

Compliance
101 Montgomery Street San Francisco CA 94104
(415) 636 7000

BY EMAIL TO: pubcom@finra.org

June 29, 2009

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

**RE: FINRA Regulatory Notice 09-25
Suitability and "Know Your Customer"**

Dear Ms. Asquith:

Charles Schwab & Co., Inc. ("Schwab") appreciates the opportunity to comment on proposed consolidated FINRA rules governing suitability and know-your-customer (KYC) obligations. Schwab supports the issuance of a strong suitability rule that clearly articulates broker-dealer obligations when making investment recommendations to its customers. Schwab believes the suitability rule provides fundamental protections for the investing public, and appropriately serves as a foundation for effective investor protection. At the same time, certain aspects of the proposed rules create practical challenges that warrant consideration of modifications.

Proposed Rule 2111

Proposed Rule 2111 would establish that a member or associated person have "a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer." We agree with FINRA that the suitability rule only applies when the member firm or associated person makes a recommendation – an unsolicited order to buy or sell a security does not trigger a suitability obligation. We also agree that if the purchase or sale of a security is recommended as part of an overall recommended investment strategy, the investment strategy must also be suitable for the customer. However, it is unclear as to what constitutes an "investment strategy involving a security or securities," and the proposed rule could be read broadly to cover recommendations that do not result in trades. We believe that FINRA should clarify the rule by stating that suitability should apply to recommendation of strategies resulting in the purchase, sale or exchange of a security or securities.

FINRA has requested comments as to whether or not the suitability rule should be expanded to all recommendations of investment products, services and strategies made in connection with a firm's business, regardless of whether the recommendations involve securities. Such an expansion would extend the FINRA suitability rule to a variety of non-securities products and services, such as life insurance, futures, debit cards and banking products, that are currently subject to the customer protection rules and regulations of other federal and state regulatory bodies. Additional substantive customer protection regulation and oversight may arise as a result of proposed federal regulatory reforms designed to enhance consumer financial protection.¹ The blanket application of FINRA suitability requirements to the sale of these products and services may create duplicative, confusing or conflicting sales practice requirements without any benefit to the investor. We believe FINRA should refrain from overlaying securities suitability requirements on non-securities products, particularly in light of possible substantive regulatory changes impacting the sales of these products.

Proposed Rule 2111 expands the categories of customer information that a member must make reasonable efforts to obtain prior to making a recommendation. In addition to information about the customer's financial status, tax status and investment objectives, the new rule would require the member to seek to obtain information concerning the customer's age, other investments, investment time horizon, liquidity needs and risk tolerance. Schwab agrees that this information is relevant in many situations where a recommendation is made; however, there are instances where a customer is seeking very limited advice with very specific criteria regarding the security that he or she would like to purchase. In those circumstances, obtaining customer information in each of the articulated categories may not be warranted. FINRA should consider building flexibility into the rule and not mandating that the member seek to obtain these new categories of information for every recommended transaction. Members should have discretion to determine what customer information is relevant to the suitability determination associated with each recommended transaction. If FINRA takes the position that this information is required to be obtained and captured, FINRA should recognize that there are substantial costs associated with developing, modifying, and implementing forms and systems to request and capture the proposed new categories of information and for firms to evaluate changes to procedures, policies and training to incorporate the newly articulated requirements. FINRA should evaluate these costs and establish an effective date to allow firms a reasonable amount of time in which to meet the new requirements.

¹ On June 17, 2009, the United States Department of the Treasury proposed a number of regulatory reforms designed to protect customers and investors from financial abuse. The proposed reforms, which are set forth in a white paper entitled "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," include a proposal to create a new federal agency with broad jurisdiction to protect consumers of financial products.

One of the new categories of information required to be collected is information about other investments. Most customers hold a variety of assets outside of their broker-dealer, which may include real estate, personal property, commodities, retirement accounts, life insurance contracts and private placements. In many instances, it is not necessary to collect, and many customer are not willing to provide, such detailed financial information when an investment recommendation is made. The circumstances of the interaction and the needs and preferences of the customer should govern the extent to which information concerning outside investments is disclosed and considered. "Other investments" should not be a mandated category of information required for a recommendation.

The suitability provisions of the proposed rule also state the recommendation must be based on "the facts known by the member or the associated person or disclosed by the customer" This provision can be read to attribute to the representative recommending the trade knowledge of every fact collected by the firm regarding the customer. This broad attribution of knowledge to the recommending representative raises practical and fairness issues, particularly for associated persons in firms with multiple business lines. Customers may provide information for a variety of different purposes (for example banking, insurance or securities transactions) to different employees working in different departments and recording the information on separate systems. A registered representative working with a client and making securities recommendations may not have access to all of that information, some of which may be subject to appropriate internal information barriers. It is sufficient for the rule to require that the representative collect information reasonably required to make a suitable recommendation without attributing to the representative every piece of factual information collected by the firm. This aspect of the rule should be deleted.

Proposed Rule 2090

FINRA has proposed a new and expanded "Know Your Customer" Rule 2090 that requires firms to use "due diligence in regard to the opening and maintenance of every account, to know and retain the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer." The supplementary material states that for purposes of this Rule, the facts "essential" to "knowing the customer" include the customer's financial profile and investment objectives or policy. Schwab believes the expansive scope of the proposed rule to include the collection of customer financial profile and investment objective information unnecessarily confuses the KYC rule with the suitability rule, is unwarranted and creates the potential for expanding member firm suitability obligations to transactions that are not recommended by the member firm or its registered representatives.

In Regulatory Notice 09-25, FINRA states that the source of proposed Rule 2090 is NYSE Rule 405, and that the know your customer concept is embedded in the just and

equitable principles of trade of NASD Rule 2110, citing Exchange Act Release No. 44178 n.7.² The cited Exchange Act Release states in relevant part:

Members should nonetheless remember that, under NASD Rule 2110, they are required to comply with know-your-customer obligations. Pursuant to these obligations, members must make reasonable efforts to obtain certain basic financial information from customers *so that members can protect themselves and the integrity of the securities markets from customers who do not have the financial means to pay for transactions* [emphasis added]. . . . Unlike the suitability rule, the NASD's know your customer requirements apply to members regardless of whether they have made a "recommendation."

In Regulatory Notice 09-25, FINRA states that the KYC rule has a much broader purpose than that of protecting the member firm and financial markets from customers who do not have the financial ability to pay for transactions. Without explanation, FINRA states that the data collected pursuant to the KYC rule is used to aid the firm in all aspects of the customer/broker relationship, including, among other things, determining whether to approve the account, where to assign the account, whether to extend margin and the extent thereof, and whether the customer has the financial ability to pay for the transactions. This expansion of the purpose of the rule is not consistent with the cited Exchange Act Release and confuses the KYC rule with suitability requirements. While the statement of a broader purpose for the KYC rule may serve to provide a justification for requiring firms to collect financial profile and investment objective information for all customers, there is no need to collect this information if the purpose of the rule, consistent with cited precedent, is to protect members and the integrity of the securities markets from customers who do not have the financial means to pay for transactions.

The collection of financial profile and investment objective information under the expanded KYC rule is potentially problematic where a customer's trading activity is self directed or directed by an independent investment adviser. The record of this KYC data may create uncertainty as to a member firm's obligations where a customer enters unsolicited trades (or a third party adviser is directing trades in the customer's account) that appear to be inconsistent with the customer's investment objective and financial profile information collected under the proposed KYC rule. It is possible that regulators or private litigants could seek to hold member firms accountable for permitting unsolicited customer trading activity that is inconsistent with the KYC suitability information that is on record at the firm. To protect against that possible exposure, members might need to keep KYC information up to date, monitor unsolicited trading activity against the recorded KYC information and consider blocking or cancelling unsolicited trading activity that is inconsistent the KYC customer information provided. The practical implications and risks associated with the collection of suitability

² Exchange Act Release No. 44178 (April 12, 2001), 66 FR 20697, 20698 n. 7 (April 24, 2001)..

Ms. Marcia E. Asquith
June 29, 2009
Page 5 of 5

information under the proposed KYC rule are significant and the benefits of gathering the information are unclear. The Supplementary Material under proposed Rule 2090 should be deleted.

Schwab appreciates the opportunity to provide comments and thanks FINRA for its consideration of the points we have raised in this letter. Please feel free to contact me at (415) 637-0866 to discuss them in more detail.

Sincerely,

Bari Havlik
SVP and Chief Compliance Officer
Charles Schwab & Co., Inc.