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July 29, 2013

VIA ELECTRONIC MAIL (rule-comments@sec.gov)

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

Re: File No. SR-FINRA-2013-025

Dear Ms. Murphy:

Charles Schwab & Co., Inc. ("Schwab") appreciates the opportunity to comment on FINRA's proposals relating to the FINRA supervision rules. We support FINRA's efforts to clarify certain supervisory requirements and appreciate the modification of several provisions of the rule proposal based on comments received.

While we believe the proposed rules generally support the objectives of providing more streamlined, clear and flexible supervisory requirements, we would like to highlight policy issues and practical concerns regarding implementation in relation to certain of the proposals, as discussed below.

Proposed Rule 3110(b)(6)(D)

Proposed Rule 3110(b)(6)(D) creates a new requirement that firms include in their supervisory procedures new conflict of interest procedures, described as:

> "procedures preventing the standards of supervision required pursuant to paragraph (a) of this Rule from being reduced in any manner, due to any conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised."

Schwab reiterates its concerns set forth in our comment letter dated July 20, 2011 to the previous version of FINRA's consolidated supervision rule proposal that the language of the provision may be read to create a strict liability standard that is both unnecessary and

unclear, and is in conflict with existing reasonableness standards set forth in NASD Rule 3010(a) and proposed Rule 3110(a).

Schwab agrees with FINRA that consideration of conflicts of interests is a necessary component of the design and execution of a reasonable and effective supervisory system. In establishing the supervisory structure, the roles and responsibilities of supervisors and the checks and balances in the system, a member firm must consider potential conflicts of interest of supervisory personnel. As noted by FINRA, a reasonably designed supervisory system must be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business, including conflicts of interest. We do not agree that a new and separate conflict of interest procedural requirement is needed; the obligation to assess and mitigate conflicts of interest is inherent in the member firm's obligation to establish and maintain a reasonable supervisory system and associated supervisory procedures.

We are concerned that in creating a requirement to establish a separate set of conflict of interest procedures, the proposal articulates an ambiguous and potentially unworkable standard requiring firms to create procedures that have the effect of preventing "standards of supervision" from being "reduced in any manner." We believe that the proposed standard is subject to widely varied interpretations and as a result, will be inconsistently applied. It is unclear how FINRA examiners will interpret the proposed language when evaluating a firm's supervisory systems, and we are concerned that hindsight application of the language in circumstances where a member firm's supervisory system failed to prevent or detect violative conduct will result in enforcement or litigation challenges based not on the reasonableness standard set forth in proposed Rule 3110(a), but on the stricter standard set forth in proposed Rule 3110(b), an asserted failure to prevent "standards of supervision" from being reduced "in any manner."

While FINRA rejected the strict liability arguments asserted in previous comment letters, it also declined to include a reasonableness standard in the rule proposal, which FINRA argues would result in an "impermissible relaxation of the standard around which the rule is designed." We believe that the reasonableness standard established by Rule 3110(a) should not be relaxed, but rather reinforced. We are concerned that the proposed language of 3110(b)(6)(D) undercuts and renders inoperative the long established reasonableness standard for supervisory systems and associated procedures.

We would support rule language that confirms the need of firms to assess and mitigate conflicts of interests with respect to associated persons in the design and establishment of a reasonable supervisory system. We do not believe new and separate conflict of interest procedures are required or appropriate.

Proposed Rule 3110(d), Transaction Review and Investigation

Proposed new FINRA rule 3110(d)(1)(A) requires that:

1) Each member shall:

(A) include in its supervisory procedures a process for the review of securities transactions that are effected for the account(s) of the member or the member's associated persons and any other covered account to identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices;

Further, proposed new FINRA rule 3110(3)(A)(i) defines "covered account:"

(3) Definitions

For purposes of this Rule:

(A) The term "covered account" for each member shall include:

(i) any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with the member where such account is introduced or carried by the member;

While FINRA states its intent in proposing Rule 3110(d) is "...to incorporate into the Consolidated FINRA Rulebook the provisions of Incorporated NYSE Rule 342.21, with some modifications, and extend the requirement beyond NYSE-listed securities and related financial instruments to cover all securities[.]," the proposed rules represents a significant departure from the requirements of NYSE Rule 342.21 for legacy NYSE member firms and represents an expansive new rule for legacy NASD member firms.

For reasons described more fully below, Schwab is concerned that the breadth of the definition of covered account is such that compliance with rules 3110(d)(1)(A) and 3110(3)(A)(i) will be impossible. It is not clear that FINRA has considered and assessed the existing regulatory approach to family member accounts and the practical implications, significant challenges and burdens that member firms, their associated persons and customers would be subject to if proposed Rules 3110(d)(1)(A) and 3110(3)(A)(i) are adopted.

Impracticality of Complying with Expanded Scope of "Covered Account"

The proposed rules would require that a member firm have supervisory procedures for the review of securities transactions that are effected for the account(s) of associated persons' non-dependent, non-household son(s), daughter(s), son(s)-in-law, daughter(s)-in-law, mother, father, mother-in-law, father-in-law, brothers and sisters including where the associated person does **not** have a financial or beneficial interest in the account(s) of such persons **nor** does the associated person exercise control or discretion or have the power, directly or indirectly, to make investment decisions (further referred to as "extended family member" accounts).

As a practical matter, an associated person may not have knowledge, entrée or access to information indicating an extended family member maintains an account with the associated person's member firm. It is difficult to imagine how a member firm would be able to identify existing accounts of associated persons' extended family members absent a legal requirement for such extended family members to disclose the information to the member firm.

While a limited number of associated persons in certain broker-dealer business models may be in positions or roles where they may have knowledge, entrée or access to certain extended family members account relationships or extended family member personally identifiable information, the vast majority of associated persons would not.

Schwab also believes the current member firm approaches to identifying or obtaining information necessary to identify accounts of an associated person's immediate, household accounts (e.g. associated person disclosure) could not be practically or meaningfully applied to the identification of extended family member accounts. Schwab believes:

- an associated person may not know whether extended family members maintain accounts with their member firm;
- an associated person may not possess, have entrée to or be able obtain account information (e.g. account number, etc.) or personally identifiable information (e.g. social security number, etc.) of extended family members necessary for the member firm to accurately identify the accounts of an associated person's extended family members;
- an associated person may not have contact with or even know how to contact certain extended family members;
- extended family members may not willingly provide such information (e.g. whether they maintain an account, the account number, their social security number, etc.) upon inquiry or at the request of an associated person, particularly as extended family members would be under no obligation, by rule or otherwise, to provide such information upon the request of an associated person.

In fact, Schwab believes customers who are extended family members of associated persons of a member firm may be unnerved and concerned by requests for sensitive, personal financial or other information from an associated person who is a relative with whom they do not have any type of professional or business relationship. In some instances, such requests may be from a person with whom they do not have any type of a personal relationship, cordial or otherwise, or from whom they prefer to safeguard such information for a variety of reasons. Schwab also believes extended family members may react adversely to such requests; possibly closing, transferring or not establishing accounts with the member firm, and would have legitimate concerns about the privacy of their personal information.

Schwab also believes possible alternative approaches, such as requesting information on the new account application as to whether the customer is a family member, as articulated in the definition of covered account, of an associated person, would not be practical or meaningful for the following reasons. A customer:

- may not be aware that a family member, as articulated in the definition of covered account, is considered an associated person of the member firm;
- may fail to provide updated information as a family member is added or removed (e.g. a customer's son marries an associated person of the member firm or family members leave or change jobs);
- may provide inaccurate information due to their lack of understanding or knowledge of the financial services industry or who might be considered an "associated person" of the member firm;[1]
- may be reluctant to contact their family members, as articulated in the definition of covered account, to inquire whether they are considered an associated person of the member firm;
- may not possess personally identifiable information of the family member they believe may be considered an associated person of the member firm that would permit the member firm to accurately determine if the person identified by the customer is an associated person of the member firm and accordingly conclude the customer falls under the definition of an extended family member of an associated person.

In fact, Schwab believes that customers, if asked to identify whether a family member, as articulated in the definition of covered account, is considered an associated person of the member, would possibly be unable to accurately respond to the inquiry and, as a result, may respond inaccurately, abandon opening an account with a member firm or close existing accounts with the member firm.

Current Laws, Rules and Regulations

Historically, when defining or identifying persons or accounts subject to their laws, rules and regulations, federal regulators and self regulatory organizations have traditionally taken a measured, thoughtful approach to such rulemaking and avoided imposing broad, sweeping obligations on associated persons, customers and member firms. Generally, persons and/or account relationships subject to such laws, rules and regulations have been purposefully identified. For example:

[1]In particular, Schwab believes this would be particularly challenging for large, diversified financial services firms that are often referred to generically (for example, a person employed by a non-member affiliate of Schwab may indicate they are employed by "Schwab" to their extended family members prompting the customer to respond affirmatively that they are an extended family member of an associated person) and financial services firms with a broadly recognized, primary line of business that is not securities related but has employees that are associated persons of member firms (e.g., a customer may not be aware that a family member employed by or an agent with an insurance company is also an associated person of a member firm).

- **NYSE Information Memo 89-17, Clarification of "Family Member" Definition and Report Filing Reminder** - The NYSE clarified that NYSE Rule 342.21(a), which the proposed rules are intended to incorporate, include only (excerpt)

> ...accounts introduced or carried by a member or member organization of the following:
>
> - an employee's spouse;
> - children of employees and the children's spouses, provided that they reside in the same household with, or are financially dependent upon the employee; and
> - any other related individual over whose account the employee has control; and
> - any other individual over whose account the employee has control and to whose financial support the employee materially contributes.
>
> It should also be noted that under Rules 406 and 407, relating to accounts carried at other than the employee's own firm, "employee accounts" include any account in which a member, allied member or employee has an interest or has the power, directly or indirectly, to make investment decisions. Any such account is subject to Rule 342.21(a)

- **Investment Adviser Codes of Ethics (In Inv. Adv. Act Rel. No. 2256, 69 Fed. Reg. 41696, July 9, 2004)** - The Commission release noted: "Access persons must submit holdings and transaction reports for "reportable securities" in which the access person has, or acquires, any direct or indirect beneficial ownership. An access person is presumed to be a beneficial owner of securities that are held by his or her immediate family members sharing the access person's household." The associated footnotes indicate that the same standards apply generally throughout the federal securities laws, including under Investment Company Act Rule 17j-1, and under the Exchange Act (which regulates broker-dealers), in Rule 16a-1(a)(s). It should also be noted that investment advisory personnel deemed "access persons" are generally limited to certain, specified investment advisor personnel.

- **NASD Rule 3050** - NASD Rule 3050(c), Obligations of Associated Persons Concerning an Account with a Member, and NASD Rule 3050(d), Obligations of Associated Persons Concerning an Account with a Notice-Registered Broker/Dealer, Investment Adviser, Bank, or Other Financial Institution, which generally require an associated person of a member firm, prior to opening an account or placing an order for the purchase or sale of securities with another member, a notice-registered broker/dealer, investment advisor, bank or other financial institution, to notify the

> associated person's employer member, applies only to an account or order in which an associated person has a financial interest or has discretionary authority.[2]

Regardless of the approaches member firms may employ to identify the accounts of extended family members of their associated persons, Schwab believes that significant (and costly) personnel, technology and other resources would need to be applied in this effort, an effort which, due to the practical challenges, would most likely fail to meet the requirement under the proposed rules and result in member firms being in the untenable position of unknowingly yet persistently violating the proposed rules.

Schwab encourages the Commission to reject the proposed rules and request that FINRA review and consider:

- the more measured, thoughtful approaches articulated in existing laws, rules and regulations;
- the practical challenges and burdens of implementing and continuously applying the proposed rules; and
- the possible impact and disruption to customer relationships.

We believe FINRA should propose a rule that is consistent with the obligations of associated persons regarding family member accounts pursuant to NASD Rule 3050 or the definition of "employee accounts" pursuant to NYSE Rule 342.21(a).

Proposed Rule 3110(b)(4), Internal Communications

Proposed FINRA Rule 3110(b)(4) and Supplementary Material .07 include provisions requiring supervisory procedures regarding the review of certain internal communications. In response to commenters' concerns, FINRA modified proposed Rule FINRA 3110(b)(4) and the accompanying Supplemental Material to more precisely reflect the guidance in Regulatory Notice 07-59. We support those changes and recommend an additional clarification confirming that members may use risk-based principals to determine those internal communications that are subject to review.

Supplementary Material .07 requires a member to use risk-based principals to decide "the extent to which additional policies and procedures for the review of . . . internal communications that are not of a subject matter that requires review under FINRA and MSRB rules and federal securities laws are necessary for its business and structure." The guidance in Regulatory Notice 07-59 articulates a different risk-based assessment, indicating that members "may decide by employing risk-based principles, the extent to

[2] It also should be noted that in Regulatory Notice 09-22, Personal Securities Transactions, (April 2009) FINRA requested comment on proposed new FINRA Rule 3210 (Personal Securities Transactions for or by Associated Persons). The proposed new rule was intended to combine and streamline certain provisions of NASD Rule 3050 and incorporated NYSE Rule 407 (in addition to adopting additional requirements). The proposed new rule retained and continued to apply only to accounts " in which an associated person has a personal financial interest "

which review of . . . internal electronic communications is necessary in accordance with the supervision of their business."

These standards could be read as inconsistent. Regulatory Notice 07-59 makes clear that a firm may determine, through a risk assessment, that certain internal communication do not require any review. The Proposal can be read to require review of all internal communications to identify those that require review under FINRA and MSRB rules and federal securities laws. We believe the application of the rule to require review of all internal communications would impose an unnecessary and overly broad supervisory requirement. For example, all internal communications in a firm do not require review to identify communications between non-research and research departments pursuant to the requirements of NASD Rule 2711(b)(3)(A). For purposes of that rule, a firm may reasonably target internal communications to and from members of the research department. To effectively and efficiently allocate supervisory resources and focus, member firms should be allowed to make appropriate risk based determinations that certain internal communications do not require review.

Schwab recommends that FINRA supplement the language in the Proposal with the language in Regulatory Notice 07-59 to allow members to employ risk-based principles to determine the extent to which the review of internal communications is necessary.

Proposed Rule 3010(c)(2)(A), Transmittal of Funds – Deletion of Parenthetical

As part of its relocation of certain provisions of NASD Rule 3012 to FINRA Rule 3010(c)(2), FINRA proposes to delete from NASD Rule 3012 a parenthetical relating to the transmittal of funds or securities from customers to third party accounts, stating:

> "the proposal eliminates NASD Rule 3012's parenthetical text "(i.e., a transmittal that would result in a change in beneficial ownership)" to clarify that all transmittals to an account where a customer on the original account is not a named account holder are included."

While described as a clarification, we believe that the elimination of the parenthetical represents a change in the rule's definition of "a transmittal of funds or securities to third party accounts," that appears to expand application of the rule and its provisions requiring "a means or method of customer confirmation, notification, or follow-up than can be documented" to transactions that are not currently subject to the rule. For example, the existing parenthetical in the current rule would appear to exclude from the rule transfers from a joint account (in which all account holders have an undivided ownership right in all of the assets) to an account of one of the joint account holders where there is no resulting change in beneficial interest under applicable law. The elimination of the parenthetical appears to subject these transfers to the notification provisions of the rule based on FINRA's assertion that "transmittals to an account where a customer on the original account is not named account holder are included."

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The apparent expansion of the application of NASD Rule 3012 warrants consideration of the policy basis for the change, its consistency and potential conflict with contractual agreements among joint account holders and between joint account holders and member firms, its consistency and potential conflict with applicable state and federal laws, the potential that multiple notifications of routine transfers among joint account holders could dilute the effectiveness of notices of transfers to unrelated accounts where there is higher potential risk of fraud, and the potential impact on member firms to the extent the change may require changes in systems, operational processes and customer notifications and forms. While such analysis may ultimately support the proposed change, there is no indication in the proposing release that these factors were considered or analyzed. We suggest that FINRA retain the existing parenthetical and address the removal of the parenthetical in a separate proposal subject to a more fulsome review and discussion of the legal, regulatory, policy and practical considerations raised by the change

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Schwab appreciates the opportunity to comment and thanks the Staff for consideration of the points raised in this letter. Please feel free to contact me to discuss any questions you may have regarding our comments.

Very truly yours,

Scott Cook
Senior Vice President and CCO
Charles Schwab & Co., Inc.