the "Exchange Act").

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] Section 401 of the Financial Services Regulatory Relief Act of 2006, Pub. L. 109-351, 120 Stat. 1966 (2006), amended the definition of "bank" in Section 3(a) (6) of the Exchange Act to include Federal savings associations and other savings associations whose deposits are insured by the FDIC. In the context of these comments, the term "bank" or "banks" include commercial banks, trust companies, savings banks, and savings associations.

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We commend the Commission, the Board and their staff members on the efforts evidenced by proposed Regulation R. We support and appreciate the direction taken by the Agencies in the proposed Regulation. Our comments will focus upon issues for broker-dealers created by the proposed Regulation in the context of third-party brokerage or "networking" arrangements. Specifically, we address:

- The unnecessary requirements for institutional and high net worth exemptions imposed by Proposed Exchange Act Rule 701 ("Proposed Rule 701").
- The need for a safe harbor for broker-dealers similar to that proposed for banks.
- The need to coordinate the effective date of Regulation R with necessary amendments to NASD Rule 3040.

I. Proposed Rule 701

Proposed Rule 701 would create a new exception allowing enhanced incentive fees to bank employees for high net worth and institutional referrals. SIFMA believes that networking arrangements are beneficial to the customers of both banks and broker-dealers. Networking arrangements provide the customer access to menus of financial products which no broker-dealer or bank, standing alone could typically offer. The opportunity for diversification carries with it professional advice from both the bank and the broker-dealer, and the benefit of supervision by both banking and securities regulators.

Proposed Rule 701 correctly recognizes that institutional and high net worth customers are able to appreciate the differences between banks, broker-dealers, and their respective products and services, and that allowing banks to pay higher compensation in association with those referrals (subject to the other networking requirements) poses no significant risks. We respectfully submit, however, that certain of Proposed Rule 701's requirements are unnecessary or inappropriate within the context of the contemplated exemption.

A. Duplicative customer qualification should not be required

Proposed Rule 701 requires both the bank and broker-dealer to qualify the referred customer as either "institutional" or "high net worth" prior to the referral and/or payment of the referral fee.[3] We believe that it is unnecessary to require that both parties perform this qualification, and that the bank and broker-dealer should be allowed to allocate that responsibility.

If required either by the Rule or by agreement to perform the customer qualification, the broker-dealer should be authorized to rely upon a signed acknowledgement of a high net worth customer in the same fashion as the bank.[4] The broker-dealer should be allowed to obtain the acknowledgement through the bank or directly from the customer.

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[3] Proposed Exchange Act Rules 701(a)(2)(ii) and 701(a)(3)(i)(B).

[4] Proposed Exchange Act Rule 701(a)(2)(ii)(B)(2).

B. Duplicative employee qualification should not be required

Proposed Rule 701 further requires that, before the referral fee is paid, both the bank and broker-dealer determine that the referring bank employee is not subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act.[5] We again believe that only one such review is required, and that the bank and broker-dealer should be allowed to allocate that task.

We note that the proposed Rule would require the bank to provide the broker-dealer "the name of the employee and such other identifying information that may be necessary for the broker-dealer to determine whether the bank employee is associated with a broker-dealer or is subject to a statutory disqualification . . . ."[6] In this situation, it is likely that the broker-dealer will have no relationship with the reviewed bank employee. Given the numerous federal and state privacy laws, the information provided by the bank to the broker-dealer may include, where appropriate, additional information necessary for the broker-dealer to perform the review (e.g., consents by the bank employee to conduct the review).[7]

C. The proposed definitions of "institutional" and "high net worth" are artificial and inappropriate

Proposed Rule 701 would define a natural person as "high net worth" if the individual, individually or jointly with a spouse, has a net worth of at least $5 million, excluding primary residence and associated liabilities. A non-natural entity would be defined as "institutional" if it possessed (1) $10 million in investments, (2) $40 million in assets, or (3) $25 million in assets if referred for investment banking services.

We believe that the qualifying amounts are unnecessarily high, and inappropriate. As to natural persons, the proposed net worth is substantially higher than existing thresholds with like purposes, such as private equity fund investors ($1 million) and "accredited" investors under Rule 501 of the Securities Act of 1933 ($1 million). We believe that the challenge in understanding the distinction between banks and broker-dealers is substantially less than that faced in understanding complex financial products, and that the proposed $5 million threshold is unnecessarily high. We suggest that "high net worth" be defined as $1 million. Likewise, the thresholds for "institutional" bear little, if any, relation to the risk and are too high. The ability of a non-natural entity to understand and appreciate the risks presented in a networking relationship is governed by the knowledge and sophistication of its principals and advisors. A new venture

[5] Proposed Exchange Act Rule 701(a)(3)(i)(A).

[6] Proposed Exchange Act Rule 701(a)(2)(iii).

[7] We note that the proposed Rule does not expressly require that the broker-dealer confirm that the referring bank employee is not associated with a broker-dealer. Proposed Rule 701(a)(2)(iii), however, requires that the bank provide the broker-dealer the information for such a review. To the extent that the Rule imposes such a requirement upon the broker-dealer, or to the extent that the Agencies believe that other rules or regulations create the obligation on part of the broker-dealer, information provided by the bank may also include authorizations to allow broker-dealers to conduct such review.

could have extremely knowledgeable and sophisticated principals, but few assets. Assuming that numerical qualifiers will be used within the definition of "institutional", we would suggest $1 million in investments or $5 million in assets.

D. The proposed "sophistication" and "suitability" analyses are both unworkable and unnecessary

Proposed Rule 701 would require that the broker-dealer perform either a suitability analysis of a requested transaction or a "sophistication" analysis of the referred customer.[8] The type and timing of the analysis to be performed depends upon whether the referral fee is contingent upon a transaction by the referred customer. If contingent, the broker-dealer must apply the rules of its applicable self-regulatory organization ("SRO") and determine that each transaction for which the bank will pay referral compensation is suitable for the customer.[9] If not contingent, the broker-dealer must determine, before the bank pays the referral compensation, that the customer is "sophisticated"; specifically, that the customer "has the capability to evaluate investment risk and make independent decisions" *and* "is exercising independent judgment based on the customer's own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations."[10] If not contingent but the customer "contemporaneously" (with the referral) requests a transaction, the broker-dealer may, in lieu of the "sophistication" analysis, perform a suitability review of the requested transaction.

We have substantial issues with the analyses required in both the contingent and non-contingent settings. Any customer referred under this proposed exemption will receive the benefit of all laws, regulations and rules applicable to its relationship with the broker-dealer. Those obligations would include a suitability analysis on all transactions *recommended* by the broker-dealer. The proposed Rule, however, would create a new obligation for broker-dealers to approve the suitability of *unsolicited* transactions. Any expansion of the suitability obligations of broker-dealers should go through normal market regulation processes, which we believe should include the relevant SROs. We are further concerned that requiring a suitability analysis on unsolicited transactions creates a new and unnecessary risk of customer claims against broker-dealers.[11]

We believe the proposed "sophistication" analysis would often be impractical and difficult to carry out. As the analysis would be conducted in the context of a non-contingent

[8] The obligations upon the broker-dealer would be indirectly imposed through the requirement that they be included in the underlying networking agreement.

[9] Proposed Exchange Act Rule 701(a)(3)(ii)(A).

[10] Proposed Exchange Act Rule 701(a)(3)(ii)(B).

[11] As we understand the proposed Rule, the broker-dealer must execute such an unsolicited order without regard to the suitability analysis and the analysis is relevant only to the payment of the enhanced referral fee. We are concerned that customers could later claim that a broker-dealer should have refused an unsolicited order which it questioned as or believed to be unsuitable.

referral fee, it would often be conducted without the benefit of the information gathered in establishing a client account.[12] Moreover, the prescribed standards of the analysis may useful in the context of recommended or contemplated transactions, but will prove difficult if not impossible to apply in the abstract: a referred customer could be "sophisticated" as to equities but not as to derivatives. This problem is significantly exacerbated by the second leg of the analysis, which incorporates the substantive requirements of NASD IM-2310-3. We believe that IM-2310-3, establishing suitability requirements for *recommended transactions* to institutional customers, is inappropriate without a contemplated transaction. We further question whether IM-2310-3, which applies to institutional customers and their resources, is an inappropriate standard for high net worth individuals. We believe that the proposed sophistication analysis is both impractical and unnecessary in the context of both high net worth and institutional referrals.

II. Broker-Dealer Safe Harbor

Proposed Rule 701 provides banks a safe harbor in those circumstances where a bank fails to meet its obligations under the Rule, but acts in good faith and has in place reasonable policies and procedures.[13] The Official Comments to the proposed Rule indicate a broader informal safe harbor may be contemplated: "If a broker or dealer . . . does not comply with the terms of the [networking] agreement, however, the bank would not become a 'broker' under Section 3(a)(4) of the Exchange Act . . . ."

We believe that Regulation R as adopted should provide a safe harbor for networking broker-dealers, protecting them from regulatory challenges.[14] The safe harbor should be available to broker-dealers which have reasonable policies and procedures to comply with the networking laws and rules, and which have acted in good faith. The protections should extend to any regulatory issues arising from or based upon a networking bank's failure to meet its obligations under the exception.

III. NASD Rule 3040 and the Effective Date of Regulation R

Subject to our substantive comments, above, we believe that Regulation R can be finalized on a timeline consistent with the proposed effective date[s]. We urge the Commission and the Board, however, to coordinate Regulation R's effective date with what we believe are necessary amendments to NASD Rule 3040 ("Rule 3040"). Sometimes called the "selling-away Rule", Rule 3040 requires broker-dealers to supervise and approve, and to maintain on the firm's books and records, all securities transactions by registered representatives which are conducted away from the firm.

As the Commission and the Board are aware, in response to GLBA many banks and their associated broker-dealers have developed business models which will utilize dual employees.

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[12] If the referral does not result in an account with the broker-dealer, the customer may refuse to provide the broker-dealer the information necessary for such a "sophistication" analysis.

[13] Proposed Exchange Act Rules 701 (a)(2)(iv).

[14] From a regulatory standpoint, the broker-dealer's ability to share commissions or revenues would be contingent upon the bank satisfying the exception.

Such dual employees represent both the bank and the broker-dealer. In their bank capacities, these individuals may assist with investment transactions under the remaining bank exceptions such as the Trust and Fiduciaries Activities Exception. Banking regulators will continue to actively examine and monitor these transactions. To require that broker-dealers apply the existing requirements of Rule 3040 to such transactions would impose significant burdens with little, if any, benefit to investors or the markets. The burdens upon broker-dealers would include the diversion of valuable supervisory resources to such reviews and approvals, and drains on systems and capacity in acquiring and preserving the information and records.

SIFMA and other industry associations have conferred with the NASD on the issues presented by Rule 3040 in this context. Before Regulation R is made effective, the NASD should be given reasonable time to review Rule 3040 and make any changes appropriate to these facts. We request that the ultimate effective date of Regulation R allow the NASD to complete its review and revisions to Rule 3040.

Conclusion

SIFMA commends the Commission and the Board for the thought and effort underlying Proposed Regulation R. We respectfully ask that you give careful consideration to the above comments and requests. If you have any questions, please contact the undersigned at (202) 434-8400 or Barry P. Harris, Ward and Smith, P.A., counsel to SIFMA, at (252) 672-5514.

Sincerely,

Alan E. Sorcher
Vice President and
Associate General Counsel

cc: Catherine McGuire, Chief Counsel, SEC (via email)
Linda Stamp Sundberg, Senior Special Counsel, SEC (via email)
Kieran T. Fallon, Assistant General Counsel, Federal Reserve Board (via email)