DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 13

[Docket No. 97–05]

RIN 1557–AB52

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 211

[Regulations H and K, Docket No. R–0921]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 368

RIN 3064–AB66

Government Securities Sales Practices

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation.

ACTION: Joint final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) are issuing rules regarding sales practices concerning government securities by depository institutions within their respective jurisdictions. The agencies are adopting the final rules in light of recent statutory changes authorizing the agencies to adopt rules governing transactions in government securities in order to provide consistent treatment for government securities customers. The final rules minimize regulatory burdens to the extent feasible, consistent with the goal of providing purchasers of government securities with consistent treatment regardless of whether they engage in transactions in government securities with banks or nonbank government securities brokers and dealers.

EFFECTIVE DATE: This joint rule is effective July 1, 1997.

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Board: Oliver Ireland, Associate General Counsel (202/452–3625), or Lawranne Stewart, Senior Attorney (202/452–3513), Legal Division, Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551. For the hearing impaired only, Telecommunication Device for Deaf (TDD), Ernestine Hill or Dorothea Thompson (202/452–3544).

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SUPPLEMENTARY INFORMATION:

The Government Securities Act Amendments of 1993

The Government Securities Act Amendments of 1993 (Amendments) (Pub.L. 103-202), codified at section 15C(b)(3) of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. 78o-5(b)(3)), authorize the agencies to adopt rules and regulations governing transactions in government securities as may be necessary to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade. *Id*. section 15C(b)(3)(A). Rules adopted pursuant to the Amendments apply to transactions in government securities by banks that have filed, or are required to file, notice as government securities brokers or dealers.

The Amendments require the banking agencies to consider the sufficiency and appropriateness of existing laws and rules applicable to government securities brokers or dealers and associated persons before promulgating rules governing transactions in government securities. *Id*. section 15C(b)(3)(C). In determining whether existing laws are sufficient, the agencies may consider rules that expressly apply to government securities activities of financial institutions and other sales practice rules that do not expressly apply to these activities but that are used by examiners and bankers as guidance for transactions in government securities. S. Rep. No. 109, 103d Cong., 1st Sess. at 14. The agencies also may consider the extent to which additional rules are necessary to establish consistent treatment for bank customers engaged in transactions involving government securities.

The Amendments also eliminated the statutory limitations on the National Association of Securities Dealers (NASD) authority to apply sales practice rules to transactions in government securities by government securities broker-dealers that are members of the NASD. See section 106 of the Amendments (15 U.S.C. 78o-3). To implement this expanded sales practice authority, the NASD proposed, and the SEC approved August 20, 1996 (see SEC Release No. 34–37588), the application of the NASD Conduct Rules (formerly, the Rules of Fair Practice) to transactions in government securities. The NASD Conduct Rules include a Business Conduct Rule and a Suitability Rule, as well as a Suitability Interpretation. The rules and the interpretation that the agencies promulgated in both the proposed and final rules (see text that follows) are substantially identical to the NASD Business Conduct and Suitability Rules and the NASD Suitability Interpretation.

The Proposal

On April 25, 1996 (61 FR 18470), the agencies requested comment on whether they should require a bank that is a government securities broker or dealer to comply with rules that are substantively identical to the NASD Business Conduct and Suitability Rules and the NASD Suitability Interpretation. The proposal defined ''bank that is a government securities broker or dealer'' as a bank that has filed notice, or is required to file notice, as a government securities broker or dealer under the provisions of the Government Securities Act (15 U.S.C. 78o-5(a)) and applicable Treasury rules (17 CFR 400.1(d) and 401).

The proposal required a bank that is a government securities broker or dealer and its associated persons: (a) To observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business as a government securities broker or dealer; and (b) to have reasonable grounds for believing that recommendations are suitable for a customer based on the facts, if any, disclosed by a customer regarding his, her, or its other securities holdings and financial situation and needs. The proposal provided that, if a bank is doing business with a non-institutional customer, the bank must make reasonable efforts to obtain information concerning the customer's financial situation and tax status and investment objectives before executing a transaction it recommended to the customer. The suitability rule contained in the proposal, like the Suitability Rule of the NASD, applies only in situations where a bank makes a ''recommendation'' to its customer.

The proposal also set out a suitability interpretation that identifies factors that may be relevant when evaluating a bank's compliance with the suitability rule when dealing with an institutional customer other than a natural person. The interpretation identified: (a) the customer's capability to evaluate investment risk independently; and (b) the extent to which the customer is exercising independent judgement in evaluating a bank's recommendation as the two most important considerations in determining the scope of the bank's responsibilities to an institutional customer. The suitability interpretation provided that a bank will have met the requirements of the suitability rule with respect to a particular institutional customer where the bank has reasonable grounds to determine that the institutional customer is capable of independently evaluating investment risk and is exercising independent judgement in evaluating a recommendation.

The proposed suitability interpretation set forth certain factors for banks to apply in evaluating an institutional customer's capability to evaluate investment risk independently. These factors include: The customer's use of consultants, advisors, or bank trust departments; the experience of the customer generally and with respect to the specific instrument; the customer's ability to understand the investment and to evaluate independently the effect of market developments on the investment; and the complexity of the security involved. The interpretation stressed that an institutional customer's ability to evaluate investment risk independently may vary depending on the particular type of instrument or its risk. Moreover, the interpretation noted that an institutional customer with general ability to evaluate investment risk may be less able to do so when dealing with new types of instruments or instruments with which the customer has little or no experience.

The proposed suitability interpretation further provided that a determination that an institutional customer is making an independent investment decision depends on factors such as the understanding between the bank and its customer as to the nature of their relationship, the presence or absence of a pattern of acceptance of the bank's recommendations, the customer's use of ideas, suggestions, and information obtained from other market professionals, and the extent to which the customer has provided the bank with information concerning the customer's portfolio or investment objectives.

While the proposed suitability interpretation stated that these factors would be considered relevant in evaluating whether a bank that is a government securities broker or dealer has fulfilled the requirements of the suitability rule with respect to any institutional customer that is not a natural person, it further stated that the factors cited would be considered most relevant for an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio or under management.

Final Rules and Comments Received

The final rules adopt the business conduct and suitability rules and the suitability interpretation as proposed, excepting only the addition of a definition of ''government security'' in the final rules and minor modifications of the suitability interpretation to conform that interpretation to the NASD's Suitability Interpretation. As discussed in greater detail below, the agencies continue to believe that banks and their customers will benefit significantly from a consistent set of rules applied to banks engaged in transactions in government securities.

The agencies received a total of 18 comments. Of these, eight were from trade organizations representing interests ranging from the banks and the securities companies to state governments and retired persons. Seven other comments were from insured depository institutions or their affiliates, two were from State governments, and the remaining comment was from a securities dealer. The comments were fairly evenly split, with banks and securities companies and their respective trade organizations generally opposing the proposal and the rest of the commenters favoring it.

Commenters typically responded to some or all of the specific questions set out in the proposal. Below is a summary of the comments, along with the agencies' responses, that follows the order of questions presented for comment in the proposal.

Issue 1. Adoption of rules substantially similar to the NASD Business Conduct and Suitability Rules

Eight commenters opposed adoption of these rules for banks while seven favored adoption of the rules.

(a) *Comments supporting adoption of the proposed rules.* Commenters representing purchasers of government securities stated that certain government securities, such as collateralized mortgage obligations, carry considerable risk and are unsuitable for certain investors. The purchasers' representatives stated further that customers need to be protected from potential misconduct in the sale of government securities. They believe that banks should be held to the same standards as apply to other entities that engage in government securities transactions and that the existence of customer protections should not depend on the type of entity selling the security. Several of the commenters also stated their support for the suitability interpretation, with one commenter stating that a suitability determination must be made on a case-by-case basis and another stating that banks should be required to ask for specific information about an investor before making a recommendation.

(b) *Comments opposing adoption of the proposed rules.* Those opposing the application of these rules to banks advanced several arguments to support their conclusion that the rule is unnecessary. Their arguments fall into the following eight broad categories.

(i) There have been no significant sales practice abuses.

(ii) The Amendments and the legislative history indicate that the banking agencies are not required to adopt sales practice rules.

(iii) There are sufficient market incentives to ensure that the good relations that exist between banks and their customers would likely discourage banks from making unsuitable recommendations of government securities.

(iv) A suitability obligation is particularly inappropriate in the case of institutional investors, because institutional investors need less protection than do retail customers and because a bank will lack adequate information needed to detect anomalies between an institutional customer's investment objectives and the type of trade.

(v) The rules will impose significant additional burdens on banks, in part because the rules are too ambiguous.

(vi) The rules could have unintended adverse consequences by discouraging investors from performing their own research in order to shift responsibility (and, therefore, liability) for making appropriate investments to the bank that makes a recommendation.

(vii) Case law and other issuances, such as the Interagency Statement on Retail Sales of Nondeposit Investment Products (the Interagency Statement), OCC Banking Circular 277—Risk Management of Financial Derivatives, the Board's Trading Activities Manual (March 1994) and SR 93–69 (FIS) (Dec. 20, 1993), and the Rules of the Municipal Securities Rulemaking Board

(MSRB), provide sufficient guidance to banks and bank examiners on appropriate sales practices.

(viii) The agencies should consider alternatives to adopting the rules as proposed, such as adopting guidelines or amending the proposal to include a statement that compliance with certain requirements creates a safe harbor.

(c) *Analysis of Issue 1.* After carefully considering all the arguments advanced by the commenters, the agencies continue to believe that the benefits of the rules in question significantly outweigh the burdens and, therefore, are adopting the rules substantially as proposed. The agencies believe that adoption of final rules substantially in the form proposed is appropriate to provide consistent treatment for government securities customers. Although bank and nonbank government securities dealers will continue to be subject to different regulatory structures, adoption of business conduct and suitability rules that are consistent with the NASD rules will ensure that customers of both bank and nonbank government securities broker-dealers receive consistent treatment in their government securities transactions. The agencies agree with those who stated that certain government securities can carry considerable risk and that the rules appropriately focus the banking industry's attention on the issue of suitability in recommending these securities. An analysis of the comments opposing adoption of the rules follows.

(i) *Lack of evidence of abuses.* Opponents of the rules are correct that sales practice abuses have not been found to be a significant problem in financial institutions engaged in government securities transactions. However, losses stemming from unsuitable transactions in government securities can create reputational risk for banks. The agencies believe that banking practices that comport with the final rules will help minimize this risk to banks due to losses incurred by their customers.

(ii) *Rules not required by statute.* Opponents of the rules also correctly noted that the Amendments and the legislative history do not require the bank regulatory agencies to adopt sales practice rules. However, the Amendments authorize the agencies to adopt rules as may be necessary to promote, among other things, just and equitable principles of trade. The final rules accomplish this by providing guidance to banks about the extent of their obligations when recommending a government security to a customer. They also enable a customer to receive consistent treatment, regardless of whether the customer conducts business with a bank or nonbank government securities broker-dealer.

(iii) *Sufficient market alternatives.* The agencies intend for the rules to facilitate the good relations noted by many commenters that exist between banks and their customers. In addition to codifying the business conduct and suitability rules, the final rules provide banks with guidance concerning those factors that a bank may find relevant when determining its suitability obligations to an institutional customer. This guidance is provided to assist banks in identifying when an institutional customer is capable of evaluating investment risk independently and is exercising independent judgement in evaluating the bank's recommendation.

(iv) *Suitability obligation inappropriate for institutional customers.* The agencies agree with the commenters who stated that any suitability rule should reflect the differences between institutional and non-institutional customers. Banks frequently will have knowledge about an investment and its risks that are not possessed or easily obtained by the non-institutional customer. A more sophisticated institutional customer, on the other hand, may have both the understanding of how a particular securities issue could perform and a desire to make investment decisions without relying on a bank's recommendation.

The final rules recognize the wide variety of customer profiles, even among institutional customers, and provides guidance intended to assist a bank in determining the nature of its suitability obligations to a customer. Under the final rules, the nature of a suitability determination changes, depending on the type of customer. For a comparatively unsophisticated customer, the determination will need to focus more on whether a particular investment is appropriate for that customer after a review of the customer's financial condition and objectives. For a more sophisticated customer, the focus of the suitability determination shifts initially to the question of whether the customer is capable of evaluating risk and the bank's recommendation. The suitability interpretation provides illustrative factors that are intended to help a bank determine how to fulfill its suitability obligation for a given institutional customer. As noted in the interpretation, these factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a bank's suitability obligations.

(v) *Increased burden.* The agencies believe that the sales practice rules will not subject banks to a material increase in regulatory burden. Almost all banks that are government securities broker-dealers also are municipal securities broker-dealers or sell other securities for which they are required to comply with business conduct and suitability rules. As a consequence, banks frequently will have obtained the information needed to comply with the business conduct and suitability rules from customers in the course of other securities transactions, and will have implemented policies and procedures that can be applied to transactions involving government securities.

(vi) *Unintended adverse consequences.* The agencies disagree with the commenters who suggested that the rules will discourage customers from consulting with their own internal or external advisors before making an investment. These commenters are concerned that the rules will shift liability to banks by creating disincentives for a customer to undertake research that is independent of that conducted by a bank. As noted in the proposal, the suitability and business conduct rules and suitability interpretation do not provide a basis for a private right of action against a bank by a customer based on a violation of these rules or interpretation. Thus, a customer will have every incentive after the rules are adopted that it had before adoption to undertake whatever due diligence it thinks is appropriate in evaluating an investment recommendation.

(vii) *Existing guidance adequate.* While those opposed to the rules are correct that there are banking agency issuances that address sales practices in other areas of securities sales, these issuances do not provide customers who engage in government securities transactions with banks with treatment that is consistent with that provided under the NASD Business Conduct or Suitability Rules or the NASD Suitability Interpretation. Moreover, existing guidance does not address government securities sales practices for all types of customers. The final rules will provide a framework that will be consistent throughout the banking industry for analyzing the obligations of a bank engaged in government securities transactions.

(viii) *Suggested alternatives.* One bank commenter recommended that the agencies adopt guidelines instead of the proposed sales practice rules. Another suggested that the agencies adopt an

''appropriateness'' standard pursuant to which a bank would focus on the customer's ability to understand the nature of, and risks inherent in, a given transaction. Two commenters suggested that the final rules contain an assurance that compliance with the interpretive guidance will create, at a minimum, a rebuttable presumption that a bank's suitability obligations with respect to institutional customers have been satisfied. Finally, another commenter suggested that banks be insulated from liability if an institutional customer has retained a third party professional investment advisor or if the bank executes a transaction that is consistent with an institutional account's specifically enumerated authorized investment guidelines.

The agencies have concluded, however, that adopting the rules in the form of a regulation will provide consistent treatment of customers, regardless of whether they conduct business with a bank or a nonbank government securities broker-dealer. The agencies also have decided not to create any safe harbors whereby a bank would be presumed to have fulfilled its suitability obligation. The creation of such a presumption would be acceptable only if a definable class of institutional customers could be identified that would not benefit from the suitability rule under any conceivable circumstance. ''Institutional customers'' include, among others, colleges, churches, charities, and governments. Given the wide diversity of characteristics that such entities present, the agencies have concluded that it is more appropriate for a bank to determine suitability on a case-by-case basis. Furthermore, nonbank broker-dealers do not have safe harbors whereby compliance with the suitability obligation is presumed. To create a safe harbor for banks would reduce the benefits of consistent treatment of customers.

Issue 2. Benefits of Consistency Among Government Securities Brokers and Dealers

Of the seven commenters responding to this issue, five stated that there are benefits of consistent treatment by government securities broker-dealers while two stated that consistency would not provide significant benefits.

(a) *Comments favoring consistency.* Several commenters stated that customers are more likely to receive equal treatment if the agencies impose rules similar to those imposed by the NASD. One commenter noted that the substance of the rules applied by the banking agencies should be as uniform as possible with those applied by the NASD to minimize the extent to which there are gaps in the existing regulatory framework. Another commenter stated that a customer should not have to bear the burden of determining which set of rules apply to different dealers who are performing exactly the same functions concerning exactly the same types of investments. In this commenter's view, the agencies'' role in maintaining the safety and soundness of banks includes protecting customers. A third commenter observed that fragmentation of the market is likely if different rules apply.

(b) *Comments opposing consistency.* A trade association representing both bank and nonbank interests stated that a majority of its members believes that adopting the final rules is not justified because the level playing field already exists in the form of remedial and enforcement authority that the agencies may exercise. Another commenter noted that there are significant differences between bank and nonbank government securities broker-dealers, and concluded that these differences justify using different standards. This commenter believes that the different standards continue to result in the same level of customer protection, thus obviating the need to adopt the rules set out in the proposal.

(c) *Analysis of Issue 2.* The agencies believe that the final rules will provide consistent treatment to customers engaging in government securities transactions, regardless of whether the customer receives a recommendation from a bank or nonbank government securities broker-dealer. The existing regulatory and common law does not provide this consistent treatment. The final rules avoid requiring customers to ascertain which rules apply to which institution. Moreover, the agencies expect that the final rules, by focusing banks' attentions on suitability concerns, will minimize the disputes between banks and their customers concerning the suitability of a given recommendation.

Issue 3. Sufficiency of the Standard Provided in the Business Conduct Rule

Five commenters responded to this issue. Four commenters believe that the business conduct rule is sufficiently clear, while one commenter believes that additional interpretation is necessary.

(a) *Comments finding business conduct rule clear.* One commenter stated that the business conduct rule, taken together with the suitability rule, is sufficiently clear. In this commenter's opinion, a rule of this nature should provide a general code of conduct that protects the integrity of the profession by setting a baseline of good conduct. Another commenter suggested that more specific guidelines may be too restrictive and not benefit the customer or bank. A third commenter restated its request for changes in the examination procedures to ensure compliance with the final rule but suggested that banks should have less latitude in the types of information requested from a customer. The fourth commenter stated its general agreement that the business conduct rule is clear.

(b) *Comments finding the business conduct rule unclear.* The one comment finding the business conduct rule unclear stated that the rule does not delineate proper conduct for sales practices. This commenter stated that it views the NASD guidance related to the business conduct rule as providing appropriate additional clarification.

(c) *Analysis of Issue 3.* The agencies believe that the business conduct rule set out in the proposal is sufficiently clear. As noted by one commenter, the rule establishes a baseline of appropriate behavior in the industry. A bank then has the flexibility to comply with this standard in ways that it finds appropriate and effective. Attempts at additional clarification in this area are likely to provide little additional meaningful guidance without becoming so detailed as to be overly burdensome and restrictive. The agencies also are concerned that additional clarification in the business conduct rule would detract from the objective of ensuring consistent treatment for customers of bank and nonbank government securities broker-dealers. The agencies note that the NASD is continuing to consider issues concerning the application of certain interpretations of their Business Conduct Rule to the government securities markets.

Issue 4. Definition of ''Recommendation''

The issue of whether to define ''recommendation'' or provide guidance as to what is and is not a recommendation generated responses from seven commenters, four of whom requested additional guidance or a definition and three of whom stated that no additional guidance or definition is needed.

(a) *Comments favoring defining ''recommendation.''* A point consistently made by those requesting additional guidance is that the rules should clarify that a recommendation does not include providing routine market information, such as market observations, forecasts about the general

direction of interest rates, and price quotations. One commenter also stated that the rules should not treat subjective analyses of market information as a recommendation, because to do so would discourage banks from providing this information. This commenter suggested that the rules exclude from the definition of ''recommendation'' the providing of several investment alternatives for an investor's consideration. Two commenters proposed definitions that would include, generally speaking, an unconditional affirmative statement by one party urging another to enter into a particular transaction, an explicit identification of the statement as a recommendation, and/or a requirement that information be given to the bank expressly for the purpose of enabling the bank to make a recommendation. One of these commenters stated that reliance should not be considered reasonable unless an institutional customer has provided information regarding its portfolio, its liabilities, and the range of investment opportunities available to the customer. Another commenter concluded that the definition is so vague that the commenter will have to assume, despite the fact that it makes no recommendations, that all current sales activities constitute making a recommendation and then build systems and increase staff to evaluate and document the suitability of each customer purchase. Another commenter suggested that a definition should not include trade or hedging ideas unless there is a written agreement between the parties or unless applicable law expressly imposes affirmative obligations to the contrary. This commenter noted that this approach would be consistent with the ''impersonal advisory services'' rule proposed by the SEC in 1994.

(b) *Comments opposing defining ''recommendation.''* Commenters opposing defining ''recommendation'' expressed concern that a definition would create a safe harbor protecting banks against liability and stated that individual facts and circumstances must be reviewed to determine whether a recommendation has been made. One commenter stated further that the line of when a bank is recommending a product is clear, namely, when the bank provides information to explain why a customer should purchase a particular product. This commenter suggested that once a customer expresses an interest in a particular product, the suitability obligation should be triggered even if no explicit recommendation is made.

(c) *Analysis of Issue 4.* The agencies have decided not to define ''recommendation,'' for several reasons. First, a determination of whether a recommendation has been made necessarily depends on the facts of a given situation. The agencies believe that a definition would not change the need to review the entire circumstances of a transaction, and, therefore, do not believe that a definition would provide a significant benefit. Second, the agencies are concerned that a definition might be misinterpreted as a safe harbor whereby a government securities broker-dealer effectively recommends an investment but argues that it had no suitability obligation because the advice technically was not a recommendation according to the literal terms of a definition. Third, the agencies believe that there is no need to define the term, because bankers and examiners already are accustomed to the use of the term in the municipal securities area where similar rules currently exist. Finally, for the reasons previously stated, the agencies believe that government securities customers will benefit from rules that are consistent for both bank and nonbank government securities broker-dealers. Given that the NASD and SEC recently decided not to define ''recommendation,'' a decision to do so in the banking agencies'' rule could result in a material difference that could undermine the benefits of consistency and could lead to confusion concerning what effect the definition would have on the other rules.

While the agencies do not believe it is appropriate to define the term ''recommendation,'' they note that they would not view the provision of general market information, including market observations, forecasts about interest rates, and price quotations, as making a recommendation under the rule, absent other conduct.

Issue 5. Adoption of Additional Rules

Of the four commenters addressing the need to adopt rules similar to other sections of the Rules of Fair Practice or interpretations similar to other NASD interpretations, all four supported adopting additional rules and interpretations.

(a) *Comments supporting additional rules.* One commenter suggested that the agencies adopt those parts of the NASD Rules of Fair Practice that require the establishment of a system to supervise personnel involved in government securities transactions. Another commenter stated that the rules should be extended to those practices that adversely affect transactions, such as markups, churning, and frontrunning. A third commenter suggested that the agencies adopt rules concerning the supervision of employees, the establishment of written procedures, and the requirement of internal inspections. This commenter noted that the banking industry and its customers would benefit from additional uniformity with nonbank government securities dealers. The final commenter suggested that the agencies adopt additional rules similar to those applicable to bank municipal securities dealers.

(b) *Comments opposing additional rules.* While no commenter specifically opposed adopting additional rules, several noted their general opposition to the agencies adopting any rules in this area. The arguments advanced by these commenters are summarized in the discussion of the first issue.

(c) *Analysis of Issue 5.* The agencies have decided not to adopt rules other than the Suitability and Business Conduct Rules and Suitability Interpretation at this time. In some cases, the NASD Rules overlap with safety and soundness standards that already apply to banks (see, e.g., Rule 3010 of the NASD's Conduct Rules, which requires each member to establish and maintain a system of supervision that is reasonably designed to achieve compliance with applicable securities laws and regulations). Other NASD Rules appear to codify existing duties and principles to which bank employees acting in a fiduciary capacity must adhere (see, e.g., Rule 2330 of the NASD's Conduct Rules, which prohibits members and associated persons from making improper use of a customer's securities or funds). While the agencies believe that the business conduct rule is sufficiently broad to address much of the conduct proscribed by other NASD Rules, the agencies will consider whether there is a need to adopt additional rules as the agencies examine banks for compliance with the rules and interpretation adopted herein. Banks should determine the adequacy and appropriateness of their policies, procedures, and internal controls with respect to the final rules.

Issue 6. Ability to contract out of the rules

Four of the six commenters addressing this issue favor allowing a bank and its customers to establish standards by contract that would govern that relationship, while two opposed this option.

(a) *Comments favoring allowing parties to contract out of the rules.* One commenter suggested that the agencies look to the Principles and Practices for

Wholesale Financial Market Transactions, prepared in 1995 under the coordination of the Federal Reserve Bank of New York, for guidance on the appropriate set of governing assumptions regarding institutional relationships. This commenter noted that the Amendments contain no limitation on the agencies'' ability to permit this flexibility. While this commenter opposed adoption of the rules in general, the commenter stated that, if the agencies adopt the rules, they should clarify that a bank would be insulated from liability to the extent that the bank and customer contractually limit liability. Another commenter opined that a written contract should control on the question of suitability and that the agencies should provide guidance on when an oral agreement will suffice (such as, for instance, allowing oral agreements to control if they are entered into on a recorded line). A third commenter stated that banks should be encouraged to clarify the nature of the relationship with their customers, including providing disclaimers about the nature of the information given if appropriate. The fourth commenter expressed its support for allowing parties to contract out of the rules but then suggested that the presence or absence of a contract should be one of the factors considered if a bank's compliance with its suitability obligation is in dispute.

(b) *Comments opposing allowing parties to contract out of the rules.* Those commenters who opposed allowing banks to contract out of the rules expressed concern that an agreement should not be used to protect banks that make unsuitable recommendations. One commenter noted that a contract should be only one factor to consider when determining whether a suitability obligation has been satisfied. The other commenter opposed to contractually limiting liability stated that, if parties are allowed to do so, the final rules should require periodic review of the contract. According to this commenter, the changing nature of financial markets may render a contract inappropriate over time.

(c) *Analysis of Issue 6.* The agencies believe that a contract establishing the nature of the relationship can be helpful in determining the relationship between the bank and its customer, but that such a contract will not be determinative of whether the bank has fulfilled its obligation under the rules. The agencies also believe that the benefits to be gained by both the banking industry and its customers from having uniform suitability rules and interpretations would be significantly undermined if banks were permitted to establish by contract a safe harbor from their obligations under the rules. Accordingly, the final rules do not go beyond the proposed interpretation, which provides that written and oral agreements will be considered as one of several factors that may be relevant in determining whether the bank has fulfilled its obligations under the suitability rule. Additionally, the agencies note that because the rules do not create a private right of action, there is no need to provide a mechanism in the rule for a bank to insulate itself from liability to customers arising from a violation of the rules.

Issue 7. Definition of ''Institutional Customer''

Eight commenters addressed the issue of how to define an ''institutional customer.'' Of these, four opposed using $50 million in total assets as the measure by which institutional customers are judged while one favored using this cutoff. Five commenters expressed support for a test based on assets under management as the appropriate measure, and one opposed any test based on asset size, portfolio size, or revenue.

(a) *Comment favoring use of $50 million in total assets.* The one commenter favoring the use of $50 million in assets as the threshold for determining who is an institutional customer stated that the level of assets usually is a good determinant of whether the customer is sophisticated. This commenter also noted that customers above that size can afford to hire a professional manager, and suggested that there is no reason to shift to the dealer the responsibility for ensuring that investments are suitable. The commenter suggested further that an appropriate benchmark for governmental entities is whether a government's budget is at least $50 million. Finally, this commenter opined that a customer should be considered ''institutional'' if it is registered as an investment adviser under either U.S. or foreign law and that the definition should clarify that a bank, savings association, or insurance company may be domestic or foreign.

(b) *Comments opposing use of $50 million in total assets.* All of the commenters opposed to defining ''institutional customer'' by using total assets stated that asset size is not a good proxy for sophistication. One commenter maintained that a rule that does not apply to all registered investment companies will result in banks being less willing to make recommendations to small investment companies because the suitability obligations to the small companies will be more onerous. Another commenter stated that this test will only place more burdens and risks on banks. The commenter opposed to any test based on asset size, portfolio size, or revenue stated that the tests are inaccurate and arbitrary. Concerning an asset size test, this commenter noted that all but the smallest local governments have assets of at least $50 million, although most of these assets are in the form of buildings, land, sewage facilities, and so on. This commenter opposed a revenue test because the cyclical nature of tax receipts will temporarily swell the amounts available for investment by a government, thereby resulting in many small governments being deemed ''institutional customers'' even though they need the protections afforded by the suitability rule. Finally, this commenter believes that portfolio size is problematic because it is unclear which governmental entity's portfolio should be considered. To illustrate this problem, this commenter asked whether investments of a state government and local governments within that state should be considered as held in one portfolio and whether pension funds invested by a city are part of the city's portfolio. Two other commenters stated their general opposition to an asset size test set at $50 million.

(c) *Comments favoring portfolio size as the appropriate test.* Of the four commenters favoring a test based on portfolio size, one agreed that $10 million was the appropriate cutoff. Two others stated that, while portfolio size is a better measure of sophistication than is asset size, $10 million is too high a threshold. Finally, one commenter stated that portfolio size should be considered, but that it should be only one of several factors looked at.

(d) *Analysis of Issue 7.* The agencies have decided to adopt a definition of ''institutional customer'' that is consistent with the NASD's definition. As a result, all customers will receive consistent treatment under the suitability rule. Moreover, transactions with all customers other than natural persons will be covered by the suitability interpretation, although the factors identified in the interpretation will be most appropriate for a customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management. If an entity has less than $50 million in total assets, a bank making a recommendation to that entity must make a reasonable effort to obtain information about the customer's financial and tax status, investment

objectives, and other information used or considered reasonable by the bank in making a recommendation.

The agencies believe that if a different measure were used, the inconsistencies between their rule and the NASD's Suitability Rule would make the agencies' rule more difficult to apply. Also, examiners, auditors, and compliance officers likely would encounter difficulties determining compliance with suitability requirements if the measure for an institutional customer varies, as some commenters suggested, depending on the type of entity and security involved.

The agencies believe that some commenters may have misinterpreted the significance of the tests for determining when an investor is an ''institutional customer.'' *All* customers, whether institutional or not, are covered by the suitability rule. In all cases, a bank must have reasonable grounds for believing that a recommendation is suitable based on the facts, if any, disclosed by a customer concerning the customer's other security holdings and financial situation and needs. Moreover, in all cases, a bank must make a determination based on the facts of a particular situation whether it has fulfilled its suitability obligation. The thresholds identified in the regulation and interpretation are provided solely for the purpose of assisting a bank in identifying the type of information that may be relevant in deciding if the suitability obligation is met in a given case. For all entities other than natural persons (but particularly for entities with at least $10 million invested in securities in the aggregate in its portfolio and/or under management), a bank should consider the factors identified in the suitability interpretation in deciding whether a customer is capable of evaluating investment risk independently and whether the customer is exercising independent judgement in evaluating a bank's recommendation. For entities (including natural persons) with less than $50 million in total assets, a bank is required to make reasonable efforts to obtain the additional information listed in the section captioned ''Customer information'' (12 CFR 13.5, 208.25(e), and 368.5, respectively). This information will be in addition to whatever other information the bank obtains in its effort to determine whether it has met its suitability obligation.

Issue 8: Other Suggestions

One commenter stated that the factors listed in the suitability interpretation concerning a customer's ability to evaluate risk are reasonable but do not require banks to provide information the customer needs in order to make an informed investment decision. This commenter suggested that the interpretation should require banks to provide certain types of transaction-specific information, such as valuation information, an instrument's behavior under a stress test, and the types of risks incurred.

The agencies agree that this information may be useful to a customer in many cases. However, a comparatively unsophisticated customer likely will rely on the bank to evaluate this information before making a recommendation, while a more sophisticated customer will, in many cases, request this information from the bank or obtain this information on its own. Accordingly, the agencies have decided not to require the information suggested by the commenter.

This commenter also identified what it believes are shortcomings in each of the considerations listed in the suitability interpretation. Many of the shortcomings cited focus on the inapplicability or inappropriateness of a certain factor in a given set of circumstances. The agencies acknowledge that not all of the factors identified will be helpful in every case. However, the interpretation is not presented as a checklist of required information. The factors listed neither create nor reduce a bank's suitability obligation. Their relevance will vary, depending on the circumstances of a given situation. The agencies believe that the factors will be helpful in assisting a bank's determination of whether it has met its suitability obligation. Therefore, the agencies are adopting the suitability interpretation as proposed, making only the modifications to the proposed interpretation that are necessary to conform the agencies' suitability interpretation to that of the NASD.

Two commenters requested that the agencies clarify that the final rules do not apply to institutions that are subject to NASD jurisdiction. The agencies recognize that many banks conduct a significant portion of their securities activities through subsidiaries or affiliates that are registered broker-dealers. The agencies confirm that securities activities conducted in registered broker-dealers that are NASD members are subject to the NASD rules and will not be subject to the agencies' final rules.

Another commenter requested that the agencies add a cross-reference in the final rules to the definition of ''government securities'' used in the Securities Exchange Act (15 U.S.C. 78c(a)(42)) in order to assist bankers working with the rules. The agencies agree that a reference to this definition would be helpful, and have amended the final rules accordingly.

Finally, one commenter asserted that the Regulatory Flexibility Act certification contained in the proposal is flawed because it fails to focus on the 300 domestic banks that are covered by the proposal.[1] The agencies note that they did focus on these banks in determining the impact that the rules would have on small entities. See 61 FR 18472 (''As an initial matter, the proposed rule would apply only to those banks that have given notice or are required to give notice that they are government securities brokers or dealers under section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5) and applicable Treasury rules under section 15C (17 CFR 400.1(d) and 401), including approximately 300 domestic banks and branches of foreign banks.''). The Regulatory Flexibility Act certification in these final rules also focuses on these banks as the appropriate pool to consider when evaluating the rules' impact on small entities. See discussion of the Regulatory Flexibility Act that follows.

Regulatory Flexibility Act

Under section 605(b) of the Regulatory Flexibility Act (RFA) (5 U.S.C. 605(b)), the regulatory flexibility analysis otherwise required under section 604 of the RFA (5 U.S.C. 604) is not required if the head of the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities and the agency publishes such certification and a statement providing the factual basis for such certification in the Federal Register along with the final rule.

Pursuant to section 605(b) of the RFA, the OCC, Board, and the FDIC each individually certifies that these final rules will not have a significant economic impact on a substantial number of small entities. As noted in the proposal and in the preamble to the final rules, the rules will apply only to those banks that have given notice or are required to give notice that they are government securities brokers or dealers under section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5) and applicable Treasury rules under section 15C (17 CFR 400.1(d) and 401).

[1] Data obtained since the proposal was published show that this figure is approximately 160 banks covered by the rule. See discussion of the Regulatory Flexibility Act for additional analysis of the number of institutions covered.

Most small banking institutions are not required to give notice under section 15C, as Treasury rules provide exemptions for financial institutions that engage in fewer than 500 government securities brokerage transactions per year and for financial institutions with government securities dealing activities limited to sales and purchases in a fiduciary capacity. See 17 CFR 401.3 and 401.4. Other exemptions from the notice requirements also are available. See 17 CFR Part 401. Additionally, the agencies note that many banks conduct a significant portion of their securities activities through subsidiaries or affiliates that are registered broker-dealers. Securities activities conducted in registered broker-dealers that are NASD members are subject to the NASD Rules and would not be subject to the agencies' final rules. As a consequence, currently there are only approximately 160 banks that are registered as a government securities broker-dealer. Of these, only 7 are ''small entities'' for purposes of the Regulatory Flexibility Act. See 13 C.F.R. 121.601.

Paperwork Reduction Act

In accordance with section 3506 of the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; see also 5 CFR 1320 Appendix a.1), the agencies have reviewed the final rules and have determined that no collections of information pursuant to the Paperwork Reduction Act are contained in the rules.

OCC Executive Order 12866 Statement

The Office of Management and Budget has concurred with the OCC's determination that these final rules are not a significant regulatory action under Executive Order 12866.

OCC Unfunded Mandates Act of 1995 Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104–4 (Unfunded Mandates Act), requires that the agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires the agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, the final rules set forth sales practice responsibilities of banks that are government securities brokers or dealers. The OCC has determined that the final rules will not result in expenditures by State, local, or tribal governments or by the private sector of more than $100 million. Accordingly, the OCC has not prepared a budgetary impact statement or addressed specifically the regulatory alternatives considered.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121, 104th Cong., 2d Sess. (1996)) provides generally for agencies to report rules to Congress and for Congress to review the rules. The reporting requirement is triggered in instances where the agency in question issues a final rule as defined by the Administrative Procedure Act at 5 U.S.C. 551. The agencies will file the appropriate reports pursuant to the statute concerning their final rules.

The Office of Management and Budget has determined that these final rules do not constitute ''major'' rules as defined by the statute.

List of Subjects

12 CFR Part 13

Banks, banking, Government securities, National banks, Securities

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Flood insurance, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 211

Exports, Federal Reserve System, Foreign banking, Holding companies, Investments, Reporting and recordkeeping requirements.

12 CFR Part 368

Banks, banking, Securities.

Office of the Comptroller of the Currency

12 CFR CHAPTER I

Authority and Issuance

For the reasons set out in the preamble, a new part 13 is added to chapter I of title 12 of the Code of Federal Regulations to read as follows:

PART 13—GOVERNMENT SECURITIES SALES PRACTICES

Sec.

Authority: 12 U.S.C. 1 *et seq.*, and 93a; 15 U.S.C. 78o–5.

§ 13.1 Scope.

This part applies to national banks that have filed notice as, or are required to file notice as, government securities brokers or dealers pursuant to section 15C of the Securities Exchange Act (15 U.S.C. 78o–5) and Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401).

§ 13.2 Definitions.

(a) *Bank that is a government securities broker or dealer* means a national bank that has filed notice, or is required to file notice, as a government securities broker or dealer pursuant to section 15C of the Securities Exchange Act (15 U.S.C. 78o–5) and Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401).

(b) *Customer* does not include a broker or dealer or a government securities broker or dealer.

(c) *Government security* has the same meaning as this term has in section 3(a)(42) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(42)).

(d) *Non-institutional customer* means any customer other than:

(1) A bank, savings association, insurance company, or registered investment company;

(2) An investment adviser registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3); or

(3) Any entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

§ 13.3 Business conduct.

A bank that is a government securities broker or dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business as a government securities broker or dealer.

§ 13.4 Recommendations to customers.

In recommending to a customer the purchase, sale or exchange of a government security, a bank that is a government securities broker or dealer shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and as to the

customer's financial situation and needs.

§ 13.5 Customer information.

Prior to the execution of a transaction recommended to a non-institutional customer, a bank that is a government securities broker or dealer shall make reasonable efforts to obtain information concerning:

(a) The customer's financial status;

(b) The customer's tax status;

(c) The customer's investment objectives; and

(d) Such other information used or considered to be reasonable by the bank in making recommendations to the customer.

Interpretations

§ 13.100 Obligations concerning institutional customers.

(a) As a result of broadened authority provided by the Government Securities Act Amendments of 1993 (15 U.S.C. 78o–3 and 78o–5), the OCC is adopting sales practice rules for the government securities market, a market with a particularly broad institutional component. Accordingly, the OCC believes it is appropriate to provide further guidance to banks on their suitability obligations when making recommendations to institutional customers.

(b) The OCC's suitability rule (§ 13.4) is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Banks' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Banks are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

(c) In recommending to a customer the purchase, sale, or exchange of any government security, the bank shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and financial situation and needs.

(d) The interpretation in this section concerns only the manner in which a bank determines that a recommendation is suitable for a particular institutional customer. The manner in which a bank fulfills this suitability obligation will vary, depending on the nature of the customer and the specific transaction. Accordingly, the interpretation in this section deals only with guidance regarding how a bank may fulfill customer-specific suitability obligations under § 13.4.[1]

(e) While it is difficult to define in advance the scope of a bank's suitability obligation with respect to a specific institutional customer transaction recommended by a bank, the OCC has identified certain factors that may be relevant when considering compliance with § 13.4. These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a bank's suitability obligations.

(f) The two most important considerations in determining the scope of a bank's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgement in evaluating a bank's recommendation. A bank must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the bank may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a bank's customer-specific obligations under § 13.4 would not be diminished by the fact that the bank was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

(g) A bank may conclude that a customer is exercising independent judgement if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the bank has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a bank's obligations under § 13.4 for a particular customer are fulfilled.[2] Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the interpretation in this section shall be applied to the agent.

(h) A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

(1) The use of one or more consultants, investment advisers, or bank trust departments;

(2) The general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;

(3) The customer's ability to understand the economic features of the security involved;

(4) The customer's ability to independently evaluate how market developments would affect the security; and

(5) The complexity of the security or securities involved.

(i) A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the bank and the customer.

Relevant considerations could include:

(1) Any written or oral understanding that exists between the bank and the customer regarding the nature of the relationship between the bank and the customer and the services to be rendered by the bank;

(2) The presence or absence of a pattern of acceptance of the bank's recommendations;

(3) The use by the customer of ideas, suggestions, market views and information obtained from other government securities brokers or dealers or market professionals, particularly those relating to the same type of securities; and

(4) The extent to which the bank has received from the customer current comprehensive portfolio information in

[1] The interpretation in this section does not address the obligation related to suitability that requires that a bank have ''* * * a 'reasonable basis' to believe that the recommendation could be suitable for at least some customers.'' *In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr.,* 50 SEC 164 (1989).

[2] See footnote 1 in paragraph (d) of this section.

connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

(j) Banks are reminded that these factors are merely guidelines that will be utilized to determine whether a bank has fulfilled its suitability obligation with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular bank/customer relationship, assessed in the context of a particular transaction.

(k) For purposes of the interpretation in this section, an institutional customer shall be any entity other than a natural person. In determining the applicability of the interpretation in this section to an institutional customer, the OCC will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While the interpretation in this section is potentially applicable to any institutional customer, the guidance contained in this section is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management.

Dated: February 18, 1997.

Eugene A. Ludwig,

Comptroller of the Currency.

Federal Reserve System

12 CFR CHAPTER II

Authority and Issuance

For the reasons set forth in the joint preamble, parts 208 and 211 of chapter II of title 12 of the Code of Federal Regulations are amended as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for Part 208 is revised to read as follows:

Authority: 12 U.S.C. 36, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1823(j), 1828(o), 1831o, 1831p-1, 3105, 3310, 3331–3351 and 3906–3909; 15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o-4(c)(5), 78o-5, 78q, 78q-1, and 78w: 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. A new § 208.25 is added to subpart A to read as follows:

§ 208.25 Government securities sales practices.

(a) *Scope.* This subpart is applicable to state member banks that have filed notice as, or are required to file notice as, government securities brokers or dealers pursuant to section 15C of the Securities Exchange Act (15 U.S.C. 78o-5) and Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401).

(b) *Definitions*—(1) *Bank that is a government securities broker or dealer* means a state member bank that has filed notice, or is required to file notice, as a government securities broker or dealer pursuant to section 15C of the Securities Exchange Act (15 U.S.C. 78o-5) and Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401).

(2) *Customer* does not include a broker or dealer or a government securities broker or dealer.

(3) *Government security* has the same meaning as this term has in section 3(a)(42) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(42)).

(4) *Non-institutional customer* means any customer other than:

(i) A bank, savings association, insurance company, or registered investment company;

(ii) An investment adviser registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-3); or

(iii) Any entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

(c) *Business conduct.* A bank that is a government securities broker or dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business as a government securities broker or dealer.

(d) *Recommendations to customers.* In recommending to a customer the purchase, sale or exchange of a government security, a bank that is a government securities broker or dealer shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and as to the customer's financial situation and needs.

(e) *Customer information.* Prior to the execution of a transaction recommended to a non-institutional customer, a bank that is a government securities broker or dealer shall make reasonable efforts to obtain information concerning:

(1) The customer's financial status;

(2) The customer's tax status;

(3) The customer's investment objectives; and

(4) Such other information used or considered to be reasonable by the bank in making recommendations to the customer.

3. A new § 208.129 is added to subpart B to read as follows:

§ 208.129 Obligations concerning institutional customers.

(a) As a result of broadened authority provided by the Government Securities Act Amendments of 1993 (15 U.S.C. 78o-3 and 78o-5), the Board is adopting sales practice rules for the government securities market, a market with a particularly broad institutional component. Accordingly, the Board believes it is appropriate to provide further guidance to banks on their suitability obligations when making recommendations to institutional customers.

(b) The Board's Suitability Rule, § 208.25(b), is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Banks'' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Banks are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

(c) In recommending to a customer the purchase, sale, or exchange of any government security, the bank shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and financial situation and needs.

(d) The interpretation in this section concerns only the manner in which a bank determines that a recommendation is suitable for a particular institutional customer. The manner in which a bank fulfills this suitability obligation will vary, depending on the nature of the customer and the specific transaction. Accordingly, the interpretation in this section deals only with guidance regarding how a bank may fulfill customer-specific suitability obligations under § 208.25(d).[1]

[1] The interpretation in this section does not address the obligation related to suitability that requires that a bank have ''* * * a 'reasonable basis' to believe that the recommendation could be suitable for at least some customers.'' *In the Matter of the Application of F.J. Kaufman and Company*

Continued

(e) While it is difficult to define in advance the scope of a bank's suitability obligation with respect to a specific institutional customer transaction recommended by a bank, the Board has identified certain factors that may be relevant when considering compliance with § 208.25(d). These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a bank's suitability obligations.

(f) The two most important considerations in determining the scope of a bank's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgement in evaluating a bank's recommendation. A bank must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the bank may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a bank's customer-specific obligations under § 208.25(d) would not be diminished by the fact that the bank was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

(g) A bank may conclude that a customer is exercising independent judgement if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the bank has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a bank's obligations under § 208.25(d) for a particular customer are fulfilled.[2] Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the interpretation in this section shall be applied to the agent.

(h) A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

(1) The use of one or more consultants, investment advisers, or bank trust departments;

(2) The general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;

(3) The customer's ability to understand the economic features of the security involved;

(4) The customer's ability to independently evaluate how market developments would affect the security; and

(5) The complexity of the security or securities involved.

(i) A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the bank and the customer. Relevant considerations could include:

(1) Any written or oral understanding that exists between the bank and the customer regarding the nature of the relationship between the bank and the customer and the services to be rendered by the bank;

(2) The presence or absence of a pattern of acceptance of the bank's recommendations;

(3) The use by the customer of ideas, suggestions, market views and information obtained from other government securities brokers or dealers or market professionals, particularly those relating to the same type of securities; and

(4) The extent to which the bank has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

(j) Banks are reminded that these factors are merely guidelines that will be utilized to determine whether a bank has fulfilled its suitability obligation with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular bank/customer relationship, assessed in the context of a particular transaction.

(k) For purposes of the interpretation in this section, an institutional customer shall be any entity other than a natural person. In determining the applicability of the interpretation in this section to an institutional customer, the Board will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While the interpretation in this section is potentially applicable to any institutional customer, the guidance contained in this section is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management.

PART 211—INTERNATIONAL BANKING OPERATIONS (REGULATION K)

1. The authority citation for Part 211 is revised to read as follows:

Authority: 12 U.S.C. 221 *et seq.*, 1818, 1841 *et seq.*, 3101 *et seq.*, 3109 *et seq.*; 15 U.S.C. 78o–5.

2. Section 211.24 is amended by revising the section heading and adding a new paragraph (h) to read as follows:

§ 211.24 Approval of offices of foreign banks; procedures for applications; standards for approval; representative-office activities and standards for approval; preservation of existing authority; reports of crimes and suspected crimes; government securities sales practices.

* * * * *

(h) *Government securities sales practices.* An uninsured state-licensed branch or agency of a foreign bank that is required to give notice to the Board under section 15C of the Securities Exchange Act of 1934 (15 U.S.C. 78o–5) and the Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401) shall be subject to the provisions of 12 CFR 208.25 to the same extent as a state member bank that is required to give such notice.

of Virginia and Frederick J. Kaufman, Jr., 50 SEC 164 (1989).

[2] See footnote 1 in paragraph (d) of this section.

By order of the Board of Governors of the Federal Reserve Board, March 11, 1997.

Jennifer J. Johnson,

Deputy Secretary of the Board.

Federal Deposit Insurance Corporation

12 CFR CHAPTER III

Authority and Issuance

For the reasons set out in the preamble, a new part 368 is added to chapter III of title 12 of the Code of Federal Regulations to read as follows:

PART 368—GOVERNMENT SECURITIES SALES PRACTICES

Authority: 15 U.S.C. 78o–5.

§ 368.1 Scope.

This part is applicable to state nonmember banks and insured state branches of foreign banks that have filed notice as, or are required to file notice as, government securities brokers or dealers pursuant to section 15C of the Securities Exchange Act (15 U.S.C. 78o–5) and Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401).

§ 368.2 Definitions.

(a) *Bank that is a government securities broker or dealer* means a state nonmember bank or an insured state branch of a foreign bank that has filed notice, or is required to file notice, as a government securities broker or dealer pursuant to section 15C of the Securities Exchange Act (15 U.S.C. 78o–5) and Department of the Treasury rules under section 15C (17 CFR 400.1(d) and part 401).

(b) *Customer* does not include a broker or dealer or a government securities broker or dealer.

(c) *Government security* has the same meaning as this term has in section 3(a)(42) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(42)).

(d) *Non-institutional customer* means any customer other than:

(1) A bank, savings association, insurance company, or registered investment company;

(2) An investment adviser registered under section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3); or

(3) Any entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

§ 368.3 Business conduct.

A bank that is a government securities broker or dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business as a government securities broker or dealer.

§ 368.4 Recommendations to customers.

In recommending to a customer the purchase, sale or exchange of a government security, a bank that is a government securities broker or dealer shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and as to the customer's financial situation and needs.

§ 368.5 Customer information.

Prior to the execution of a transaction recommended to a non-institutional customer, a bank that is a government securities broker or dealer shall make reasonable efforts to obtain information concerning:

(a) The customer's financial status;

(b) The customer's tax status;

(c) The customer's investment objectives; and

(d) Such other information used or considered to be reasonable by such bank in making recommendations to the customer.

§ 368.100 Obligations concerning institutional customers.

(a) As a result of broadened authority provided by the Government Securities Act Amendments of 1993 (15 U.S.C. 78o–3 and 78o–5), the FDIC is adopting sales practice rules for the government securities market, a market with a particularly broad institutional component. Accordingly, the FDIC believes it is appropriate to provide further guidance to banks on their suitability obligations when making recommendations to institutional customers.

(b) The FDIC's suitability rule (§ 368.4) is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Banks' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Banks are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

(c) In recommending to a customer the purchase, sale, or exchange of any government security, the bank shall have reasonable grounds for believing that the recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by the customer as to the customer's other security holdings and financial situation and needs.

(d) The interpretation in this section concerns only the manner in which a bank determines that a recommendation is suitable for a particular institutional customer. The manner in which a bank fulfills this suitability obligation will vary, depending on the nature of the customer and the specific transaction. Accordingly, the interpretation in this section deals only with guidance regarding how a bank may fulfill customer-specific suitability obligations under § 368.4. [1]

(e) While it is difficult to define in advance the scope of a bank's suitability obligation with respect to a specific institutional customer transaction recommended by a bank, the FDIC has identified certain factors that may be relevant when considering compliance with § 368.4. These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a bank's suitability obligations.

(f) The two most important considerations in determining the scope of a bank's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgement in evaluating a bank's recommendation. A bank must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the bank may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable

[1] The interpretation in this section does not address the obligation related to suitability that requires that a bank have '' * * * a 'reasonable basis' to believe that the recommendation could be suitable for at least some customers.'' *In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr.,* 50 SEC 164 (1989).

of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a bank's customer-specific obligations under § 368.4 would not be diminished by the fact that the bank was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

(g) A bank may conclude that a customer is exercising independent judgement if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the bank has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a bank's obligations under § 368.4 for a particular customer are fulfilled. [2] Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the interpretation in this section shall be applied to the agent.

(h) A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

(1) The use of one or more consultants, investment advisers, or bank trust departments;

(2) The general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;

(3) The customer's ability to understand the economic features of the security involved;

(4) The customer's ability to independently evaluate how market developments would affect the security; and

(5) The complexity of the security or securities involved.

(i) A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the bank and the customer. Relevant considerations could include:

(1) Any written or oral understanding that exists between the bank and the customer regarding the nature of the relationship between the bank and the customer and the services to be rendered by the bank;

(2) The presence or absence of a pattern of acceptance of the bank's recommendations;

(3) The use by the customer of ideas, suggestions, market views and information obtained from other government securities brokers or dealers or market professionals, particularly those relating to the same type of securities; and

(4) The extent to which the bank has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

(j) Banks are reminded that these factors are merely guidelines that will be utilized to determine whether a bank has fulfilled its suitability obligation with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular bank/customer relationship, assessed in the context of a particular transaction.

(k) For purposes of the interpretation in this section, an institutional customer shall be any entity other than a natural person. In determining the applicability of the interpretation in this section to an institutional customer, the FDIC will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While the interpretation in this section is potentially applicable to any institutional customer, the guidance contained in this section is more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management.

By order of the Board of Directors, dated at Washington, D.C., this 11th day of March, 1997.

Federal Deposit Insurance Corporation

Robert E. Feldman,

Deputy Executive Secretary.

[FR Doc. 97–6803 Filed 3–18–97; 8:45 am]

BILLING CODES: 4810–33–P, 6210–01–P, 6714–01–P

[2] See footnote 1 in paragraph (d) of this section.