MEMORANDUM

TO: File

FROM: Geeta Dhingra

RE: Meeting with Representatives of Charles Schwab

DATE: December 13, 2017

On Wednesday, December 13, 2017, representatives of the Securities and Exchange Commission ("SEC") participated in a meeting with representatives of Charles Schwab & Co., Inc. ("Charles Schwab"). The SEC representatives present were Daniel Deli, Jennifer Juergens, Mattias Nilsson, and Iulian Obreja from the Division of Economic and Risk Analysis; Sara Cortes, Benjamin Kalish, Jennifer Porter, Douglas Scheidt, and Roberta Ufford from the Division of Investment Management; and Bradford Bartels, Geeta Dhingra, Lourdes Gonzalez, and Emily Westerberg Russell[1] from the Division of Trading and Markets. The Charles Schwab representatives present were Jeffrey Brown, Scott Eckel, and Christopher Gilkerson.

At the meeting, SEC and Charles Schwab representatives discussed a number of issues affecting registered broker-dealers, including applicable standards of conduct for broker-dealers and investment advisers providing investment advice to retail investors.

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[1] Emily Westerberg Russell participated via telephone.

Harmonizing the DOL Conflict of Interest / Fiduciary Rule, with SEC Standard of Care for Broker-Dealers and Investment Advisers

Charles Schwab & Co., Inc.

December 2017

Overview and Summary

Charles Schwab & Co. is the largest US BD in terms of assets under custody: $3 trillion+

- Schwab has a unique perspective because approximately 50% of assets under custody are held by retail investors and 50% are in accounts advised by independent RIAs

Key facts about Schwab's business:

- 60% of all retail households at Schwab have at least one IRA
- A typical household has more than two accounts at Schwab, taxable and non-taxable
- Our representatives already operate under ERISA and the Investment Advisers Act when they recommend managed account services (adding over 50,000 accounts a year)
- We have over 7,500 independent RIAs (and their mostly retail customers) on our platform
- Financial advisers give investment advice to the client and household, not specific accounts

For consistency, to preserve distinctions between IAs and BDs, create a level playing field, and protect investors, it is critical to Schwab and our clients for DOL and the SEC:

- To harmonize the standard of care to require non-discretionary investment advice in the best interest of customers no matter the account type,
- In the least burdensome manner that works for BDs and IAs,
- While preserving access to a full range of services for retail investors and the right of investors to contract and pay for as much or as little investment advice as they need

Overview and Summary

There is an opportunity and necessity to harmonize the DOL and SEC standards of care to cover both taxable and non-taxable accounts

- The DOL has deferred until July 1, 2019 the applicability date of most of the Best Interest Contract Exemption (BIC)
  - The DOL Fiduciary Rule remains in effect (as of June 9, 2017)
  - The Impartial Conduct Standards (ICS) of the BIC remain in effect
- BDs and IAs have already adapted their business models to comply with the new rule for non-taxable accounts
- The vast majority of the industry supports a new SEC rule for BDs
- **ICS is the key to harmonization**: To tailor narrowly, and choose the least burdensome alternative, the SEC should incorporate the ICS into BD and IA rules to create a uniform standard
  - Keeping it simple and principles based with straight-forward disclosure
  - **Making it applicable only to the one area where IAs and BDs overlap: non-discretionary investment advice recommendations**

Schwab Position on the DOL Fiduciary Rule

We were supportive of the DOL Rule…

- Investors should know that the fees they pay for investment advice are reasonable
- Best interest fiduciary standard should apply
- The "Impartial Conduct Standards" generally make sense and are mostly consistent with FINRA and Advisers Act requirements
- Conflicts of interest should be clearly disclosed to allow informed investment decisions

…but we had implementation concerns with the BIC Exemption

- A required contract with warranties and cumbersome point of advice and web disclosures are unnecessary and unjustified
- Firms should be able to harmonize practices to comply with SEC/FINRA and DOL requirements in a seamless way for customers across all accounts
- Disclosures should be simple and firms should have the ability to tailor them to their own business models (e.g., RIAs should be able to use the Form ADV)

Breakdown of the Impartial Conduct Standards

1. Best interest investment advice. Provide investment advice in the best interest of the customer under the ERISA standard
   a. "Investment advice" is defined to mean non-discretionary recommendations to (i) open a roll-over IRA, (ii) buy/sell/hold a security, (iii) recommend an investment strategy, and (iv) recommend a managed account
   b. The first three forms of investment advice are defined consistently with FINRA requirements (DOL borrowed from FINRA)
   c. The fourth is already covered under the Advisers Act, and firms today can only recommend managed accounts in their IA capacity
2. Reasonable compensation. Compensation firms and their representatives receive as the result of the recommendation must be "reasonable," meaning within the industry norm
3. Accurate statements. Statements firms and their representatives make about the recommendation, their compensation, and material conflicts of interest must not be materially misleading

Impartial Conduct Standards - ERISA Best Interest

The ERISA Best Interest Standard's three components:

(1) "Provide advice with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims,"

(2) "based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor,"

(3) "without regard to the financial or other interests of the [individual adviser], Financial Institution or any affiliate or [related party]."

Breaking it down (referencing the 3 components above):

(1) This is part of a **duty of care**, with three elements – prudence, diligence, and competence

(2) This also is part of the **duty of care** (essentially FINRA suitability)

(3) This is part of the **duty of loyalty**, requiring steps to assure that no conflicts of interest interfere with the obligation to give best interest advice

Impartial Conduct Standards – Duty of Care and Current BD Obligation for Taxable Accounts

- FINRA Suitability Rule 2111 requires an advice giver:
  - "Have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [firm] or associated person to ascertain the customer's investment profile."
- Other FINRA rules require education and training and "know your product" in addition to "know your customer"
- In combination, the above are equivalent to the prudence/diligence/competence obligations under ERISA, which is a **duty of care**
- An SEC Rule could codify and harmonize this duty through adoption of the ICS

Impartial Conduct Standards – Duty of Loyalty and Current BD Obligation for Taxable Accounts

- Unlike ERISA and the Investment Advisers Act, the element of untainted advice assured through reasonable compensation and accurate disclosure of conflicts is not as explicit under current BD Regs
  - FINRA rules set outer limits on commissions, mark-ups and third party payments, but are not as "tight" as under a fiduciary standard
  - The anti-fraud provisions of the securities laws, and the "shingle theory" imply a duty to disclose any material factors that a representative considers when making investment recommendations such as his/her compensation
- An SEC Rule could harmonize and codify this **duty of loyalty** using the ICS to apply only at the time BDs make non-discretionary investment advice recommendations

Elements of an SEC Standard of Conduct Rule

- Follow the Impartial Conduct Standards
- Document policies and procedures that show compliance with the IPC
- Disclose (written or electronic) at account opening and maintain evergreen on the firm's website the following:
  - Scope of services, including when the firm or its reps will make investment advice recommendations
  - An affirmative statement of fiduciary status when providing investment advice, with a description of the ICS
  - The firm's material conflicts of interest when giving investment advice (including if product recommendations are limited)
  - The firm's compensation practices (i.e., how the firm makes money from recommendations and compensates its representatives)
- Nothing more - Keep it simple and principles-based

Implementation of SEC Standard of Conduct Rule

- **For BDs**, propose and adopt a new rule under Sec. 15 of the Securities Exchange Act
- **For IAs**, adopt a new interpretive rule
  - No need to add to the rule book, given that the Investment Advisers Act is already principles-based
  - Does not "water down" the fiduciary standard, because it is contextual to the limited RIA function of non-discretionary investment advice
  - Guidance could include how IAs can use the Form ADV to meet the disclosure obligation
- **The above is consistent with Dodd-Frank Section 913**, codified at SEA Sec. 15(k) and IAA Sec. 211(g)
  - The harmonized standard of conduct would be "as stringent" for BDs and IAs, because it covers the limited circumstances when IA and BD conduct overlaps: providing non-discretionary investment advice
  - Discretionary investment management, which is already subject to a longstanding fiduciary duty, would continue to be covered under court decisions and SEC cases interpreting IAA Section 206

Appendix – Key Prior Schwab Letters to DOL and SEC

Schwab Letter to DOL dated 8/7/17 recommends a streamlined exemption for firms that pay representatives neutral compensation when making investment advice recommendations (p. 4 of letter), or in the alternative a "Best Interest Advice Exemption" instead of the BIC that would consist of a principles-based approach to the Impartial Conduct Standards, and a straight-forward 5 point disclosure (p. 9 of letter). This serves as a blueprint for a harmonized a standard of care for taxable accounts when giving non-discretionary investment advice.

https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB82/00543.pdf

Schwab Letter to SEC dated 8/30/10 (pre-SEC study), a short white paper reviewing BD and RIA activities and current regulatory standards, and focusing on the one narrow place where RIAs and BDs overlap: giving non-discretionary investment advice.

https://www.sec.gov/comments/4-606/4606-2670.pdf

Schwab Letter to SEC dated 7/5/13, responds to the Commission's request for data and other information on duties of broker-dealers and investment advisers and discusses the results of a Schwab survey of over 800 RIAs regarding the costs they would incur if subject to broker-dealer-like rules (well over $1B in the aggregate), and setting forth a "least burdensome alternative" for a uniform standard of conduct (p. 14 of letter).

https://www.sec.gov/comments/4-606/4606-3137.pdf