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March 24, 2020

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: *Proposed Rule Requiring Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (File No. S7-24-15)*

Dear Ms. Countryman:

Charles Schwab & Co., Inc. ("Schwab")[1] supports the Commission's desire to help make sure retail investors who trade or invest in Leveraged/Inverse Investment Vehicles ("LIIV") understand the risks of buying and holding them. These risks unique to LIIVs include that the securities seek to deliver multiples of short-term performance (or the opposite of the performance) of the index or benchmark they track, the amount of leverage or exposure necessary to seek that performance resets each day (potentially compounding the risk), and that they are generally designed for daily use and not intended to be used as long-term investments due to these characteristics.

Schwab **does not** make recommendations to our clients to purchase these securities. We do make them available to self-directed clients while providing risk information and other

[1] Charles Schwab & Co., Inc., (member SIPC) is the broker-dealer subsidiary of The Charles Schwab Corporation (NYSE: SCHW), a leading provider of financial services, with more than 325 offices and 12.33 million active brokerage accounts, 1.74 million corporate retirement plan participants, 1.39 million banking accounts, and $4 trillion in client assets as of December 31, 2019. Through its operating subsidiaries, The Charles Schwab Corporation provides a full range of securities brokerage, banking, money management and financial advisory services to individual investors and independent investment advisors. Charles Schwab & Co., Inc. and affiliates offer a complete range of investment services and products including an extensive selection of mutual funds; financial planning and investment advice; retirement plan and equity compensation plan services; referrals to independent fee-based investment advisors; and custodial, operational and trading support for independent, fee-based investment advisors through Schwab Advisor Services.

educational materials.[2] Because LIIV products are listed and approved for trading by the Commission and the applicable exchange, we believe that it is important to continue to make LIIVs available to self-directed clients some of whom greatly value them. To that end, Schwab would support a new uniform mandatory risk disclosure rather than the proposed, more elaborate account approval process.

We set out below (1) why we believe any new rule should apply only to unsolicited trades, (2) why a mandatory risk disclosure is the right approach instead of an account approval process similar to options trading approval, and (3) modifications to the proposed rule to accomplish this.

1. **Recommended Trades and Discretionary Accounts Should be Excluded Because They Are Covered by Existing Requirements**

It is unnecessary to apply the new rule to broker solicited trades, which as of June 30 will be subject to Regulation Best Interest and its obligations including care and disclosure. Likewise, it is unnecessary to apply the new rule to registered investment advisers because RIA recommendations to or discretionary trading on behalf of their clients are subject to the fiduciary protections and risk disclosure requirements under the Investment Advisers Act.

That said, to the extent representatives of broker-dealers or investment advisers recommend LIIVs to their clients, the SEC and FINRA have made clear through notices and enforcement actions that representatives of those firms must consider, understand and disclose the additional risk as part of knowing their clients and knowing the investments they recommend.[3] Firms who recommend LIIVs should have written policies and procedures, and training and supervision reasonably designed to address those risks, likely to include monitoring a client's account or making a follow-up recommendation to exit the position. The Commission should consider ways to reinforce those requirements with firms and their representatives. However, the proposed approach requiring client account approval - when the client is relying on the firm to make suitable recommendations in the client's best interest - is not directly responsive to the need for firms to meet their best interest and disclosure obligations.

2. **Issue To Address with Leveraged/Inverse Investment Vehicles is Different from the Issue that Requires Account Approval for Options Trading**

The current proposal goes beyond the historical approach of product education and disclosure. Under the proposed rule, broker-dealers would be required to obtain new categories of information, analyze and assess that data and make a forward-looking judgment on whether a retail investor has the "capacity" to make informed investment decisions. We believe that the

[2] In addition to including a mandatory click-through disclosure agreement similar to the one set forth in the Appendix and discussed below, Schwab proactively notifies clients when twelve months have passed since the client first acknowledged the disclosure, provides a "warning label" on the ETF research pages of our website, and prominently displays other educational materials about LIIVs.

[3] *See, e.g.,* In the Matter of Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Securities Exchange Act of 1934 Release No. 88295, Investment Advisers Act of 1940 Release No. 5451 (Feb. 27, 2020); and FINRA Regulatory Notice 09-31 (June 2009).

better approach is to provide self-directed investors with the necessary information to understand and acknowledge the risks before making an initial purchase.

All types of investment products have some element of inherent risk and unique characteristics and complexities. As the recent coronavirus-related market gyrations show, even broad-based groupings of common stocks can be quite volatile. There are a number of publicly-traded products which could be considered "complex" to some degree. These include over-the-counter equities, exchange-traded options, REITs, business development companies, special purpose acquisition companies, master limited partnerships, high-yield bonds, municipal securities, non-transparent ETFs, variable annuities and principal protected notes and CDs. Options trading is different from those investment products (as well as LIIVs), because an effective options trading strategy involves a number of steps and potentially complicated considerations, discussed further below. In contrast, although the risks of LIIV can be significant, the way to address those risks is more straight-forward.

LIIVs can be volatile, particularly if held overnight or longer. The inherent risks of the product, however, are not so complicated as to elude the understanding of the average investor who has the basic information. LIIVs are tied to a particular reference index, but are more volatile since they employ derivatives to magnify the potential gains and losses of their holdings. Since these funds reset their portfolios on a daily basis, their performance may vary substantially from the underlying reference index. The use of leverage has not historically mandated a review and approval process by itself. For example, retail clients open margin accounts on their own initiative simply if they accept the terms of a margin account agreement with the necessary disclosures. No further review and analysis by the brokerage firm is considered necessary. An investor can buy and sell LIIVs easily through an exchange, without needing have in-depth knowledge or appreciation of the underlying derivatives or reference index; the key consideration for a LIIV investor is whether the investor understands that the products are not intended as a long-term holding.

In contrast, options trading strategies are inherently more complicated. Unlocking the secrets of the options pricing model earned Black and Scholes a Nobel Prize in economics. Every options contract on an underlying security involves puts and calls, which investors can both buy and sell. The purchase or sale of any options contract has particular risks which must be understood. For example, the risk to an investor in buying a call option (loss of premium paid) is very different than selling a put. There are typically many different series of options contracts for each underlying security or index, each with different strike prices, market values and durations until expiration. In addition, two, three or four related options contracts may be traded in combination strategies such as spreads, straddles, and condors. These multi-leg strategies are designed to take advantage of various anticipated price movements and usually require extensive education and experience to employ successfully. Successful options traders must understand and be able to apply the "Greeks," *e.g.*, Delta (how much an option's price is expected to change per change in the price of the underlying security or index), Gamma (the rate of change in an option's Delta per change in the price of the underlying stock), and Theta (how much the price of an option should decrease as the option nears expiration). Other relevant concepts include Implied Volatility, which estimates how the price of a security may change in the future. The proper application of all of these factors requires a high degree of mathematical and trading rigor and discipline, which

not everyone possesses. Given these complexities, specific registration categories for those who supervise options transactions have been created. These complexities and challenges of implementing a successful options trading strategy go well beyond anything presented by an investment in LIIVs.

The Commission's concerns about LIIVs appear to arise not so much from the inherent complexities of the funds themselves, but the manner in which a number of retail investors have been using them. Rather than setting up a burdensome account approval process that would be challenging for both retail investors and firms to manage, we believe that a disclosure-based approach is a more direct and effective form of regulation to address the particular issue the Commission has identified.

3. A New Rule should Require a Plain-English, Pre-Trade Risk Disclosure with an Annual Reminder

Instead of imposing a cumbersome new account approval process, the Commission first should remind broker-dealers and advisory firms who recommend LIIVs to their clients of their best interest, care, and disclosure obligations (see above text accompanying footnote 2). Second, the Commission should require broker-dealers to provide their self-directed clients with clear disclosures of the potential risks of trading LIIVs. This disclosure should be provided at or immediately before order entry of an initial unsolicited order whether online, by phone, or in person. Generally Schwab prefers principles-based, non-prescriptive rules when it comes to sales practices because there are many different industry models that warrant a flexible approach. In this case, because the risks to retail investors are essentially the same no matter where they choose to have their account and trade, it would be best for a Commission rule to state with some particularity what should be in the disclosure and how it should be delivered. In the Appendix to this letter we set forth revisions to the proposed rule to accomplish this approach.

The rule, as set forth in the Appendix, should include the following elements:

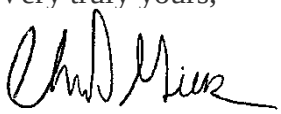
- Short so as not to be unduly burdensome and to uphold the principles of plain-English
- General enough it is applicable to the broad category of LIIVs, but specific enough to identify the particular risks of these investment products
- A reminder for the investor to review the prospectus
- The requirement of an acknowledgement of receipt of the disclosure (which can be electronic through a simple click, verbal, or in writing to allow sufficient flexibility)
- An annual reminder that would be acknowledged again if the customer seeks to place an order 12 months after the initial (or previous) risk disclosure
- Only applicable to purchases and not sales, because purchases create the risk while sales reduce the risks
- A corresponding recordkeeping obligation.

Conclusion

Schwab appreciates the SEC's commitment to protecting retail investors. That commitment should be applied in a direct manner to address the problem of some self-directed retail investors

not being sufficiently informed of the risk. This is possible through a uniform brokerage industry approach to a product risk disclosure without resorting to an intrusive and extensive account approval process. We appreciate the opportunity to comment on the proposed rule and thank the Commission for its consideration of the views we express above. If you have any questions regarding our comments, please contact the undersigned.

Very truly yours,



Christopher Gilkerson
SVP, General Counsel
Charles Schwab & Co., Inc.

David Whitcomb

David Whitcomb,
VP, Associate General Counsel
Charles Schwab & Co., Inc.

cc: The Honorable Jay Clayton
The Honorable Hester Pierce
The Honorable Elad Roisman
The Honorable Allison Lee
Brett Redfearn, Director, Division of Trading and Markets

APPENDIX

§ 240.15*l*-2 Broker and dealer disclosure for leveraged/inverse investment vehicles.

(a) *Required disclosure*. No broker or dealer registered or required to be registered under the Securities Exchange Act of 1934, or any associated person of the broker or dealer, may accept an unsolicited order from a customer that is a natural person (or the legal representative of a natural person) to buy shares of a leveraged/inverse investment vehicle unless the broker or dealer has provided a disclosure, which must be acknowledged by the customer, at the time of an initial order to buy shares of a leveraged/inverse investment vehicle (prior to accepting the order) that contains the following:

i. Leveraged/inverse investment vehicles seek to deliver multiples of the short-term performance (or the opposite of the performance) of the index or benchmark they track.

ii. The amount of leverage or inverse exposure resets each day. The daily resetting has a compounding effect that can cause these securities to perform worse than their multiple would suggest over any period longer than one day.

iii. Most of these securities are designed for daily use only, and are not intended to be held overnight. They generally are not intended for inexperienced investors or those investors with moderate or conservative risk tolerances.

iv. Before you invest, read the prospectus to understand fully the risks and proper use of the particular leveraged/inverse investment vehicle you are considering for purchase.

The disclosure may be provided and acknowledged electronically for an order submitted through electronic means, verbally for an order submitted over the phone, or verbally or in writing for an order submitted in person. Once a customer has received the disclosure, a broker or dealer is only required to provide the disclosure once every twelve months and only

if the customer submits another order to buy shares of a leveraged/inverse investment vehicle twelve months after the prior disclosure was provided.

(b) *Recordkeeping*. A broker or dealer must maintain a written record of the disclosure and acknowledgement under paragraph (a) of this section and the versions of the firm's policies and procedures requiring that disclosure and acknowledgement for a period of not less than six years (the first two years in an easily accessible place) after the date of the closing of the customer's account.

(c) *Exclusion.* The disclosure requirements of paragraph (a) shall not apply to orders submitted to a broker-dealer by a registered investment adviser acting on behalf of a client.