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Merrill Lynch

May 7, 2007

By Electronic Delivery

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: RIN 3064-AD15 – Notice of Proposed Rulemaking – Industrial Bank Subsidiaries of Financial Companies

Dear Mr. Feldman:

Merrill Lynch & Co., Inc. ("Merrill Lynch") appreciates the opportunity to comment on the Notice of Proposed Rulemaking issued by the Federal Deposit Insurance Corporation ("FDIC") relating to industrial bank subsidiaries of financial companies, 72 Fed. Reg. 5217-5228 (Feb. 5, 2007) (the "Proposal"). Merrill Lynch is a diversified holding company with operating subsidiaries engaged in, among other things, securities brokerage, capital markets, banking, investment research, asset management and insurance activities. Merrill Lynch is the ultimate parent of two U.S. banking organizations – Merrill Lynch Bank USA ("MLBUSA"), a Utah state-chartered industrial bank, regulated by the FDIC and the State of Utah Department of Financial Institutions and Merrill Lynch Bank & Trust Co., FSB, a federal savings bank regulated by the Office of Thrift Supervision ("OTS"). Merrill Lynch is also a savings and loan holding company subject to supervision by the OTS and a consolidated supervised entity supervised by the Securities and Exchange Commission ("SEC").

We appreciate the opportunity to express our views on the following two primary areas of the Proposal – (1) the requirement that industrial bank holding companies that are not otherwise grandfathered must be engaged "solely in financial activities;" and (2) the treatment of the SEC as a federal consolidated supervisor equivalent to the Federal Reserve Board ("FRB") and the

OTS. In addition, the final part of this letter contains our responses to the specific questions posed by the FDIC in the Proposal.

Non-Financial Activities

We are not aware of any credible arguments in the public discourse that there is a valid safety and soundness concern relating to *diversified financial organizations that are supervised by a federal consolidated supervisor*. We therefore suggest modifying section 354.1(b)(1) of the Proposal by deleting "...that is engaged solely in financial activities" so that the provision reads, "[a]ny industrial bank that will become, after the effective date of the rules, controlled by a company that is subject to Federal Consolidated Supervision by the FRB, the OTS or the SEC [(per additional suggestions discussed below)]." Such a change would help minimize duplicative federal consolidated supervision.

The concerns expressed in Congressional hearings have been focused on the perceived risks associated with predominantly commercial enterprises holding FDIC-insured depository institutions. One of the central arguments against commercial ownership has been that the current regulatory system is not adequate to supervise commercial entities that own banks, due, in part, to a lack of expertise of the federal financial regulators in conducting examinations of non-financial companies and setting appropriate capital requirements. We do not believe that other diversified financial organizations, including SEC-supervised consolidated companies that may engage in some activities that are not "financial in nature," are the subject of similar concerns. As far as we are aware, there is no credible argument that there are demonstrable safety and soundness issues in continuing to permit diversified financial organizations to own industrial banks. Therefore, we do not believe that there is a supervisory need to exclude such organizations from holding industrial bank subsidiaries.

The Proposal would prohibit a company engaged in <u>any</u> non-financial activity from establishing or acquiring an industrial bank. In this respect, we believe the Proposal is more restrictive than necessary to achieve any stated supervisory objective of the FDIC, and the final rule should not unnecessarily limit an industrial bank holding company's ability to engage in activities not deemed financial for the purposes of Federal Reserve regulatory oversight.

The Proposal defines "financial activity" to include activities that are "financial in nature" or "incidental to a financial activity," as those terms are defined in the Bank Holding Company Act (the "BHC Act"). This definition would not capture some activities that are still most commonly engaged in by financial firms (e.g., certain commodities and private equity activities). As such, some diversified financial organizations would effectively be prohibited from acquiring industrial banks. We would recommend that the FDIC adopt more flexible standards in the final rule that would permit any diversified financial organization to own an industrial bank if it is subject to federal consolidated supervision (including supervision by the SEC) and in the judgment of its supervisor has the resources and expertise to successfully operate a bank. For those companies that do not already have a U.S. financial regulator (FRB,

OTS, or SEC) at the holding company level, we recommend that the FDIC defers to any standards adopted in federal legislation should legislation be enacted. However, if the agency elects to develop its own standards, we propose a principles-based standard that gives the agency the ability to review the overall nature of an organization's activities on a case-by-case basis. This may involve an assessment of whether the organization is engaged in activities that are most commonly engaged in by financial firms. Alternatively, we would recommend that the final rule adopt an objective revenue-test.

SEC as Consolidated Supervisor

The SEC regime for Consolidated Supervised Entities ("CSEs") provides consolidated supervision to holding companies that is broadly consistent with FRB and OTS oversight of bank holding companies and savings and loan holding companies, respectively. As such, we believe CSEs should be afforded similar treatment as financial companies that are supervised by the OTS and the FRB.

The SEC supervises CSEs on a consolidated basis, with SEC oversight and reviews extending beyond the registered broker-dealer to affiliates of the broker-dealer and the holding company that are not otherwise subject to supervision. In supervising the CSEs, the SEC focuses on the financial condition and internal controls of the group with the aim of reducing the likelihood that weakness in the holding company or an unregulated affiliate could endanger a regulated entity. Like other consolidated supervisors overseeing internationally active institutions, the SEC requires CSEs to compute and maintain regulatory capital consistent with the Basel Accord. The SEC also requires CSE holding companies to maintain sufficient liquidity outside of regulated entities to deal with losses in unregulated affiliates or deterioration in the unsecured funding market.

Like the supervisory programs of the FRB and the OTS, the SEC regularly reviews each CSE's consolidated capital adequacy, liquidity, credit and market risk and financial strength and meets with senior management, market and credit risk, corporate treasury, financial controllers, business leaders and internal auditors. The SEC also conducts targeted on-site inspections to test firm-wide internal controls, risk measurement systems and capital computations. The SEC also conducts topical reviews of businesses, products and pricing and risk models.

CSEs are required to provide the SEC with regular reports including (1) consolidated financial information, with an audited consolidated balance sheet and income statement; (2) capital adequacy measures; (3) results of reviews by the internal auditor of the risk management and control systems; and (4) certain reports that the CSE regularly provides to its senior management to assist in monitoring and managing risk.

The SEC also has broad authority to impose additional conditions on CSEs, including mandating changes to risk management policies and procedures and requiring additional liquidity to be maintained by the parent.

The effectiveness and equivalence of the CSE regime is recognized domestically and internationally. European regulators have formally recognized the equivalence of the SEC, along with the FRB and OTS, as a consolidated supervisor to European supervisors. The industrial bank holding company bill (H.R. 698) that was recently approved by the House Financial Services Committee for full consideration by the House also recognizes the SEC as a consolidated supervisor equivalent to the FRB and the OTS. In addition, earlier this year, the U.S. Government Accountability Office ("GAO"), after an extensive review, found that the FRB, the OTS, and the SEC were all generally meeting criteria for comprehensive, consolidated supervision.[1] The GAO noted that the FRB, the OTS, and the SEC all examine risks, controls, and capital levels on a consolidated basis for the largest, most complex U.S. financial services firms.

For all of the above reasons, we would recommend that the term "Federal Consolidated Bank Supervision" used in the Proposal should be changed to "Federal Consolidated Supervision" in the final rule and include the SEC when it is regulating a qualified securities company as a "consolidated supervised entity."

Response to Questions

Set forth below are the specific questions raised by the FDIC in the Proposal followed by Merrill Lynch's responses.

1. ***Should the regulations include a cure period in the event that the industrial bank or its parent company initially comply with these requirements, but later fall out of compliance? If so, should such a cure period be provided for all requirements or just some of them (please specify)?***

We fully support the inclusion of a cure period, which we believe is an important mechanism for a holding company or bank that falls out of compliance inadvertently or in circumstances beyond its control. Congress has consistently recognized the importance of cure periods and conformance periods in various contexts. For example, section 4(m) of the BHC Act provides that where a financial holding company ("FHC") fails to meet certain eligibility criteria, the FHC has 180 days to correct any deficiencies, before the FRB may require it either to divest control of its depository institutions or, at the FHC's option, to cease any activities not permissible for a "traditional" bank holding company ("BHC").[2] Section 4(f)(4) of the BHC Act, which sets forth the CEBA divestiture requirements on grandfathered holding companies, provides a 180-day period. In general, we believe the CEBA requirements are viewed as a relatively stringent regime. In another example, section 4(a)(2) of the BHC Act delays the

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[1] *Financial Market Regulation, Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration*, GAO-07-154 (Mar. 2007).
[2] 12 U.S.C. § 1843(m)(4)

applicability of the nonbanking prohibitions on the activities of any company that becomes a BHC for two years in order to give the new BHC time to conform its activities.[3] In yet another example, under section 4(c)(2) of the BHC Act, a BHC or any of its subsidiaries may acquire shares in satisfaction of a debt previously contracted in good faith, and has at least two years of the date of acquisition to divest.[4]

Any cure period or periods provided for in a final rule should focus on the degree of the deficiency or nonconformance. Thus, an area that may expose a bank to serious, imminent risks may be subject to a shorter, defined cure period, whereas noncompliance involving less significant risks may only require remediation within a reasonable period of time or within a period determined by the FDIC on a case-by-case basis. For example, if a holding company engages in a detrimental activity that is not specified in a bank's business plan, a shorter defined period to correct may be appropriate, whereas if the independent membership of a bank's board of directors falls below a required level, bank's management should have an unspecified, reasonable time to find the most qualified candidate.

2. ***Should the rules provide for remedies beyond cease and desist orders and civil money penalties, e.g., should violations of some of these requirements require divestiture of the industrial bank similar to the divestiture provisions in section 4(m)(4) of the BHC Act, 12 U.S.C. 1843(m)(4)? If so, for which requirements? Should the written agreement with the parent company and the industrial bank include a provision requiring the parent company to divest the industrial bank if the parent company begins to engage, directly or indirectly, in non-financial activities?***

We do not support the inclusion of additional remedies in the final rule because we believe the FDIC presently has sufficient authority for remedial actions. Specifically, under section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. § 1818(b)), the FDIC may issue a cease and desist order against an institution-affiliated party who has engaged in an unsafe or unsound practice in conducting the business of an institution, or violated a law, rule, regulation, or a condition imposed in a written agreement with the agency. The FDIC may require the institution-affiliated party to cease and desist from the violation or practice and to take affirmative actions to correct the condition resulting from the violation or practice. This authority includes the authority to place limitations on the activities or functions of an institution-affiliated party. The FDIC also may order an institution-affiliated party to make restitution or provide reimbursement, indemnification, or guarantee against loss if the institution-affiliated party was unjustly enriched in connection with the violation or practice, or the violation or practice involved a reckless disregard for the law or any applicable regulation or prior agency order.

3. ***Under the Bank Holding Company Act, a commercial company that becomes a bank holding company has a period of time after becoming a bank holding company subject***

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[3] Id. § 1843(a)(2).

[4] Id. § 1843(c)(2).

to the supervision of the FRB in which to divest itself of its nonconforming commercial activities or, alternatively, of its bank(s). Should a commercial company seeking to acquire an industrial bank and to divest itself of its commercial activities so that it would become a Non-FCBS Financial Company similarly be given a period of time by the FDIC within which it would be subject to the FDIC's supervisory oversight, but would be allowed to divest itself of its commercial activities or its industrial bank(s)? If so, for what period of time?

Assuming the FDIC has sufficient statutory authority to require the parent company of an industrial bank to not engage in otherwise legitimate commercial activities permitted by existing law (an issue we believe to be uncertain), we would recommend giving a Non-FCBS Financial Company (as that term is defined in the Proposal) parity with a BHC with respect to its ability to divest its commercial activities or its industrial bank(s). Pursuant to section 4(a)(2) of the BHC Act, the FRB may require a commercial company that becomes a BHC to conform its existing direct and indirect nonbanking activities and investments (including by divestiture if necessary) to the requirements of the BHC Act within two years. This conformance period may, in the discretion of the FRB, be extended by up to three one-year extensions, if, in the judgment of the FRB, such an extension would not be detrimental to the public interest.[5] Again, assuming the FDIC has authority to require an industrial bank holding company to conform its non-bank activities, we would be in favor of the FDIC taking a similar approach to that of the FRB.

4. ***Should the FDIC further define "services essential to the operations of the industrial bank" as that phrase is used in the proposed section 354.5(e)? Should the restriction in that section be clarified to include core banking services or risk management functions?***

We do not believe prior approval for "services essential to the operations of the industrial bank" or any of the items listed in section 354.5[6] of the Notice should be necessary for the FDIC

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[5] 12 U.S.C. § 1843(a)(2).

[6] Section 354.5 of the Proposal provides: Without the FDIC's prior written approval, no industrial bank that becomes a subsidiary of a Non-FCBS Financial Company after the effective date of the rules shall:

(a) Make a material change in its business plan during the first three years after becoming a subsidiary industrial bank,

(b) add or replace a member of the board of directors, board of managers, or a managing member, as the case may be, of the subsidiary industrial bank during the first three years after becoming a subsidiary industrial bank,

(c) add or replace a senior executive officer during the first three years after becoming a subsidiary industrial bank,

(d) employ a senior executive officer who is associated in any manner (e.g., as a director, officer, employee, agent, owner, partner, or consultant) with an affiliate of the industrial bank, or

(e) enter into any contract for services essential to the operations of the industrial bank (for example, loan servicing function) with its parent financial company or any subsidiary thereof.

to fulfill its mission to ensure the safety and soundness of industrial banks. The FDIC should have ample opportunity during the examination process to review any of the changes specified in section 354.5 and use its cease and desist authority if an industrial bank has engaged in an unsafe or unsound practice or violated a law, rule or a condition imposed in a written agreement with the FDIC.

Nonetheless, if the prior approval requirement specified in section 354.5 of the Proposal remains, we would recommend that the final rule provide more specificity in order to assist institutions in avoiding inadvertent violations that may result from differences in interpretation. Therefore, it would be helpful to provide specific examples of "services essential to the operations of the industrial bank" and/or provide objective standards as to what may constitute significant or essential agreements.

5. ***For purposes of transparency and identifying any potential risks to the industrial bank, we have included commitments requiring examination and reporting. Is this approach the best way to gain that transparency, or is there a better way? To what extent, if any, is the FDIC's supervision enhanced by requiring a parent company of an industrial bank to consent to examination of the company and each of its subsidiaries as proposed in part 354?[7] Is there another way to identify any potential risks?***

First, we note that the FDIC has existing statutory power to examine the affairs of affiliates of industrial banks. Pursuant to Section 10(b)(4) of the Federal Deposit Insurance Act,[8] the FDIC has the authority to examine a holding company of an industrial bank "as may be necessary to disclose fully: (i) the relationship between the institution and any such affiliate, and (ii) the effect of the relationship on the institution." The FDIC also has enforcement authority over any company that controls an industrial bank as an institution-affiliated party.[9] The FDIC exercises these powers now to the extent it believes necessary and appropriate to understand the condition of the parent and the sufficiency of the services it provides to the bank.

In a complex financial organization like Merrill Lynch, which has hundreds of subsidiary entities and dozens of functional financial regulators, we are concerned that an agreement authorizing the FDIC to examine bank affiliates may cause the FDIC to feel compelled to review entities that have no connection to or impact on the safety and soundness of the industrial bank. If anything, this approach would only cause unnecessary regulatory burdens on industrial bank

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[7] Section 354.4 of the Proposal, among other things, requires a Non-FCBS Financial Company to (i) furnish the FDIC an initial listing, with annual updates, of all of the company's subsidiaries; (ii) consent to the FDIC's examination of the company and each of its subsidiaries; (iii) submit to the FDIC an annual report on the company and its subsidiaries, and such other reports as the FDIC may request; and (iv) maintain such records as the FDIC deems necessary to assess the risks to the industrial bank and to the Deposit Insurance Fund.

[8] 12 U.S.C. § 1820(b)(4)

[9] See 12 U.S.C. § 1818(b).

holding companies with no real benefit to the FDIC in fulfilling its mandate and would exceed the FDIC's statutory authority.

As a general matter, we suggest that the FDIC consider less burdensome examination techniques in the audit of the holding companies of its supervised banks. We would prefer offsite monitoring, which may include reviewing reports that the FDIC finds necessary to assess: (i) a material risk to a supervised bank, (ii) compliance with a law that the FDIC has specific jurisdiction to enforce, or (iii) the company's systems for monitoring and controlling financial and operational risks within the holding company system that may pose a threat to the safety and soundness of its subsidiary bank. In addition, we recommend that the FDIC consider less burdensome requirements for publicly traded Non-FCBS Financial Companies on the basis that material information regarding the operations of the company should be available in public filings.

6. ***Is it appropriate for the FDIC to impose reporting and recordkeeping requirements on a parent company of an industrial bank and/or the parent company's subsidiaries?***

   Please see response to question 5.

7. ***The Gramm-Leach-Bliley Act of 1999 imposed certain restrictions on the extent to which a Federal banking agency may regulate and supervise a functionally regulated affiliate of an insured depository institution... In view of these restrictions, should the conditions and requirements contained in the proposed rules be modified to the extent that they might apply to insurance companies and securities companies that may wish to control an industrial bank?***

We strongly recommend that the Proposal be modified to clarify that affiliates that are otherwise functionally regulated would not be subject to duplicative oversight and/or examination by the FDIC.

8. ***The proposed regulation does not apply to a financial company that is supervised by the FRB or the OTS. Should this treatment be extended to a financial company that is subject to consolidated Federal supervision by the U.S. Securities and Exchange Commission as a "consolidated supervised entity"?***

As discussed above, we believe that companies supervised as CSEs by the SEC should be treated similarly to financial companies that are supervised by the FRB or the OTS. Imposing the Proposal's requirements on Non-FCBS Financial Companies that are CSEs would have the potential to unnecessarily duplicate supervision efforts and significantly increase regulatory burden for such companies, without a discernible benefit.

9. ***In order to ensure that each parent financial company can serve as a source of strength to its industrial bank subsidiary and fulfill its obligation under a capital***

maintenance agreement, should the FDIC include a commitment that the parent company will maintain its own capital at such a level that the Tier 1 capital ratio for the company, on a consolidated basis, is at least 4% or some other level in some or all circumstances?

Although we are not opposed to minimum capital ratios for the parent companies of industrial bank holding companies, we do not believe that the FDIC should impose additional capital requirements on firms already subject to capital requirements by other holding company regulators, including organizations subject to consolidated supervision by the SEC.

10. If, at the conclusion of the moratorium, Congress has not acted on legislation, how should the FDIC address the pending and any future applications by commercial companies?

The FDIC is responsible for administering the laws Congress has enacted. As such, absent Congress taking legislative action that effectively precludes commercial enterprises from holding industrial banks, we believe it is the FDIC's responsibility to process applications for new industrial banks and the acquisition of existing industrial banks by all companies with the resources, expertise and integrity to successfully operate a bank. These rules could be modified to apply to such companies.

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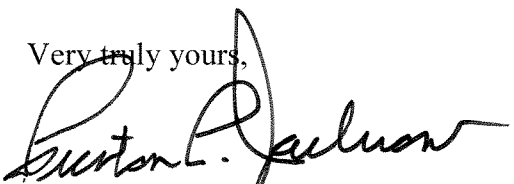
We appreciate the opportunity to comment on the Proposal and we would be pleased to offer any additional information that the FDIC may find helpful. Please feel free to contact the undersigned or my colleague, Paul Tufaro, General Counsel, Merrill Lynch Bank USA (212-236-2667), with any questions or comments.

Very truly yours,



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