



The Commonwealth of Massachusetts

Secretary of the Commonwealth

State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth

March 26, 2007

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

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

Re: Definition of Terms and Exemptions Relating to the “Broker” Exceptions for Banks; Securities and Exchange Commission Release No. 34-54946 – File No S7-22-06; Federal Reserve System, 12 CFR Part 218 [Regulation R; Docket R-1274]

Dear Ms. Morris and Ms. Johnson:

The Massachusetts Securities Division appreciates this opportunity to comment on proposed Regulation R, defining terms and exemptions relating to the “broker” exceptions for banks.

The Massachusetts Securities Division (“Securities Division”) is a department within the Office of the Secretary of the Commonwealth of Massachusetts. The Securities Division is charged with the responsibility to implement and enforce the Massachusetts securities laws. As such, the Secretary of the Commonwealth is the chief securities regulator for Massachusetts.

Background and Discussion

Regulation R represents the latest proposal after years of effort on the part of the Securities and Exchange Commission (“SEC”), and more recently the Board of Governors of the Federal Reserve System (collectively “Federal Regulators”), to define the eleven exceptions from the definition of broker under the Securities Exchange Act of 1934 as amended by Congress in the Gramm-Leach-Bliley Act (“GLBA”).

The Securities Division views Regulation R as inappropriately tilting in favor of deregulation of the brokerage activities of depository institutions to the detriment of retail investors. Given the breadth of Regulation R, this comment letter is necessarily limited to the broad concerns raised by proposed Regulation R – primarily its retreat from GLBA’s mandate of functional regulation.

Many of the exceptions defined by Regulation R represent an expansion of the activities that depository institutions may engage in without triggering the broker-dealer registration requirement under the Securities Exchange Act of 1934. These exceptions would permit more banks to engage in traditional securities activities without the oversight of securities regulators such as the SEC. Such a result is contrary to Congress’s intent under GLBA to create a system of functional regulation. Therefore, the Securities Division urges the Federal Regulators to withdraw Regulation R and re-propose rules similar to either the previously proposed Regulation B or the Interim Rules.

Proposed Regulation R Is Contrary to the Gramm-Leach-Bliley Act’s Mandate of Functional Regulation

The exception for third party brokerage arrangements is one example of how Regulation R enables banks to engage in activities beyond the text and purpose of GLBA. In particular, the text of GLBA clearly bans the payment of all “incentive compensation” to bank personnel except for the very limited instance of a referral fee:

[B]ank employees do not receive incentive compensation for any brokerage transaction ... except that the bank employees may receive compensation for the referral of any customer **if the compensation is a nominal one-time cash fee of a fixed dollar amount and the payment of the fee is not contingent on whether the referral results in a transaction.**¹

Despite this statutory language, Regulation R creates an exemption that essentially allows a bank to pay an employee a fee for referring an institutional or high net worth customer to a broker-dealer that is greater than a “nominal” amount and dependent upon the amount ultimately invested.² Significantly, this exemption did not exist in either Regulation B, or the Interim Rules. The Regulation R release justifies this exemption by arguing, without elaboration, that high net worth individuals possess the ability 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.”³

Such an exemption directly conflicts with the text of GLBA and its mandate of functional regulation.⁴ In fact, this proposed exemption provides a strong incentive for

¹ 15 U.S.C. § 78c(a)(4)(B)(i)(VI) (emphasis added).

² 71 Fed. Reg. 77522, 77545 (Dec. 26, 2006) (Proposed Exchange Act Rule 701).

³ *Id.* at 77525.

⁴ The Securities Division questions the appropriateness of the use of the general exemptive authority provided at § 36 of the Securities Exchange Act of 1934 in this instance. Section 36 requires such exemptions to be “necessary or appropriate in the public interest, and is consistent with the protection of investors.” 15 U.S.C. § 78mm. However, many of Regulation R’s provisions appear designed to

unregistered bank personnel to promote sales of securities, essentially turning them into finders or salespersons for the broker-dealer. Moreover, Regulation R would even allow a referral fee to be paid “based on a fixed percentage of the total dollar amount of assets placed in an account with the broker or dealer.”⁵ This formula may result in the payment of incentive compensation to the unregistered bank employee that functionally resembles broker compensation. Therefore, the Securities Division urges the Federal Regulators to remove this exemption from the proposal in its entirety.

The “Nominal” Fees Payable to Bank Personnel Under Regulation R Would Not Be Truly Nominal

Under GLBA, bank personnel may receive only a nominal fee for referring to the broker-dealer any other customer that does not meet the proposal’s definition of “high net worth.” However, the proposed definition of “nominal” appears to be inconsistent with the plain meaning of nominal. In particular, the proposal would allow a nominal referral fee to be calculated based on an employee’s “job family,” such that the payment would be either: (1) twice the average of the minimum and maximum hourly wage established by the bank for that job family, or (2) 1/1000th of the average of the minimum and maximum annual base salary established by the bank for the particular job family.⁶ Therefore, a bank employee may be paid a referral fee that is more than twice his or her hourly rate of pay. The Securities Division believes this calculation would create an undue incentive on the part of the bank employee to refer customers to the broker-dealer. As such, the Securities Division urges the Federal Regulators to more narrowly construe the definition of nominal so as to remove this apparent conflict of interest.

Proposed Regulation R would put bank employees into the chain of compensated persons involved in offering securities products. But because bank employees will not be licensed as broker-dealer agents, the protections that apply to brokerage employees will be missing. Such protections include: qualifying tests and background checks, licensure, inspection and oversight by securities regulators, obligation of securities brokerage supervision, individual compliance responsibilities that apply to agents, and potential disciplinary action by regulators.

The Massachusetts Securities Division Has Encountered Serious Sales Practice Violations at Banks

The Securities Division has a strong interest in preventing any blurring of the roles of bank and brokerage personnel that may occur as a result of many of the exceptions and exemptions that Regulation R would create. The Securities Division has amassed a substantial administrative record demonstrating the harm of such blurring by broker-dealers at some the nation’s largest depository institutions, including Bank of America and Citizens Bank. The Securities Division has found through its investigations

accommodate the business practices of depository institutions, not to further the public interest consistent with investor protection.

⁵ 71 Fed. Reg. at 77527.

⁶ *Id.* (Proposed Exchange Act Rule 700(c)).

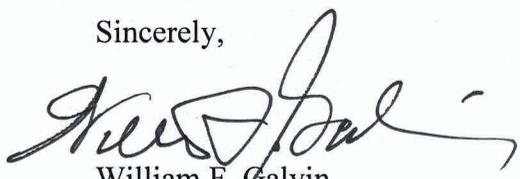
that bank customers often did not and could not distinguish between bank employees offering traditional bank products and commissioned salespeople selling non-depository investments.

The Securities Division first acted against Bank of America's brokerage unit on July 12, 2005. In the settlement of that matter, the Securities Division required that the company establish training and procedures focused on sales conducted on bank premises and the use of depository funds to purchase non-FDIC insured investment products.⁷ In another matter, the Securities Division entered into a consent order with the brokerage unit of Citizens Bank for impermissible blurring between the bank and broker-dealer.⁸ This action was based on a complaint alleging that the bank and broker-dealer "collaborated to assure a steady stream of business" would flow from bank deposits into brokerage accounts.⁹ As the Citizens Bank complaint stated, these "tangled business practices...mised Massachusetts investors as to the risks associated with investing in non-bank products."¹⁰

These recent regulatory actions indicate a continuing failure by both banks and broker-dealers to adhere to even the basic principles mandated by GLBA, like the requirement of physical separation of bank and brokerage activities. Many of Regulation R's proposals would only exacerbate these well-documented problems by creating conflicts of interest and economic incentives for a bank to systematically funnel customers to the broker-dealer without the oversight of securities regulators. While the federal banking regulators have at times stated that they are able to adequately monitor such activities, the recent events in the area of sub-prime mortgages indicates the likely inability for those regulators to take on additional regulatory oversight.

Please contact me, or Bryan J. Lantagne, Director of the Massachusetts Securities Division, at (617) 727-3548 if you have questions about these comments or if I can assist in any way.

Sincerely,



William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts

⁷ *Banc of Am. Inv. Servs. Inc.*, Memo. of Understanding, Docket No. E-2005-0060 (Mass. Sec. Div. 2005).

⁸ *Citizens Inv. Servs. Corp.*, Consent Order, Docket Nos. E-2004-0050, E-2005-0004, E-2005-0140 (Mass. Sec. Div. 2005).

⁹ *Citizens Inv. Servs. Corp.*, Admin. Comp., Docket No. E-2004-0050 (Mass. Sec. Div. 2005).

¹⁰ *Id.*