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Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Proposed Rule: Regulation B -- The Networking Exception
File Number S7-26-04

To Whom It May Concern:

We are writing in response to the Securities and Exchange Commission's solicitation of comments on Regulation B, a proposal to broaden the number of exemptions available to banks, savings banks, and savings associations that effect transactions in securities.[1] We are commenting on behalf of the Pace Investor Rights Project (PIRP) at Pace University School of Law. PIRP is committed to advocacy, research, and education in the area of investor rights, with a strong focus on the law governing the rights of small investors.

We are concerned with the impact the third-party brokerage exception in Exchange Act Section 3(a)(4)(B)(i)[2] (the "Networking Exception") may have on small investors and unsophisticated bank customers. While we recognize the Commission's desire to facilitate banks' compliance with the Gramm-Leach-Bliley Act (GLBA),[3] we believe that the proposed rule does so at the expense of investor protection. By moving access to securities into banks, the Networking Exception blurs the line between saving and investing. Because the proposed rule permits referral fees that are more than nominal, bank employees may have an incentive to engage in behavior that is beyond the scope of the referral services authorized by Congress. In addition, current regulations are

[1] Regulation B, 69 Fed. Reg. 39682, 1 (proposed June 30, 2004) (to be codified at 17 C.F.R. pts. 240 and 242).

[2] *Id.* at 11, citing 15 U.S.C. 78(c)(a)(4)(B)(i).

[3] *Id.* at 1.

insufficient to protect small investors exposed to broker-dealers through interactions at their local banks. Therefore, we propose: (1) amending the proposed definition of "nominal one-time cash fee of a fixed dollar amount" to place a $25 ceiling on the value of the referral fee; (2) defining what constitutes acceptable clerical and ministerial tasks under 15 U.S.C. § 78(c)(a)(4)(B)(i)(V); and (3) creating guidelines to help banks police themselves and to ensure that the necessary oversight is provided.

1. <u>Problem: Unsophisticated investors cannot delineate between bank products and securities.</u>

PIRP operates in conjunction with the Pace University School of Law's Securities Arbitration Clinic (SAC), a division of John Jay Legal Services, Inc. that represents small investors in disputes with their broker-dealers.

One scenario we often see is as follows:

> An individual goes into his bank to renew a CD. When he reaches the teller, the teller asks "Wouldn't you like to talk to someone about your investment so that you can get a greater return on your money?" The individual agrees and soon finds himself in an investment situation he does not understand because it is not made sufficiently clear to the customer that what he is buying is not an FDIC insured bank product but really a security.

Our experience indicates that unsophisticated investors in this situation may not fully understand the differences between bank and broker products. Particularly in an era of low interest rates, investors on fixed incomes may be attracted by the prospect of higher returns and may not sufficiently understand the downside risk involved in securities investments. Furthermore, they may have limited funds available for investment purposes and often cannot tolerate the losses caused by this lack of understanding. This is especially problematic in light of the fact that the Networking Exception provides bank tellers and other bank employees with incentives to recommend meeting with brokers. This can lead to serious financial problems for small investors who often find themselves lured into unsuitable investment strategies.

We simply do not believe that bank employees can successfully convince customers to use the broker's services without also selling the customer on the broker's products. While GLBA imposes some limitations on the activities of bank employees, the current regulatory structure does little to prevent bank employees from using sales tactics to entice customers. This salesmanship poses a problem for small investors.

2. <u>The problem is exacerbated by the value of the referral fee.</u>

We support the Commission's view "that the term 'nominal' as used in the GLBA should be defined as that term is commonly understood"[4] and agree that "[i]n the context

[4] *Id.* at 14.

of compensation, and in common legal usage, a 'nominal' fee is a small one of no concern to the payor and little value to the payee."[5] However, we do not believe that the Commission's proposed definitions are consistent with this understanding of the term "nominal."

> The Commission's proposal
>
> to amend the definition of 'nominal one-time cash fee of a fixed dollar amount' to mean that a referral payment must have a value that does not exceed the greater of three alternative measures: the employee's base hourly rate of pay, a dollar amount equal to $15 in 1999 plus an adjustment for inflation, or $25[6]

does not eliminate the incentive to sell securities, in violation of "the broker-dealer registration provisions in the federal securities laws,"[7] for two reasons: (1) the actual value of the referral fee is not nominal, and (2) the proposal ignores the cumulative effect of making multiple referrals.

a. The actual value of the referral fee is not nominal.

According to the U.S. Department of Labor Bureau of Labor Statistics, in 2003 the mean hourly wage for a bank teller was $10.07 and the mean annual wage was $20,940.00.[8] Assuming that these figures represent the average wage of most bank employees, under the proposed definitions a bank employee could receive as much as $25 per referral,[9] substantially more than his hourly wage. While this may be a small amount of money to a bank (payor), to an employee (payee), this bonus could serve as a powerful incentive to *sell* people on the broker's products and services, especially when receipt of the referral fee is contingent upon the customer keeping his appointment with the broker. Under this definition, it is in the employee's best interest to become skilled at convincing customers to see the brokers; an effective, short sales-pitch could provide the employee with extra pay without having to work extra hours. Over a period of time, such behavior could result in a bonus that is far from nominal, as explained by the following discussion on the cumulative effect of such a fee. This degree of salesmanship is clearly beyond the intended scope of the referral fee contemplated by Congress.

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[5] *Id.*

[6] Regulation B, 69 Fed. Reg. 39682, 15 (proposed June 30, 2004) (to be codified at 17 C.F.R. pts. 240 and 242).

[7] *Id.* at 14.

[8] U.S. Department of Labor, Bureau of Labor Statistics, at http://www.bls.gov/oes/2003/may/oes_43Of.htm.

[9] Robert C. Sahr, *Consumer Price Index (CPI) Conversion Factors to Convert 1999 Dollars (Final)*, (2000) at http://oregonstate.edu/Dept/pol_sci/fac/sahr/cv99.pdf (rev. March 30, 2000) (The rule provides for payment of either the employee's hourly wage, 15 inflation adjusted 1999 dollars, or a flat rate of $25; using Sahr's table and formula we were able to approximate the value of 1999 dollars in 2003 (15*1.105=16.575~=16.60) and in 2004 (15*1.133=16.995~=17)).

b. The proposal ignores the cumulative effect of making multiple referrals.

Using the above-stated wage approximations and referral fees, it becomes apparent that by making as few as 5 qualifying referrals a week, an employee could dramatically increase his paycheck.[10] Assuming the employee receives the $25 flat rate referral fee, 5 referrals a week would increase his salary by $125. If the employee can maintain this rate for a full year, he could increase his salary by $6,000.[11] This represents a real increase in buying power for the average employee.

The provision stating that "[t]he fee could be paid to a bank employee no more than one time per customer referred by that employee," does not address the issue of cumulative fees because it does not deter the bank employee from encouraging *every* customer to meet with the broker-dealer. This behavior is actually encouraged by the current definitions. As the above-stated calculations indicate, it does not take a large number of willing customers to provide an employee with a very worthwhile bonus. By simply approaching every new customer with whom he interacts, the employee increases his chances of earning a substantial bonus.

The same problems exist when a non-cash bonus system is used. As long as the system used allows the employee to accumulate points in a meaningful way, the incentive to sell the customer on the broker's products and services remains.

3. <u>Current regulations are insufficient to protect the interests of small investors.</u>

While NASD Conduct Rule 2350 requires the broker to disclose fully the risks involved with an investment[12]and specifically forbids misleading communications with the public,[13] in our experience these provisions are insufficient to protect the interests of small investors. We specifically question whether brokers adequately discuss with unsophisticated bank customers the "investment risks, including possible loss of the principal invested"[14] when comparing bank products and securities investments. Brokers frequently fill out paperwork for investors and have them sign without fully explaining the meaning of what they are signing. These small investors are willing to trust the broker because they feel comfortable *investing through the bank.*

The statute itself, 15 U.S.C. § 78(c)(a)(4)(B)(i), also does little to protect investors. The statute requires promotional *materials* to "clearly indicate that the brokerage services are being provided by the broker or dealer and not by the bank"[15] and

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[10] Assuming a 40-hour workweek, the average employee makes $402.80. Five qualifying referrals would result in the following range of bonuses: $50.35, $83 (2003), $85 (2004), and $125. Such a bonus represents 12.5-31% of the employee's weekly salary, a substantial bonus.

[11] This assumes a 48-week year.

[12] NASD Conduct Rule 2350(c)(3).

[13] NASD Conduct Rule 2350(c)(4).

[14]NASD Conduct Rule 2350(c)(4)(B).

[15] 15 U.S.C. § 78(c)(a)(40(B)(i)(III).

to be "in compliance with the Federal securities laws . . . ."[16] However, no such restrictions are placed on oral promotions by bank employees. The statute only restricts employee conduct to the performance of "clerical or ministerial functions ... except that bank employees may ... describe in general terms the types of investment vehicles available."[17] It provides little guidance on what the term "clerical or ministerial functions" means and it also fails to limit the scope of the "description" of the investment options. The statute also fails to establish oversight provisions to ensure that bank employees do not perform impermissible functions, such as engaging in "selling" activities. Furthermore, the disclosure requirements[18] it provides do little to protect investors.

4. <u>Solution: Decrease the incentive to engage in inappropriate conduct and provide banks with tools to regulate their own behavior.</u>

In order to increase the distinction between bank products and securities and to decrease the incentive to bank employees to "sell," we recommend the following course of action:

a. Amend the definition of "nominal one-time cash fee of a fixed dollar amount."

We believe that the definition should be amended to provide the employee with the lesser of the employee's hourly wage or $25. This would ensure that the bank teller's fee is no more than his hourly wage, while also providing a cap on the fees paid to higher-paid bank employees. By eliminating the need to calculate the value of inflation-adjusted 1999 dollars and limiting the fee to a truly nominal amount, we believe that bank compliance will be made simpler and the incentive to sell securities will be decreased.

b. Further define what constitutes acceptable clerical and ministerial tasks under 15 U.S.C. § 78(c)(a)(4)(B)(i)(V). Forbid bank employees from initiating conversations with customers about the broker's services.

Neither the statute nor the proposed regulations adequately limits the bank employee's role. The statute allows bank employees to "describe in general terms the types of investment vehicles available from the bank and the broker or dealer under the arrangement,"[19] but does not require that description to contain any specific disclosures. It also does not provide guidance on how the bank employee ought to approach the subject of the broker's products and services. To resolve this problem, we think that the bank employee should be prohibited from suggesting meeting with the broker unless the customer first indicates a desire to learn about ways to increase his return on investment. This would help eliminate the incentive to solicit each customer provided by the referral fee, by limiting the number and type of customer the bank employee could approach.

We would also like to ensure that any initial information provided by the bank employee to the customer about the broker includes the disclosures in 15 U.S.C. §

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[16] 15 U.S.C. § 78(c)(a)(40(B)(i)(IV).

[17] 15 U.S.C. § 78(c)(a)(40(B)(i)(V).

[18] 15 U.S.C. § 78(c)(a)(40(B)(i)(VII) and 15 U.S.C. § 78(c)(a)(40(B)(i)(IX).

[19] 15 U.S.C. § 78(c)(a)(4)(B)(i)(V).

78(c)(a)(4)(B)(i)(IX) and conforms to the guidelines for promotional materials in 15 U.S.C. § 78(c)(a)(4)(B)(i)(III) and 15 U.S.C. § 78(c)(a)(4)(B)(i)(IV). When the customer begins this dialogue, the bank employee also should endeavor to communicate the inherent risk of investing as opposed to saving.

c. Create guidelines to help banks police themselves and to ensure that the necessary oversight is provided.

Banks who wish to comply with the regulation need guidance on how to monitor employee conduct to ensure against the use of sales tactics to earn bonuses. They also need to be able to rely on an effective enforcement mechanism to substantiate their desire for compliance.

We believe that clarification is necessary to establish who -- the SEC or the bank regulators -- will be responsible for ensuring that the Networking Exception is not abused. As bank regulators are primarily concerned with the safety and stability of the bank and its money supply, not investor protection, we do not believe that our concerns will be adequately addressed by their monitoring functions. We are concerned that by not specifying who is in charge of enforcing these provisions and how they ought to do so, there will not be anyone looking out for the interests of small investors and ensuring that mandatory disclosures are provided and bank employees do not act in ways that exceed their limited authority.

Thank you for your consideration of these comments. Please do not hesitate to contact us if we can provide additional information.

Sincerely yours,

/s/ Barbara Black

Barbara Black, Director

/s/ Jill I. Gross

Jill I. Gross, Director

/s/ Michele Glass

Michele Glass, Student Intern