UNION BANK OF CALIFORNIA

March 23, 2007

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

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

Re: **Comments on Proposed Regulation R**
Board Docket No. R-1274
Commission Release No. 34-54946; File No. S7-22-06

Dear Ms. Johnson and Ms. Morris:

Union Bank of California, N.A. (the "Bank") is pleased to respond to the request of the Board of Governors of the Federal Reserve System (the "Board") and the Securities and Exchange Commission (the "Commission," and together with the Board, the "Agencies") for comments on proposed Regulation R issued December 18, 2006.[1] Section 3(a)(4)(B) of the Securities Exchange Act of 1934 ("Exchange Act") describes several categories of securities activities in which a bank may engage without being subject to registration and regulation as a "broker" under the Exchange Act. Regulation R would define key terms used in certain of those statutory exceptions and includes a number of proposed exemptions for related activities.

The Bank is a national bank headquartered in San Francisco, California, with banking offices in California, Oregon, and Washington. The Bank is among the 25 largest banks in the United States, with approximately $52 billion in assets as of December 31, 2006. The Bank provides a broad range of trust, fiduciary, and custody services for individuals and institutions. As of December 31, 2006, the Bank administered more than 21,000 trust, fiduciary, and custody accounts holding aggregate assets in excess of $230 billion.

In general, the Bank views the Proposal as a positive step in the rulemaking process as it relates to the "broker" exceptions, and we appreciate the efforts of the Agencies to design Regulation R to "accommodate the business of banks and protect investors."[2] We also believe, however, that certain aspects of the proposal raise questions and issues that require clarification or modification. In this regard, it is important to recognize that Congress, in enacting the statutory exceptions as part of the Gramm-Leach-Bliley Act of 1999 ("GLBA"), intended to

1 71 Fed. Reg. 77522 (Dec. 26, 2006).

2 71 Fed. Reg. at 77523.

"facilitate certain activities in which banks traditionally have engaged."[3] As indicated below, certain aspects of proposed Regulation R do not appear to be entirely consistent with this Congressional objective.

The Bank supports and endorses the comments submitted by the American Bankers Association and the ABA Securities Association (referred to together as "ABA") on the proposal. The remainder of this letter highlights important matters that we believe deserve additional emphasis.

Networking Exception

The statutory exception for "networking" arrangements provides that, subject to certain exceptions, bank employees may not receive "incentive compensation for any brokerage transaction." Proposed Rule 700(b) defines "incentive compensation" generally as compensation that is intended to encourage a bank employee to refer customers to a broker-dealer or give the employee an interest in the success of a securities transaction by the broker-dealer.

Proposed Rule 700(b)(1) provides that certain types of bonus and similar compensation programs will not be considered incentive compensation for this purpose. Specifically, compensation paid on a discretionary basis and based on multiple factors and variables that include factors not related to securities transactions and do not include "referrals" made by the employee or any other person will not be considered "incentive compensation." We agree with this definition because it permits compensation based on such things as revenue generated by, or the profitability of, customer relationships and other factors and variables that are not related to securities transactions, and does not preclude consideration of other factors that are securities related, such as revenues derived from securities underwriting and brokerage services provided by the broker-dealer as a result of a bank employee referral. We have two suggestions regarding this proposed Rule. First, we see no particular reason why non-discretionary, pre-established compensation program based on the appropriate factors described in proposed Rule 700(b)(1)(ii) should not also be excepted from "incentive compensation." Accordingly, we suggest that Rule 700(b)(1)(i), which states that compensation will not be considered incentive compensation only if it is paid under a "discretionary" program, be deleted. Second, proposed Rules 700(b)(1)(ii)(B) and (C) indicate that compensation may not be based on "referrals" by the employee or by any other person (as the case may be). To make this language more consistent with its intent, we suggest that it be modified to describe referrals "to the broker-dealer."

Proposed Rule 700(b)(2) makes it clear that compensation based on financial performance of the bank on a stand-alone or consolidated basis, any of the bank's affiliates or operating units, or (provided the compensation is based on the appropriate factors and variables) a broker-dealer, also is not considered incentive compensation. We support this concept and request that the Agencies clarify that such compensation also may be based on the financial performance of a branch, division, or operational unit of a broker-dealer.

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3 *See*, H.R. Conf. Rep. No. 106-434, at 163-64 (1999).

Exemption for Receipt of "Non-Nominal" Referral Fees

Proposed Rule 701 would allow a bank employee to receive a referral fee that is not limited to "a nominal one-time cash fee of a fixed dollar amount" (as required under the statutory exception for networking arrangements) if the employee refers a "high net-worth customer" or "institutional customer" to a broker-dealer involved in a networking arrangement with the bank, and certain other conditions are satisfied. "High net worth customer" is defined to include a natural person who, individually or jointly with his or her spouse, has at least $5 million in net worth, excluding primary residences and associated liabilities of the person and, if applicable, his or her spouse. The net worth determination requires that assets held jointly with a spouse be limited to 50% of such assets. An "institutional customer" is a non-natural person that has at least $10 million in investments or $40 million in assets. An "institutional customer" also includes a non-natural person with $25 million in assets *if* the referral is made for "investment banking services."[4] The proposal indicates that these conditions "recognize that sizable institutions and high net worth individuals, when provided appropriate information, are more likely to understand and evaluate the relationship between the bank and its employees and its broker-dealer partner and any resulting securities transaction with the broker-dealer."[5]

We support the basic concept and rationale of the exemption. However, we question the need for the introduction of additional detailed and complicated financial status tests and the very high customer dollar limits that must be satisfied before a bank can rely on the exemption. We believe that "high net worth customer" instead should be defined identically or by reference to "accredited investor" under the Commission's Regulation D under the Securities Act of 1933. In this regard, we note that the Board has used "accredited investor" status to distinguish sophisticated from "retail" customers in orders regulating the activities of "Section 20 affiliates" of bank holding companies.[6] We submit that an individual satisfying the net worth and income tests specified in Rule 501(a) under Regulation D is just as, if not more, capable of understanding and evaluating the relationship between a bank and its employees and its broker-dealer partner than a person meeting the new proposed tests for "high net worth customer."[7] In addition, like an "accredited investor," a "high net worth customer" also should be able to include all assets held jointly with his or her spouse in the net worth calculation, not only one-half of such assets as indicated in proposed Rule 701.

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4 According to the Agencies, the distinction for "investment banking services" is designed to "permit banks to facilitate access to capital markets by referring *smaller businesses* to broker-dealers" (emphasis added).

5 71 Fed. Reg. at 77525.

6 12 C.F.R. § 225.200, footnote 4 ("a retail customer is any customer that is not an 'accredited investor' as defined in 17 C.F.R. 230.501(a)").

7 We note that the Commission has proposed to modify the definition of "accredited investor" for purposes of private sales of interests in hedge funds. 72 Fed. Reg. 400 (Jan. 4, 2007). We do not believe the modified definition necessarily would be applicable here, given the differing purposes and goals of the Commission in proposing the modification and the Agencies objectives for Regulation R, as described above.

With respect to "institutional customers," we believe the dollar limits under both alternative definitions are too high to be useful for banks and their institutional customers. We also think the definition itself, which consists of two alternative definitions and three separate financial tests which apply depending on the type of services for which the referral is made, is unnecessarily complex. We urge the Agencies to accept the ABA's recommendations on this point.

Trust and Fiduciary Activities Exception

The statutory exception applies to securities transactions effected by a bank acting in a trustee or fiduciary capacity if certain conditions are satisfied. One of these conditions is that the bank must be "chiefly compensated" on the basis of certain types of compensation, which the proposal defines as "relationship compensation." The latter term includes an "administration or annual fee," a "percentage of assets under management," a "flat or capped per order processing fee" equal to not more than the cost incurred by the bank in connection with executing securities transactions, or any combination of such fees. Proposed Rules 721 and 722 provide that the "chiefly compensated" requirement is satisfied if a bank's "relationship compensation" exceeds 50% of the bank's total compensation for each trust/fiduciary account or is equal to or greater than 70% of compensation for all such accounts on a bank-wide basis. This percentage is to be computed by dividing relationship compensation by total compensation during each of the immediately two preceding years, and averaging the two percentages.

We believe the general approach outlined in Regulation R is a significant improvement over prior proposals. There are, however, certain issues and questions that we request the Agencies to address or clarify.

(1) We understand that, under the proposal as currently written, a bank using the calendar year as its fiscal year technically will not be required to demonstrate compliance with the chiefly compensated requirement (*i.e.*, by computing its "relationship-total compensation percentage") until 2011 at the earliest.[8] Specifically, a bank will be considered in compliance with that requirement for 2009 and 2010 because it will not have two years of data on which to base its computation. Although the bank necessarily will need to take 2009 and 2010 data into account in making its computation for 2011, it will be expected to determine its computations for purposes of the exception no earlier than the point during 2011 at which the data necessary to make the computation for 2010 (as well as 2009) are available.

(2) Although it is integral to the "chiefly compensated" requirement, proposed Regulation R does not define "total compensation." We think some guidance from the Agencies on this issue would be helpful. The Agencies' discussion of "relationship compensation" is helpful in this context in that it indicates that such term includes compensation that (i) is "attributable to" a trust or fiduciary account; (ii) is paid by any entity or person (*i.e.*, it does not

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[8] Proposed Rule 781 states that a bank is exempt from the definition of "broker" until the first day of its first fiscal year beginning after June 30, 2008.

have to be paid solely from the fiduciary account or by account principal); and (iii) may relate to securities assets or non-securities assets of the account. It seems that the same standards generally should apply in identifying "total compensation." However, we request that the Agencies confirm that internal payments or allocations to a bank's trust business unit from the commercial side of the bank or from affiliated banks and other affiliates (*e.g.*, for trust/fiduciary account cash held temporarily in bank deposits) are not part of "total compensation" and therefore not to be taken into account in the chiefly compensated calculation.

(3) We ask that the Agencies confirm that "cost" and other restrictions in the statutory exception and proposed Regulation R on "per-order processing fees" are applicable only to fees charged by a bank for effecting securities transactions. Those restrictions therefore are inapplicable to "per transaction" fees a bank may charge for services and transactions that do not involve effecting the purchase or sale of a security. These fees or charges may include, for example, "settlement fees" for settling securities transactions that a third-party manager has placed with a broker-dealer, and "disbursement fees" or "wire transfer" fees charged for making payments from a trust/fiduciary account to a beneficiary or a counterparty to an investment transaction. In our view, these fees should be classified as "administration fees" (as described in the statutory exception) and therefore should be included in "relationship compensation" without regard to the "costs" incurred by the bank in providing the services.

Exemption for Safekeeping and Custody Activities Involving Order Taking

Proposed Rule 760 is based on the Commission's initial interpretation that safekeeping and custody activities engaged in as part of a bank's "customary banking activities" permitted under the statutory exception *do not* include accepting customer orders for securities transactions. We continue to disagree with this premise and the need for Rule 760. As noted above, the statutory exceptions enacted by the GLBA were intended to "facilitate certain activities in which banks traditionally have engaged." In particular, the safekeeping and custody exception on its face authorizes a bank to engage in such activities as part of its "customary banking activities." As we have stated in the context of the Commission's earlier proposals, it is clear that traditional activities of banks in the custody area have included accepting customer orders for securities transactions.[9] Moreover, the notion that the statutory exception does not include order taking is based on the Commission's interpretation reflected in its earlier rule proposals. The Agencies have stated, however, that "[a]ny discussion or interpretation of these prior rules in their accompanying releases would not apply" to Regulation R.[10] Accordingly, we

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9 *See, e.g.,* Securities and Exchange Commission, "Initial Report on Bank Securities Activities" at 3, n 2 (January 3, 1977) ("customer transaction services" of banks surveyed by Commission staff for report to Congress described as service "in which a bank accepts orders from customers for the purchase or sale of a corporate stock selected by the customer and transmits those orders to a broker-dealer for execution.") *See also* Exchange Act § 3(a)(4)(C), which requires a bank relying on the safekeeping and custody exception to transmit certain trades to a registered broker-dealer for execution. There would be no need for such a requirement if the bank were not accepting orders under the exception in the first place.

10 71 Fed. Reg. at 77535.

do not believe that Proposed Rule 760 is necessary, and we urge the Agencies to issue an interpretation to the effect that order taking is encompassed within the statutory exception.[11]

To the extent the Agencies believe nonetheless that proposed Rule 760 should be retained, we offer the following comments.

(1) Proposed Rule 760 states that the exemptions provided under that Rule (other than the exemption for non-custodial administrators and recordkeepers) apply to a bank that acts as "custodian" or "a custodian." We assume there is no intention to restrict those exemptions to situations in which the bank is formally designated as "custodian." We assume, rather, that the exemptions are applicable to a bank that performs custodial functions, regardless of the formal or designated capacity in which it performs those functions. We think it would be helpful if the Agencies could make it clear that the exemptions are applicable to accounts for which a bank performs custodial functions in any capacity – other than the capacities of trustee or fiduciary (as provided in proposed Rule 760(d)(1)) – including, among others, agent, fiscal agent, paying agent, and other similar non-trustee or fiduciary capacities.

(2) The proposal does not specifically define what constitutes "accepting an order" for purposes of the statutory exception or the proposed exemptions. We believe, however, that the concept connotes a request that the bank itself take steps to effect a securities transaction, including, among others, exercising authority or discretion to place the trade with a broker-dealer. In many cases, however, a bank may be asked to transmit a custody customer's order or instruction to a broker-dealer selected by the customer for execution. We believe that merely transmitting a customer's order to the broker-dealer at the request of the customer does not amount to "accepting an order" for a securities transaction that requires compliance with the exemption. We think it would be helpful if the Agencies confirmed this understanding.

Exemption for Securities Lending Activities Conducted as "Agent"

Proposed Rule 772 would allow a bank to engage in certain securities lending activities "to the extent that" it engages in those activities "as an agent" on behalf of certain types of investors. We agree with the need for, and support the proposal of, this exemption. In our view, however, the proposed exemption's use of the term "as an agent" introduces potential confusion over whether a bank must (or may) rely on the statutory exception for safekeeping and custody activities (which encompasses securities lending activities) or the exemption for securities lending activities conducted as agent. We believe this issue could be clarified if the exemption were to provide expressly that it applies to a bank that engages in securities lending transactions to the extent the bank does not perform custodial functions with respect to the securities.

In contrast to the statutory exception, the proposed exemption limits the customers to whom the bank may provide securities lending services as agent to "qualified investors" (as

[11] We would not object to making the statutory exception subject to an "accommodation" requirement similar to the concept to be elaborated by the federal banking regulators in connection with the proposed exemption.

defined in Exchange Act Section 3(a)(54)(A)) or employee benefit plans with $25 million or more in investments. We question why securities lending activities conducted by a bank as agent should be limited only to customers that meet these restrictive standards, none of which appear in the statutory safekeeping and custody exception permitting the same services.[12] When it initially proposed the exemption in 2002, the Commission stated that it intended that the exemption be "available for banks' current securities lending business," but limited it to securities lending services provided to "qualified investors" as defined in Exchange Act Section 3(a)(54).[13] This apparently was based on the Commission's understanding that banks typically provided securities lending services to "institutional customers."[14] We fail to understand the need for such limitations, however, particularly in light of the fact that Congress did not see fit to impose these or other restrictions in the context of the safekeeping and custody exception. We do not object to limiting the provision of securities lending services conducted as agent to institutional customers. On the other hand, we do not see a justification for imposing the high dollar limits, which effectively preclude smaller institutional customers from obtaining securities lending services (*e.g.*, on a commingled basis).

Regulation R and NASD Rules

An important issue the proposal does not address is the regulation of "dual employees" – *i.e.*, persons employed concurrently by a bank and a registered broker-dealer. In short, requirements imposed on broker-dealer members of NASD, Inc. ("NASD") potentially overlap and are inconsistent with rules applicable to banks operating within the networking exception and exemptions described in the proposal.

For example, NASD Conduct Rule 3040 generally prohibits any person associated with an NASD member firm from engaging in a "private securities transaction" for "selling compensation," unless certain reporting and oversight conditions are satisfied. This oversight responsibility creates difficult practical issues for banks and their employees who also are associated persons of affiliated broker-dealers. For example, if employees of a bank's trust department engaging in securities transaction activities within the scope of the statutory exception for trust and fiduciary activities are dual employees, the bank's trust activities could be subject to NASD oversight because Rule 3040, by its terms, requires all securities transactions of the dual employees to be supervised by and reflected on the books and records of the broker-dealer with which the dual employee is associated. This could lead to the anomalous result of having permissible bank securities activities subject to regulation by the NASD rather than or in addition to the Agencies under Regulation R.

Another open question relates to NASD rules governing "referrals" to broker-dealers. Prior to the enactment of the GLBA, the NASD expressed the view that persons who locate,

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12 We note that the proposal nowhere suggests that the statutory exception is subject to the restrictions and limitations imposed by the proposed exemption.

13 67 Fed. Reg. 67496, 67503 (Nov. 5, 2002).

14 *Id.* at 67502.

introduce, or refer retail customers to a broker-dealer should be considered "representatives" of a broker-dealer.[15] Under that approach, persons who receive compensation for such activities would subject to registration and qualification with the NASD. The NASD proposed, but never adopted, a rule that would have codified this view. Nor, however, has the NASD modified or withdrawn its interpretations. If these interpretations were to apply to payments made to bank employees for referrals of customers to networking broker-dealers who effect securities transactions for those customers, the payments could be prohibited unless the recipient becomes a registered representative and associated person of the broker-dealer. That result would not be consistent with the networking exception or the Agencies' notions of payments to unregistered bank employees that would be permissible under Regulation R.

In sum, NASD regulation of bank securities activities conducted pursuant to the statutory exceptions and proposed exemptions would not be consistent with the intent of the GLBA or, for that matter, NASD's authority under the Exchange Act. We therefore strongly encourage the Agencies, working with the NASD (or any successor), to resolve these issues before Regulation R is adopted in final.

We would be pleased to respond to any questions the Board, Commission, or their respective staffs may have with respect to these comments. Please direct any such questions to William H. Wilson at (619) 230-4620 or Bill.Wilson@uboc.com.

Very truly yours,

UNION BANK OF CALIFORNIA, N.A.

By:____________________________
Johannes H. Worsoe
Executive Vice President

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15 *See* NASD Notice Members 97-11 (March 1997), Notice to Members 89-3 (Jan. 1989).