



FINANCIAL SERVICES  
FOR THE GREATER GOOD

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March 26, 2007

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

Nancy M. Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Regulation R -- File Number S7-22-06  
Docket No. R-1274

Dear Ms. Johnson and Ms. Morris:

I am writing on behalf of the Teachers Insurance and Annuity Association of America and College Retirement Equities Fund ("TIAA-CREF") in response to the proposed Regulation R, the joint proposal by the Securities and Exchange Commission (the "Commission") and the Board of Governors of the Federal Reserve System (the "Board") to clarify the scope of the bank exemptions from the term "broker" under the Securities Exchange Act of 1934, as amended (the "Proposal"). TIAA-CREF is a national financial services organization with over \$400 billion in combined assets under management and is the leading provider of retirement savings products and services in the academic, research, medical and cultural fields.

We appreciate the opportunity to comment on the Proposal and we are generally supportive of several aspects of the Proposal that we believe are improvements over prior proposals. However, we have significant concerns that without modification the Proposal would seriously disrupt existing arrangements between banks, insurance companies and plans in the context of governmental and non-profit defined contribution plans without any corresponding investor protection benefits. To avoid such disruptions, we would like to make three specific recommendations on how the Proposal can be improved.

1. Insurance transactions through NSCC and directly with issuers

We strongly support proposed § \_\_.775 permitting banks under the fiduciary, transfer agent and safekeeping and custody exemptions to effect transactions in mutual funds through the Mutual Fund Services of the National Securities Clearing Corporation (“NSCC”) or directly with the transfer agent acting for the mutual fund. We believe that such an exemption is consistent with Section 17A of the Exchange Act in promoting efficient settlement of securities transactions and reducing risk to the financial system. However, we believe that such an exemption should be available to variable annuities, as well as mutual funds. Particularly in the context of governmental and non-profit defined contribution pension plans, many plans now offer both mutual funds and variable annuities as investment options for participants.

A. Section 403(b) benefit plans

As background, tax-exempt, not-for-profit employers have historically established defined contribution plans under Section 403(b) of the Internal Revenue Code. The rules governing Section 403(b) plans were tailored to meet the needs of the not-for-profit community, and particularly higher education. The plans are simple, easy to establish, and inexpensive. They do not require that an employer maintain a large infrastructure to support them. The funding vehicles are similarly simple; originally, the only permissible investments were annuity contracts. In 1978, mutual funds were permitted as an investment option. To date, no other investments are allowed. Typically, plans now utilize both annuities and mutual funds as investment choices, seeking the most appropriate investment vehicle without regard to the legal structure of the product. Rules were established by the IRS in 1990 to allow for easy movement of funds between the various funding vehicles within a plan.<sup>1</sup> Over the years, Section 403(b) plans have proven to be very successful in enabling employees in higher education to meet their retirement goals. Part of that success is due to this simple structure, which results in low costs.

By limiting the exemption to mutual funds, however, the Board and the Commission will be injecting significant complexity into the infrastructure that supports Section 403(b) plans that are funded with both variable annuities and mutual funds without a commensurate investor protection benefit. If banks, and therefore insurance companies, are required to use a broker-dealer to move retirement accumulations from one investment to another within a plan, unnecessary costs will be added to an arrangement specifically designed to be low cost. The impact of such a change would not be trivial. Plans that are established under Section 403(b) had an estimated \$650 billion in assets in 2006. This is a fast growing market, up from approximately \$450 billion in assets in 2003. Eight of the top ten companies (ranked by Section 403(b) plan assets under management) providing funding vehicles to Section 403(b) plans are insurance companies.

As funding vehicles in the accumulation stage, annuities and mutual funds serve identical functions in such plans, and are indeed used interchangeably by plan sponsors and participants.

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<sup>1</sup> The tax free status of transfers between plan mutual fund investments in Section 403(b)(7) custodial accounts and Section 403(b)(1) annuity contract interests in fixed and variable annuities is well established. See IRS Revenue Rule 90-24 (February 21, 1990).

However, by discouraging the use of variable annuities in Section 403(b) plans, the Proposal will impede one of the fundamental purposes of such plans - to provide lifetime income to plan participants. Many plans established under Section 403(b) are not supplemental savings plans; rather they constitute the employee's basic retirement plan. They were designed to provide benefits akin to defined benefit plans, specifically, lifetime income. This objective can be achieved only through the use of life annuities and to the extent that the proposal discourages the use of annuities in these plans it will frustrate that goal.

#### B. No transfer agent for variable insurance products

Unlike mutual funds, insurance company separate accounts do not utilize a transfer agent, but instead have the issuing insurance company or separate account maintain policy holder records and perform related administrative functions. This is recognized by Section 3(a)(25) of the Exchange Act which states: "[t]he term 'transfer agent' does not include any insurance company or separate account which performs such functions solely with respect to variable annuity contracts or variable life policies which it issues..."<sup>2</sup> Unless variable annuities are added to the exemption offered by § \_\_.775, transactions between mutual fund and variable annuity investment options under a plan would need to be routed through a broker-dealer for settlement. This would significantly complicate the existing structure for these plans where the custodian bank for the plan customarily settles variable annuity transactions directly with the issuing insurance company.

#### C. NSCC services for insurance products

Similarly, we believe that allowing banks to settle variable annuity transactions through NSCC is in the public interest. Congress in Section 17A(b)(3)(B) of the Exchange Act clearly lists insurance companies as one of the types of entities that may become a participant in a clearing agency. Indeed, NSCC now offers a variety of settlement services for variable annuities which are functionally similar to those it offers for mutual funds.

#### D. Competitive equality and efficiency

We believe that for the Board and the Commission to not grant this exemption would disrupt existing market practice without enhancing investor protection.<sup>3</sup> We also believe that amending the proposed mutual fund transaction exemption to allow banks to effect transactions in variable annuities directly with the issuing insurance company or separate account or through NSCC would be in the public interest and consistent with Section 17A of the Exchange Act and existing SEC precedent.<sup>4</sup> We further believe that such an exemption is necessary to maintain competitive equality between mutual funds and variable annuities in the defined contribution pension plan

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<sup>2</sup> In excluding insurance companies from regulation as transfer agents, Congress recognized that insurance companies were already subject to extensive regulation under state law.

<sup>3</sup> Since variable annuities are regulated by the various states, they are already subject to a comprehensive regime of consumer protection laws and regulation (e.g., NY Insurance Law Article 26 and Article 32).

<sup>4</sup> See First of America Brokerage Service, Inc. SEC No-Action Letter (September 28, 1995) (funds for variable annuities to be sent directly to issuing insurance company).

market. Without the extension of the exemption to variable annuities, we believe the Board and the Commission will be favoring mutual funds over variable annuities as funding vehicles for pension plans and, thereby, imposing a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act and which the Board and the Commission cannot justify under the rulemaking standards established by Section 23(a)(2) of the Exchange Act. We further submit that extension of the exemption to variable annuities would promote efficiency and competition in the operation of Section 403(b) pension plans without reducing investor protection and as such, would satisfy the rule making standards set forth in Section 3(f) of the Exchange Act, which requires consideration of the promotion of efficiency, competition and capital formation in rulemaking under the Exchange Act.

E. Proposed language

We propose that § \_\_\_\_.775 be revised to read as follows:

**§ \_\_\_\_.775 Exemption from the definition of “broker” for the way banks effect excepted or exempted transactions in investment company securities and variable annuity contracts.**

(a) A bank that meets the conditions for an exception or exemption from the definition of the term “broker” except for the condition in section 3(a)(4)(C)(i) of the Act (15 U.S.C. 78c(a)(4)(C)(i)), is exempt from such condition to the extent that it effects transactions either in securities issued by an open-end company that is neither traded on a national securities exchange nor through the facilities of a national securities association or an interdealer quotation system or in variable annuity contracts and the subaccounts thereunder, provided that:

(1) Such transactions are effected through the National Securities Clearing Corporation's Mutual Fund Services or Insurance Services or directly with a transfer agent acting for the open-end company or the issuing insurance company or separate account for variable annuity contracts; and

(2) The securities are distributed by a registered broker or dealer, or the sales charge is no more than the amount a registered broker or dealer may charge pursuant to the rules of a securities association registered under section 15A of the Act (15 U.S.C. 78o-3) adopted pursuant to section 22(b)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-22(b)(1)).

2. Banks that utilize banks as sub-custodians

Section \_\_\_\_\_.760 of the Proposal generally exempts a bank from the definition of “broker” to the extent that it effects securities transactions for an employee benefit account or an IRA or similar account for which the bank acts as custodian. The Proposal, however, does not directly address situations where a bank with a direct relationship with an employee benefit plan as custodian utilizes a sub-custodian bank to act as a service provider to process securities transactions. The Proposal addresses only in a footnote situations in which a bank, acting in a fiduciary capacity, utilizes another entity as sub-custodian to effect securities transactions.<sup>5</sup> This type of back office outsourcing arrangement, which is an accepted means of back office

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<sup>5</sup> 71 Fed. Reg. 77529 at footnote 76.

outsourcing, is widespread among smaller banks, including our own federal savings bank. We utilize one sub-custodian bank in connection with our fiduciary business, which processes mutual fund transactions on our behalf through the NSCC's Mutual Fund Services, and use another sub-custodian bank to process (i) custodial IRA mutual fund transactions through NSCC's Mutual Fund Services and (ii) IRA variable annuity transactions with an insurance company as recordkeeper for such variable annuity contracts.

We believe that allowing a bank to utilize a sub-custodian bank to effect securities transactions and gain access to the securities settlement system, including NSCC's Mutual Fund Services, is in the public interest and reflects how many smaller banks have structured their existing operations. The expense involved in these organizations restructuring their operations, for example, to gain direct access to NSCC would be considerable and would not serve to protect investors in any meaningful way.

Under the Proposal as drafted, it is not clear whether a sub-custodian bank would be permitted to rely on § \_\_\_\_.760 to effect securities transactions for its client bank. In our view, no investor protection concerns are compromised in any respect if a sub-custodian bank is permitted, subject to the same conditions, to rely on the custody exemption available to the named custodian bank. Thus, both the named custodian bank and its sub-custodian bank should be able to rely on § \_\_\_\_.760(a) and not be restricted in the manner in which they are compensated. Under the existing Proposal, the named custodian bank could rely on § \_\_\_\_.760(a) in structuring its compensation, but the sub-custodian bank would not be able to avail itself of subsection (a). Similarly, it is not clear whether the sub-custodian bank would be permitted to rely on § \_\_\_\_.760(b), and even if it could, the sub-custodian bank would be constrained by the transaction fee restriction of § \_\_\_\_.760(b)(3). We do not see how such a structure enhances investor protection, particularly when there is no direct interaction between the sub-custodian and the client, and, therefore, no opportunity for the sub-custodian bank to influence the behavior of customer accounts.

Moreover, not allowing sub-custodian banks to avail themselves of this exception would disrupt the custodial activities of smaller banks, many of which do not have the operational, technical or human resources infrastructure to maintain full-fledged custody operations. This disruption, in turn, could have inhibiting anticompetitive effects on small bank custodians of the sort that also would not be necessary or appropriate for the protection of investors, and, therefore, not consistent with Section 23(a)(2) of the Exchange Act.

To address these concerns, we would recommend that § \_\_\_\_.775 be amended to clarify that a bank may rely on another bank as a sub-custodian to effect securities transactions through NSCC, with transfer agents and insurance companies or to handle aspects of securities transactions on behalf of the bank, including the placing of transactions with a registered broker-dealer for execution, provided that the custodian and sub-custodian bank operate under a written sub-custody agreement that satisfies the requirements of § \_\_\_\_.760(g)(1)(iii). In addition, the nature of the client relationship between the customer and the named bank custodian/fiduciary bank should govern the character of the compensation allowable to both this bank and its sub-custodian service provider.

### 3. Directed Trustees of Benefit Plans and IRAs

Section \_\_.760(g)(1) defines an “account for which the bank acts as custodian” as (i) an employee benefit plan account for which the bank acts as custodian, (ii) an IRA or similar account for which the bank acts as custodian, or (iii) an account established by written agreement that sets forth the fees, rights and obligations of the bank regarding the safekeeping or custody of the account’s securities. As proposed, § \_\_.760(g)(1) of the Proposal does not include any plan or account for which the bank acts as a directed trustee and § \_\_.760(d)(1) and as drafted, would exclude such bank-trusted employee benefit plans and IRAs from the safekeeping and custody exemption.

We believe the Proposal does not adequately recognize the role banks play as directed trustees of employee benefit plans and IRAs. We believe such a result is ill advised and does not reflect longstanding industry practice. The Employee Retirement Income Security Act of 1974 (“ERISA”) generally requires benefit plans to establish trusts to protect plan assets.<sup>6</sup> However, under Section 403(a)(1) of ERISA, the plan can expressly provide that the “trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper direction of such fiduciary...” When banks serve as directed trustees of such plans, they are ERISA fiduciaries for purposes of holding the plans assets, but they do not have discretion to select or initiate transactions. For this reason, they are the functional equivalent to bank custodians for plans that are not required by statute to establish a trust or which utilize non-bank trustees. Similarly, under Section 408(a) of the Internal Revenue Code, an IRA generally is required to be established as a trust. Section 408(g), however, allows custodial accounts held by a bank to be treated as a qualifying trust for purposes of Section 408, and in so doing recognizes that the functional equivalency between an IRA trustee and an IRA custodian.

We believe that Congress’s use in Section 3(a)(4)(B)(viii)(I)(ee) of the phrase “or provider of other related administrative services” is broad enough to address the situation in which a bank acts as a directed trustee of a benefit plan or IRA and lacks investment discretion. We recommend that proposed § \_\_.760(g)(1)(i) and (ii) be amended to add at the end of each the phrase “or for which the bank acts as a directed trustee without investment discretion.”

We understand the Board and Commission’s concerns that the custody and safekeeping exemption not be used by banks as a loophole to avoid the compensation restrictions imposed by the fiduciary exemption. However, we believe that a carve-out for non-discretionary trustees of benefit plans and IRAs would be appropriate. Exchange Act Section 3(a)(4)(D) defines “fiduciary capacity” for purposes of the fiduciary exemption in three subsections: (i) a list of specific fiduciary capacities that are covered, (ii) a functional definition of fiduciary as “any capacity in which the bank possesses investment discretion on behalf of another,” and (iii) a catchall of “any similar capacity.”<sup>7</sup> We believe that Congress’s intent was to have the

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<sup>6</sup> ERISA § 403.

<sup>7</sup> Interestingly, transfer agent is a listed fiduciary capacity in 3(a)(4)(D)(i) and thus subject to the fiduciary exemption, but transfer agent is also a capacity addressed in 3(a)(4)(B)(iv) which addresses transfer agency services.

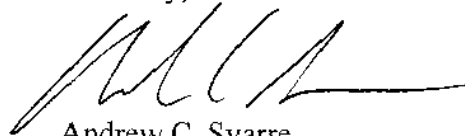
“investment discretion on behalf of another” be the substantive test for falling within the fiduciary exemption as well as the trigger for the compensation restrictions of Section 3(a)(4)(B)(ii)(1). In our opinion, to force directed trustees of benefit plans and IRAs to comply with the terms of the fiduciary exemption, rather than the safekeeping and custody exemption, would elevate form over substance.

The policy rationale for the compensation test under the fiduciary exemption is to prevent fiduciaries from having an incentive to use their discretion to obtain excessive transaction-related compensation, and, therefore, use the fiduciary exemption as a device to conduct a general incentive-based brokerage business. In the case of a directed trustee of a benefit plan or an IRA or similar account, however, transaction compensation should be an appropriate form of compensation for the trustee since it does not control the number of transactions initiated by the plan or account. Accordingly, we recommend that § \_\_.760(d)(1) be changed to add at the end the phrase “except in the case of directed trustees without investment discretion of employee benefit plan accounts and individual retirement plan accounts or similar accounts.” We believe that without the recommended changes to the safekeeping and custody exemption, there will be significant disruptions to the large number of benefit plans that currently utilize banks as directed trustees.

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Again, we appreciate the opportunity to comment on the Proposal. If we can answer any questions or be of further assistance, please contact me at (212) 916-4229 or Evan Giller at (212) 916-4653.

Sincerely,



Andrew C. Svarre

cc: John M. Reich  
Director  
Office of Thrift Supervision

Deborah Dakin  
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Thus, we do not believe Congress intended that each exemption must operate exclusive of the other exemptions provided.