

DEPARTMENT OF THE TREASURY**Office of the Comptroller of the Currency****12 CFR Part 13**

[Docket No. 96-09]
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; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation.

ACTION: Joint notice of proposed rulemaking.

SUMMARY: The Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, Federal banking agencies or agencies) are requesting comment on a proposed rule regarding the responsibilities of banks that are government securities brokers or dealers with respect to sales practices concerning government securities. The proposed rule would establish standards concerning the recommendations to customers and the conduct of business by a bank that is a government securities broker or dealer. The agencies also propose to adopt an interpretation concerning recommendations to institutional customers with respect to government securities transactions.

DATES: Comments must be received by June 24, 1996.

ADDRESSES: Comments should be directed to:

OCC: Communications Division, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219, Attention: Docket No. 96-09; FAX number 202/874-5274 or internet address regs.comments@occ.treasury.gov. Comments may be inspected and photocopied at the same location.

Board: William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, Attention: Docket No. R-0921, or delivered to room B-2222,

Eccles Building, between 8:45 a.m. and 5:15 p.m. Comments may be inspected in Room MP-500 between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in § 261.8 of the Board of Governor's rules regarding availability of information, 12 CFR 261.8.

FDIC: Jerry L. Langley, Executive Secretary, Attention: Room F-402, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429. Comments may be delivered to Room F-400, 1776 F Street, NW., Washington, DC 20429, on business days between 8:30 a.m. and 5 p.m. or sent by facsimile transmission to FAX number 202/898-3838 or via Internet to: comments@fdic.gov. Comments will be available for inspection and photocopying in room 7118, 550 17th Street, NW., Washington, DC 20429, 8:30 a.m. and 5:00 p.m. on business days.

FOR FURTHER INFORMATION CONTACT:

OCC: Ellen Broadman, Director, or Elizabeth Malone, Senior Attorney, Securities & Corporate Practices Division (202/874-5210).

Board: Oliver Ireland, Associate General Counsel (202/452-3625), or Lawranne Stewart, Senior Attorney (202/452-3513), Legal Division. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), Earnestine Hill or Dorothea Thompson (202/452-3544).

FDIC: William A. Stark, Assistant Director (202/898-6972), Miguel Browne, Deputy Assistant Director (202/898-6789), Dennis Olson, Senior Financial Analyst (202/898-7212), Division of Supervision; Jeffrey M. Kopchik, Counsel, (202/898-3872), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, N.W. Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION: The Government Securities Act Amendments of 1993 (Amendments) included a provision permitting the Federal banking agencies to adopt sales practice rules for sales of government securities by banks that have filed, or are required to file, notice as government securities brokers or dealers. The Amendments also authorized the National Association of Securities Dealers (NASD) to adopt sales practice rules with respect to sales of government securities by government securities broker/dealers that are members of the NASD. See Pub.L. 103-202, section 106 (15 U.S.C. 780-3 and 780-5).

The NASD, acting under its new authority, has approved a proposal to extend its Rules of Fair Practice, where appropriate, to activities relating to

government securities, and has forwarded the proposal to the Securities and Exchange Commission (SEC) for approval.¹ The NASD proposal includes the extension to government securities transactions of section 1 (NASD Business Conduct Rule) and section 2 (NASD Suitability Rule) of Article III of the NASD Rules of Fair Practice (NASD Rules). At the same time, the NASD approved an interpretation concerning suitability obligations to institutional customers under section 2 (NASD Suitability Interpretation).² This interpretation addresses the responsibilities of brokers and dealers under the NASD Suitability Rule with respect to recommendations to institutional customers and also is subject to SEC approval.

The OCC, Board, and the FDIC are requesting comment on the adoption of rules substantially similar to the NASD Business Conduct Rule and the NASD Suitability Rule and on the adoption of an interpretation substantially similar to the NASD Suitability Interpretation.³ The agencies request comment on the application of such requirements to the government securities transactions of banks that are required to file notice under the provisions of the Government Securities Act (15 U.S.C. 780-5(a)) and applicable Treasury rules (17 CFR 400.1(d) and 401).

The NASD Rules

The NASD Business Conduct Rule provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."⁴

¹ Amendments to the NASD proposal have been published for comment by the SEC. 61 FR 11655 (March 21, 1996). The comment period on this notice closes on April 22, 1996. The full NASD proposal was published for comment by the SEC on October 24, 1995. 60 FR 54530.

² *Id.* The NASD published its proposed interpretation for comment on two occasions prior to its adoption. See NASD Notice to Members 95-21 (April 1995) and NASD Notice to Members 94-62 (August 1994).

³ Should further amendments be made to the NASD proposal with respect to the NASD Business Conduct or Suitability Rules or the NASD Suitability Interpretation prior to final approval by the SEC, the agencies will consider incorporating such amendments into the final rule. Commenters therefore should consider any further amendments to the NASD proposal in commenting on the agencies' proposed rules.

Additionally, at the present time the agencies are not considering the adoption of rules similar to other NASD Rules, as the agencies believe that the standard established by the NASD Business Conduct Rule is sufficiently broad that practices that arise in connection with the government securities activities of banks may be dealt with adequately under such a rule.

⁴ NASD Rules of Fair Practice (NASD Rules), Article III, section 1. The agencies do not propose to adopt any of the NASD's specific interpretations of this rule.

The NASD Suitability Rule provides that, in recommending a transaction to a customer, a member must have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."⁵ The rule also provides that, for customers that are not institutional customers, the member must make reasonable efforts to obtain information concerning the customer's financial and tax status and investment objectives before executing a transaction recommended to the customer.⁶ The NASD Suitability Rule applies only in situations where a member makes a "recommendation" to its customer.

The NASD Suitability Interpretation

The NASD Suitability Interpretation identifies factors that may be relevant when evaluating compliance with the NASD Suitability Rule with respect to an institutional customer other than a natural person. The interpretation sets forth the two most important considerations in determining the scope of a government securities broker's or dealer's responsibilities under the NASD Suitability Rule with respect to an institutional customer. Those two considerations are (1) the customer's capability to evaluate investment risk independently and (2) the extent to which the customer exercises independent judgement in evaluating a member's recommendation. The NASD Suitability Interpretation provides that a government securities broker or dealer may be considered to have met the requirements of the NASD Suitability Rule with respect to a particular institutional customer where the government securities broker or dealer 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 NASD Suitability Interpretation sets forth certain factors for brokers or dealers to apply in evaluating an institutional customer's capacity to evaluate investment risk independently. Factors considered relevant to this determination include the customer's

use of consultants or advisors, 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 stresses that an institutional customer's ability to evaluate investment risk independently may vary depending on the particular type of investment at issue. 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 NASD Suitability Interpretation further provides that a determination that an institutional customer is making an independent investment decision depends on factors such as the understanding between the member and its customer as to the nature of their relationship, the presence or absence of a pattern of acceptance of the member'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 member with information concerning its portfolio or investment objectives.

While the NASD Suitability Interpretation provides that these factors would be considered relevant in evaluating whether a government securities broker or dealer has fulfilled the requirements of the NASD Suitability Rule with respect to any institutional customer that is not a natural person, it further provides that the factors cited would be considered most relevant for an institutional customer with at least \$10 million of assets in its securities portfolio or under management.

Rules Applicable to Banks

The agencies are requesting comment on whether they should adopt rules substantially similar to the NASD Business Conduct Rule and Suitability Rule and the NASD Suitability Interpretation for banks that are government securities brokers or dealers in order to provide standards with respect to government securities sales practices by such banks. Compliance with such rules by a bank would be enforced principally through the examination process on the basis of the examiner's assessment of an institution's policies and procedures and its adherence to those policies and

procedures.⁷ The NASD Rules, on the other hand, are enforced through complaints filed with, and proceedings before, an NASD District Business Conduct Committee or other NASD committee.⁸ The differences in the process by which such rules would be applied to banks may raise questions as to whether the rules should be modified to reflect the bank supervisory structure.⁹

Request for Comments

The agencies request comment generally as to the need for and desirability of the proposed rule and interpretation, and on the following specific issues:

(1) Should the agencies adopt rules that are substantially similar to the NASD Business Conduct Rule and the NASD Suitability Rule, or would other rules be more appropriate? Under the NASD Suitability Rule, a member must make recommendations based on any facts disclosed by the customer as to the customer's other securities holdings, financial situation and needs, but the member is required to request information concerning financial and tax status and investment objectives only from non-institutional customers. Should a bank, like an NASD member, be required to request such information of non-institutional customers before making a recommendation, or should a bank be able to base recommendations on the customer's investment objectives alone, without requesting or considering information concerning the customer's other holdings and financial situation when such information has not been volunteered? In the alternative, should the rule for banks be uniform for both institutional and non-institutional customers?

(2) In considering whether an alternative to the NASD Rules would be appropriate for banks operating as government securities brokers and dealers, are there benefits to consistency among government securities brokers and dealers that the agencies should

⁷ The legislative history of the Government Securities Act Amendments of 1993 provides no indication that Congress intended the amendments included in section 106 of that act to create a private right of action, and the agencies do not intend to create a private right of action by a customer against a bank based on a violation of the agencies' rule or interpretation. See *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979).

⁸ See generally NASD Code of Procedure.

⁹ In this regard, the agencies note that the rules of the Municipal Securities Rulemaking Board (MSRB) are enforced through the bank examination process with respect to banks that are brokers or dealers in municipal securities. The MSRB rules include provisions that are similar to the NASD Business Conduct Rule and Suitability Rule. See MSRB Rules G-17 and G-19.

⁵ NASD Rules, Article III, section 2(a).

⁶ NASD Rules, Art. III, section 2(b). For the purposes of section 2, an institutional customer includes a bank, savings and loan association, insurance company, registered investment company or investment advisor, or any other entity with total assets of at least \$50 million. NASD Rules, Art. III, section 21. As part of the revisions to the NASD Rules, this definition will be incorporated in section 2.

consider? Given the differences in enforcement mechanisms, will equal treatment of customers be more likely to be achieved by a rule that is consistent with the NASD rule or by an alternative rule?

(3) Does a rule substantially similar to the NASD Business Conduct Rule provide a sufficiently clear standard for the conduct of sales of government securities by a bank that is a government securities broker or dealer, or is greater specificity preferable?

(4) The proposed rule, like the NASD Suitability Rule, does not define the term "recommendation." The agencies request comment as to whether, given the differences in the nature of government securities in comparison to equity and private debt securities, further guidance is needed by banks on the activities that may be considered to constitute a recommendation in connection with discussions concerning government securities. In particular, is it sufficiently clear that the provision of market observations, forecasts about the general direction of interest rates, other descriptive or objective statements concerning government securities or the government securities markets, or price quotations would not be considered to constitute making a "recommendation" concerning a government security, absent other conduct?

(5) Although the NASD has proposed to extend its Rules of Fair Practice generally to transactions in government securities, the agencies currently are considering only the adoption of rules similar to the NASD Business Conduct Rule and Suitability Rule and the NASD Suitability Interpretation for banks acting as government securities brokers or dealers. Should the agencies consider adopting rules similar to other sections of the Rules of Fair Practice or interpretations similar to other NASD interpretations?¹⁰ For example, should the agencies consider adopting a rule or specific guidelines concerning banks' supervision of government securities activities?¹¹ Explicit adoption of other

¹⁰ The agencies note that the NASD does not view all of its Fair Practice rules and interpretations as applicable to government securities transactions, and that the manner in which Section 4 is to apply to such transactions remains under consideration. The notice published by the SEC includes an amended summary list of the NASD rules and interpretations and their applicability to transactions in government securities. 61 FR 11655 (March 21, 1996).

¹¹ Article III, section 27, of the NASD Rules addresses supervision by NASD members, and requires the establishment and maintenance of a system to supervise the activities of personnel that is reasonably designed to achieve compliance with applicable law and rules. In addition to requirements for the establishment of written procedures, internal inspections, designation of

sections of the NASD Rules would provide more certainty on how the agencies will administer the Business Conduct and Suitability Rules, but would limit the agencies' ability to apply those rules flexibly to take into account potentially distinct aspects of banks acting as government securities brokers or dealers.

(6) Should a bank and its customer be permitted to establish the standards applicable to the relationship between the customer and the bank by agreement, effectively contracting out of the rule? The NASD Suitability Interpretation provides that written and oral agreements between the broker or dealer and an institutional customer will be considered in determining whether the broker or dealer has fulfilled its obligations under the NASD Suitability Rule. Is this sufficient, or should the agencies include a more specific provision for bank contracts? If so, should such a provision be limited to negotiated contracts, contracts with institutional customers, or some other class of contracts? For example, an exclusion could be provided for negotiated contracts, with the presumption that a contract between a bank and an institutional customer, or some class of institutional customers, would be considered to be negotiated.

(7) Under the proposed rule, a customer that is not a bank, savings and loan association, registered investment company, or registered investment advisor, or that does not have total assets of at least \$50 million is considered to be a "non-institutional customer." Is \$50 million in total assets an appropriate measure for determining which entities should be considered to be institutional customers for the purposes of the rule? Are other measures, such as the amount of "assets under management" more appropriate? For example, the NASD Suitability Interpretation and the agencies' proposed interpretation states that, while the interpretations are applicable to any customer that is not a natural person, it is particularly relevant to customers that have at least \$10 million in securities in its portfolio or under management. If such a measure is more appropriate, what amount of assets in a portfolio or under management would be appropriate in determining which entities should be treated as institutional customers for the purposes of the rule? Should the agencies adopt

persons with supervisory responsibility, and investigation of qualifications of personnel, the rule includes provisions that facilitate oversight by the NASD.

a measure that is uniform for both the rule and the interpretation?

A draft rule and interpretation based on the NASD Business Conduct Rule and Suitability Rule and NASD Suitability Interpretation, but modified in certain technical respects as needed to apply to banks, follow.

Regulatory Flexibility Act

Under section 605(b) of the Regulatory Flexibility Act (RFA) (5 U.S.C. 605(b)), the initial regulatory flexibility analysis otherwise required under section 603 of the RFA (5 U.S.C. 603) 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 succinct statement explaining the reasons for such certification in the Federal Register along with its general notice of proposed rulemaking.

Pursuant to section 605(b) of the RFA, the OCC, Board, and the FDIC each individually certifies that this proposed rule will not have a significant economic impact on a substantial number of small entities. 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. 780-5) and applicable Treasury rules under section 15C (17 CFR 400.1(d) and 401), including approximately 300 domestic banks and branches of foreign banks. 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 directly subject to the NASD Rules and would not be subject to the agencies' proposed rule.

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 proposed rule and have determined that no collections of information pursuant to the Paperwork Reduction Act are contained in the proposed rule.

OCC Executive Order 12866 Statement

The OCC has determined that this joint proposed rule is not a significant regulatory action as defined in Executive Order 12866.

OCC Unfunded Mandates Act of 1995 Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act), requires that an 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 an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. As discussed in the preamble, the joint proposed rule sets forth sales practice responsibilities of banks that are government securities brokers or dealers. The OCC has therefore determined that the rule 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.

List of Subjects

12 CFR Part 13

Government securities, National banks.

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, Government 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 of chapter I of title 12 of the Code of Federal Regulations is proposed to be added to read as follows:

PART 13—GOVERNMENT SECURITIES SALES PRACTICES

Sec.

- 13.1 Scope.
- 13.2 Definitions.
- 13.3 Business conduct.
- 13.4 Recommendations to customers.
- 13.5 Customer information.

Interpretations

- 13.100 Obligations concerning institutional customers.

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 Treasury rules under section 15C (17 CFR 401.1(d) and 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 Treasury rules under section 15C (17 CFR 401.1(d) and 401).

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

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

- (1) A bank, savings association, insurance company, or registered investment company;
- (2) An investment advisor registered under section 203 of the Investment Advisors 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) Under § 13.4, a bank that is a government securities broker or dealer must have reasonable grounds for believing that a recommendation to a customer concerning a government security is suitable for the customer, based on any facts disclosed by the customer concerning the customer's other security holdings and financial situation and needs. The interpretation in this section identifies factors that may be relevant when considering the bank's compliance with § 13.4 with respect to an institutional customer. 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 obligations under § 13.4.

(b) The two most important considerations in determining the scope of a bank's obligation under § 13.4 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 customer. 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 obligation 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.

(c) 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. 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.

(d) 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.

(e) 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.

(f) These factors are guidelines that will be utilized to determine whether a bank is in compliance with § 13.4 with respect to a specific institutional customer's transaction. 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.

(g) For purposes of the interpretation in this section, an institutional customer is 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: April 4, 1996.
Eugene A. Ludwig,
Comptroller of the Currency.

Federal Reserve System
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 proposed to be amended as follows:

12 CFR CHAPTER II

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 Treasury rules under section 15C (17 CFR 401.1(d) and 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 USC § 78o–5) and Department of Treasury rules under section 15C (17 CFR 401.1(d) and 401).

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

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

- (i) A bank, savings association, insurance company, or registered investment company;
- (ii) An investment advisor registered under section 203 of the Investment Advisors 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) Under § 208.25(d), a bank that is a government securities broker or dealer must have reasonable grounds for believing that a recommendation to a customer concerning a government security is suitable for the customer, based on any facts disclosed by the customer concerning the customer's other security holdings and financial situation and needs. The interpretation in this section identifies factors that may be relevant when considering the bank's compliance with § 208.25(d) with respect to an institutional customer. 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 obligations under § 208.25(d).

(b) The two most important considerations in determining the scope of a bank's obligation under § 208.25(d) 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 customer. 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 obligation 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.

(c) 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. Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, this interpretation shall be applied to the agent.

(d) 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.

(e) 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.

(f) These factors are guidelines that will be utilized to determine whether a bank is in compliance with § 208.25(d) with respect to a specific institutional customer's transaction. 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.

(g) For purposes of the interpretation in this section, an institutional customer is 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 (g) 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.

* * * * *

(g) *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 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.

By order of the Board of Governors of the Federal Reserve Board, April 17, 1996.

William W. Wiles,

Secretary of the Board.

Federal Deposit Insurance Corporation
Authority and Issuance

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

12 CFR CHAPTER III

**PART 368—GOVERNMENT
SECURITIES SALES PRACTICES**

Sec.

368.1 Scope.

368.2 Definitions.

368.3 Business conduct.

368.4 Recommendations to customers.

368.5 Customer information.

368.100 Interpretations.

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 Treasury rules

under section 15C (17 CFR 401.1(d) and 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 Treasury rules under section 15C (17 CFR 401.1(d) and 401).

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

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

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

(2) An investment advisor registered under section 203 of the Investment Advisors 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 Interpretation.

(a) Under § 368.4, a bank that is a government securities broker or dealer must have reasonable grounds for believing that a recommendation to a customer concerning a government security is suitable for the customer, based on any facts disclosed by the customer concerning the customer's other security holdings and financial situation and needs. The interpretation in this section identifies factors that may be relevant when considering the bank's compliance with § 368.4 with respect to an institutional customer. 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 obligations under § 368.4.

(b) The two most important considerations in determining the scope of a bank's obligation under § 368.4 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 customer. 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 obligation 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.

(c) 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. 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.

(d) 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.

(e) 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.

(f) These factors are guidelines that will be utilized to determine whether a bank is in compliance with § 368.4 with respect to a specific institutional

customer's transaction. 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.

(g) For purposes of the interpretation in this section, an institutional customer is 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 4th day of April, 1996.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Deputy Executive Secretary.

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