



CORPORATION

July 7, 2017

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San Francisco, CA 94105

By Electronic Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Vice President and Deputy Corporate Secretary
Office of Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Re: Special Notice – Engagement Initiative

Dear Ms. Mitchell:

Charles Schwab & Co., Inc. (“Schwab”) appreciates the opportunity to comment on FINRA’s Special Notice, Engagement Initiative (the “Notice”)¹ and commends FINRA for all of FINRA’s recent engagement efforts, including:

- The FINRA360 initiative
- FINRA President and CEO Robert Cook’s “listening tour”
- Dissemination of FINRA’s Board of Governors (the “Board”) meeting agenda
- FINRA’s Retrospective Rule Review

Schwab strongly supports FINRA’s dedication to investor protection and market integrity through effective and efficient regulation of broker-dealers. Schwab is encouraged by FINRA’s effort to “...build an even better FINRA”² via outreach to FINRA’s varied stakeholders, including member firms and FINRA’s recognition that “...the nature of self-regulation requires us to embrace the challenge of incorporating industry expertise into our regulatory programs in order to be a nimble, more responsive regulator that adapts quickly and creatively to change.”³

We also appreciate FINRA CEO Robert Cook’s recent statement that:

¹ Special Notice – Engagement Initiative (March 21, 2017), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Special-Notice-032117.pdf

² Remarks From the 2017 FINRA Annual Conference, FINRA President and Chief Executive Officer Robert W. Cook (May 17, 2017), available at <http://www.finra.org/newsroom/speeches/051717-remarks-2017-finra-annual-conference>.

³ Remarks From the 2017 FINRA Annual Conference, FINRA President and Chief Executive Officer Robert W. Cook (May 17, 2017), available at <http://www.finra.org/newsroom/speeches/051717-remarks-2017-finra-annual-conference>.

Transparency can reinforce and enrich engagement. Giving firms information about what we are doing, and why, enables them to develop more informed views and provide us with more constructive feedback. In addition, transparency helps promote public confidence in our work—by providing investors and others with information about how we are working to protect them and promote the integrity of the markets. And

transparency supports accountability—by providing information that enables interested parties to develop views about the extent to which we are appropriately executing our mission, and to tell us when they believe we are falling short.⁴

“Through Clients’ Eyes” is at the core of how we operate at Schwab. We are pleased that FINRA is embracing a similar philosophy by transparently engaging with and seeking the perspectives of key stakeholders; investor advocates, fellow regulators, industry groups, policymakers, member firms and other interested parties. Schwab looks forward to participating in FINRA’s engagement efforts by providing thoughtful, relevant and actionable feedback to FINRA.

Executive Summary

In this letter, we address a number of the topics that FINRA requested comment on regarding how FINRA can enhance certain programs to promote its mission and its effectiveness as an SRO. In particular, Schwab suggests that FINRA:

- Institute formal practices to increase committee transparency, document committee commentary on rulemaking or regulatory initiatives and provide tangible, documented feedback on the results of committee efforts.
- Subject all rulemaking, including rulemaking FINRA believes is not material or is technical, to committee review. If a committee believes the rulemaking is material or meaningfully impacts member firms or other key stakeholders, FINRA should apply the rulemaking process outlined in the Notice.
- Leverage the committee structure to review interpretative guidance prior to issuance. In cases where the industry is not requesting guidance, engage in the rulemaking process rather than the issuance of interpretative guidance. This will help assure that interpretive guidance is “reasonably and fairly implied”⁵ by the FINRA rule.
- Establish a new committee or create a sub-committee of the Board to advise FINRA on whether rule interpretations in enforcement actions are “reasonably and fairly

⁴ Remarks: SIFMA Compliance and Legal Society, FINRA President and Chief Executive Officer Robert W. Cook (January 10, 2017), available at <https://www.finra.org/newsroom/speeches/011017-remarks-sifma-compliance-and-legal-society>.

⁵ Section 19 of the Securities Exchange Act of 1934; 17 CFR 240.19b-4; “[a] stated policy, practice, or interpretation of the self-regulatory organization shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization.”

implied”⁶ by the FINRA rule and whether adequate notice was provided to member firms or associated persons prior to issuance of a complaint.

- Rigorously apply FINRA’s “Framework Regarding FINRA’s Approach to Economic Impact Assessment for Proposed Rulemaking,”⁷ especially in the area of consulting with key stakeholders in the development of rules and aggregating data to assess a proposal’s cost effectiveness, including consideration of alternative means of regulation.
- Provide more transparency into sources of revenue and spending and publicly share a meaningful summary of the reports to the FINRA Board and Audit Committee on the projects and purposes for which enforcement fine monies have been used.
- Share the results of the surveillance and examination programs risk assessments with member firms.

Engagement Through Advisory, *Ad Hoc* and District Committees

The Notice provides detailed information on the breadth and scope of FINRA’s committee structure, the role and activities of each committee and the membership of each committee. We applaud FINRA for developing and supporting the committee infrastructure and are cognizant of and appreciate FINRA’s efforts to maintain, inform and partner with the committees. As a participant in a number of the committees, Schwab recognizes the meaningful role FINRA affords the committees and values the contributions of the committees.

Generally, Schwab believes that FINRA should consider implementing more rigorous, formal processes related to committee review of regulatory and policy initiatives and improve the transparency of this process. In particular, Schwab suggests the following:

Multiple Committee Review – In circumstances where FINRA presents the same regulatory initiative or rule proposal to multiple committees for review and commentary, Schwab suggests that each committee’s commentary be documented and shared with the other committees reviewing the regulatory initiative or rule proposal. Schwab also suggests that for regulatory initiatives or rule proposals aligned with the areas of expertise of an Advisory or Ad Hoc committee, the relevant Ad Hoc or Advisory committee conduct the initial review of the regulatory initiative or rule proposal and the Ad Hoc or Advisory committee’s commentary be documented and shared with the other committees requested to review the regulatory initiative or rule proposal.

Documentation of Committee Commentary - It does not appear that there is a formal process to document committee commentary and to obtain committee review and acceptance of committee commentary to be presented to FINRA executive management or Board. Schwab believes that where committee commentary on a regulatory initiative or rule proposal

⁶ Ibid. 5.

⁷ FINRA “Framework Regarding FINRA’s Approach to Economic Impact Assessment for Proposed Rulemaking” (September 2013), available at https://www.finra.org/sites/default/files/Economic%20Impact%20Assessment_0_0.pdf

is to be presented to FINRA executive management and/or Board, such commentary should be documented and should be reviewed and accepted by the committee members prior to presentation to the FINRA executive management or Board.

Complex, Substantive Regulatory Initiatives or Rule Proposals – Where FINRA presents complex, substantive regulatory initiatives or rule proposals to a committee for review and commentary, the committee should be expressly permitted to share the materials with subject-matter-experts at their firm. In addition, a committee should be able to request that a sub-committee or working group be formed from within or across the committees to participate with FINRA staff in an in-depth review of the regulatory initiative or rule proposal.

Schwab also supports SIFMA's commentary regarding empowering FINRA's committees with a greater role in the rulemaking process, development of regulatory initiatives, and resolution of industry issues. In particular, Schwab urges FINRA to strongly consider SIFMA commentary that FINRA demonstrate "...ways in which committee feedback was incorporated, thereby signifying that such feedback is valued..."⁸ Schwab further echoes SIFMA's recommendations to make committee work more transparent and suggests that minutes of committee deliberations be compiled and made publicly available in a format similar to the FINRA Board of Governors Meetings updates⁹ so as not to inhibit committee member participation.

While we note that FINRA is not subject to "Sunshine Laws" and regulations, Schwab believes to that extent practical and plausible FINRA would benefit by emulating the principles inherent in these laws and regulations.

Engagement in Connection With FINRA Rulemaking

Rulemaking is perhaps FINRA's most significant, purposeful obligation, permitting FINRA to draw on its inherent advantage as a self-regulatory organization; to broadly seek the perspective of member firms, market participants and other key stakeholders. Thoughtful rulemaking, whether principle or rule based, provides notice of expected behaviors and sets industry standards of conduct. Schwab believes that when rigorously and consistently applied, FINRA's rulemaking process as described in the Notice and its website¹⁰ meaningfully provides member firms and other stakeholders with the opportunity to review, analyze and provide commentary on proposed FINRA rules.

As rulemaking is an integral component of FINRA's regulatory responsibilities, in addition to Schwab's previous suggestion that FINRA consider a more rigorous, formalized, transparent process to consider committee commentary in the rulemaking process, Schwab would also suggest the following:

⁸ SIFMA comment letter, Special Notice – Engagement Initiative (May 8, 2017), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/SN-32117_SIFMA-Kenneth-E_comment.pdf.

⁹ FINRA "Board of Governors Meeting Updates" available at <https://www.finra.org/industry/governors-meetings>.

¹⁰ "FINRA Rulemaking Process," available at <http://www.finra.org/industry/finra-rulemaking-process>.

Committee Review of All Rulemaking - Schwab notes that consultation with relevant advisory committee(s), the Regulatory Notice process and consideration of committee and public feedback prior to the filing of a proposed rule with the SEC is not required by the Exchange Act or SEC rules. Schwab understands that FINRA may choose to bypass this process when FINRA believes "...a proposed rule change may be technical or not material, or because FINRA determines that time is of the essence for the proposed rule change."¹¹ Schwab believes that there have been instances where FINRA has submitted material rulemaking, including certain rulemaking that may be considered "technical," to the SEC without presenting the committees, member firms and other key stakeholders with the review and comment opportunities referenced in the Notice.¹²

Schwab suggests that all FINRA rulemaking, irrespective of whether FINRA believes the rulemaking is not material or is simply technical, be subject to committee review and that if a committee believes the rulemaking is material or will have a meaningful impact on member firms or other key stakeholders, FINRA subject the rulemaking to the rigorous, exacting rulemaking process described in the Notice. Schwab also suggests that FINRA codify, via a formal framework or policy, the rulemaking process outlined in the Notice.

Rulemaking by Interpretative Guidance – FINRA routinely provides rule interpretative guidance via notices, interpretative letters, frequently asked questions, annual examination priorities letters and various other means. Schwab appreciates FINRA's willingness to provide interpretative guidance, when such guidance is "reasonably and fairly implied" by the FINRA rule, the standard required pursuant to SEC Rule 19b-4, Filings With Respect to Proposed Rule Changes by Self-Regulatory Organizations.¹³

In some instances, FINRA's interpretative guidance appears to be based on new, novel interpretations of a rule that may not be consistent with the rule, the underlying rulemaking, the intent of the rule or may meaningfully alter or expand the scope of the rule, thereby

¹¹ FINRA "What to Expect" Webcast Series, Rulemaking Process, page 2, available at http://www.finra.org/sites/default/files/Education/p038464_0.pdf

¹² For example, on September 10, 2009 FINRA submitted SR-2009-060, Proposed Rule Change to Amend FINRA Rule 8210 (Provision of Information and Testimony and Inspection and Copying of Books), which included a substantive rule change "to amend FINRA Rule 8210 to clarify the scope of the rule." As noted in Section 2 "Procedures of the Self-Regulatory Organization" "At its meeting on July 16, 2009, the FINRA Board of Governors authorized the filing of the proposed rule change with the SEC. No other action by FINRA is necessary for the filing of the proposed rule change[.]" and Section 5, "Self Regulatory Organization's Statement of Comments on the Proposed Rule Change Received from Members, Participants, or Others," "Written comments were neither solicited nor received." Available at <https://www.finra.org/sites/default/files/RuleFiling/p119951.pdf>.

There have also been instances where "technical specifications" for FINRA reporting or submission of information requirements have resulted in the creation of records or information that member firms are not otherwise required to maintain pursuant to SEC books and records rules or FINRA rules.

¹³ Ibid. 5.

introducing new regulatory requirements that were not contemplated or considered in the making of the rule.

Rulemaking via interpretative guidance also deprives FINRA of leveraging one of the key benefits of being a self-regulatory organization; receiving member firm and other stakeholder feedback on the feasibility and impact of a proposed rule. Rulemaking via interpretative guidance also can create practical challenges and may put member firms in the untenable position of immediately building business, supervisory and/or compliance infrastructure to apply the interpretative guidance without the meaningful notice, transparency and understanding that member firms obtain via the formal rulemaking process outlined in the Notice. In addition, rulemaking via interpretative guidance may result in inefficient implementation, increasing costs or negatively impacting customers.

By adhering to the rulemaking process outlined in the Notice, member firms are afforded the opportunity to thoughtfully, effectively and efficiently implement a new or amended rule. Schwab suggests that FINRA subject any meaningful or substantive interpretative guidance to review by committees for feedback on whether such interpretative guidance is consistent with the underlying rule and “reasonably and fairly implied” by the rule.

Regulation by Enforcement – Tangential to rulemaking by interpretative guidance and sharing all the attendant challenges for member firms and lost opportunities for FINRA, is regulation by enforcement.

Schwab recognizes, appreciates and approves of FINRA’s efforts to “...advance investor confidence in the securities markets through vigorous, fair and effective enforcement of FINRA and MSRB rules, and federal securities laws and rules[.]”¹⁴ and believes that FINRA has demonstrated this ability with many important, relevant enforcement actions.

Schwab supports holding member firms and associated persons accountable for violating existing rules and “reasonably and fairly implied” interpretations of those rules. However, Schwab suggests that in some instances FINRA enforcement actions may introduce new or novel interpretations of a rule that may not be consistent with the rule, the underlying rulemaking or the intent of the rule. Enforcement actions may also meaningfully alter or expand the scope of a rule or establish new standards of conduct or disclosure.

In such cases, Schwab is concerned that FINRA may be engaging in regulation by enforcement and is also concerned that member firms are deprived of developing informed views on the issues, providing constructive feedback and receiving adequate notice of a change in rule application or standard of conduct on which the enforcement action is based. Schwab believes that enforcement actions should not establish new standards of disclosure or conduct that more appropriately should emanate from rulemaking and the attendant notice, transparency and member firm and stakeholder feedback.

As Commissioner Piwowar recently stated when addressing a similar perceived concern regarding the SEC:

¹⁴ FINRA “Enforcement,” available at <https://www.finra.org/industry/enforcement>.

For me, due process starts with fundamental notions of fairness. Persons should be on notice as to what acts, or failures to act, constitute violations of the law and our regulations. Persons should also be on notice as to the potential sanctions and liabilities that may be imposed as a result of those violations.¹⁵

And when addressing perceived SEC regulation by enforcement:

Nevertheless, I have significant concerns when Commission orders – especially in settled administrative actions – create new interpretations of the laws or regulations or impose new regulatory requirements. When Commission actions create such results, we fail in our duty to uphold due process.¹⁶

Schwab shares Commissioner Piwowar's concerns and believes that FINRA should also be cognizant and consider these concerns in the administration of FINRA's enforcement program.

Schwab appreciates the thoroughness of the investigation and enforcement review processes noted in FINRA Regulatory Notice 09-17, Investigations and Formal Disciplinary Actions¹⁷ and the "Guide to Disciplinary Hearing Process"¹⁸ described on FINRA's website. Schwab notes that, prior to the filing of a settlement or complaint, the "Investigations and Formal Disciplinary Actions"¹⁹ review process is administered strictly by FINRA staff, typically senior managers from Enforcement and Market Regulation or FINRA trial lawyers, and that FINRA's "Independent Office of Disciplinary Affairs," also comprised of FINRA personnel, albeit independent of enforcement, "...reviews all significant cases and those matters where novel legal or factual issues exists."²⁰

Schwab suggests that where enforcement appears to be advancing a new or novel rule interpretation, an unproven legal theory, a new standard of conduct or disclosure that:

- Enforcement, as a component of the review process, identify such situations and specifically address the questions of whether the interpretation of the rule is reasonably and fairly implied by the rule and whether adequate notice was provided by providing publicly available documentation from the rulemaking process or otherwise to support Enforcement's perspective.
- FINRA consider establishing a new Advisory committee or a sub-committee of the Board to advise FINRA Enforcement on whether Enforcement's interpretation of the

¹⁵ Remarks to the Securities Enforcement Forum 2014, Commissioner Michael S. Piwowar (October 14, 2014), available at <https://www.sec.gov/news/speech/2014-spch101414msp>.

¹⁶ Ibid. 15.

¹⁷ FINRA Regulatory Notice 09-17, Investigations and Formal Disciplinary Actions (May 18, 2009), <https://www.finra.org/industry/notices/09-17>.

¹⁸ FINRA "Guide to the Disciplinary Process," available at <http://www.finra.org/industry/guide-disciplinary-hearing-process>.

¹⁹ Ibid. 17, 2-5.

²⁰ Ibid. 17, 4.

rule is reasonably and fairly implied by the rule and whether adequate notice was provided.

- FINRA consider the framework espoused by UCLA professor James J. Park in his paper “The Competing Paradigms of Securities Regulation” that “...[i]n deciding how to respond to misconduct, regulators should carefully consider whether the principle they are enforcing is well established, whether its application coheres with existing rules, whether there is a compelling evidence of misconduct, and whether the conduct targeted caused foreseeable harm to the public.”²¹ If the answer is no, Schwab suggests that FINRA consider whether rulemaking is a more appropriate and effective approach.

Economic Impact Assessment – Schwab agrees with FINRA’s belief expressed in its “Framework Regarding FINRA’s Approach to Economic Impact Assessment for Proposed Rulemaking”²² (the “Framework”) that:

...clarity with regard to the potential economic impact of proposed rulemaking increases both transparency and accountability. By adhering to the principles outlined here, FINRA’s rulemaking will clearly present our analysis, including assumptions and risks, as to why the proposal is necessary and how it best achieves its stated goal(s). This analysis, in turn, will be valuable to the public and other stakeholders as they assess and comment on the rule proposal.²³

In particular, like SIFMA, Schwab would like to see a more rigorous application of the Framework, especially in the area of consulting with key stakeholders in the development of rules and aggregating data to assess a proposal’s cost effectiveness, including consideration of alternative means of regulation. We believe that FINRA should gather sufficient and meaningful cost and benefit data to assist the SEC with their obligation to determine whether SRO rules “...do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Act].”²⁴ Otherwise, member firms may be burdened by unworkable and unnecessarily costly rules that impact and often raise investor costs.

Reporting on FINRA’s Operations

FINRA’s Financial Reporting - Schwab supports SIFMA’s commentary regarding the transparency of operations of FINRA, particularly related to fees and income collected by FINRA and specifically SIFMA’s recommendations that FINRA:

- Review its fees to more broadly align the amount of fees it charges with its actual cost of regulation.
- Ensure that the fees are equitably and reasonably allocated.

²¹ Park, James, J., The Competing Paradigms of Securities Regulation, Duke Law Journal, Vol. 57, 2007; Brooklyn Law School, Legal Studies Paper No. 79, 689. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=999474.

²² Ibid. 7.

²³ Ibid. 7, 2.

²⁴ Section 15A(b)(9) of the Securities Exchange Act of 1934.

- Provide detailed public disclosure as to how it allocated the revenue it receives from its various fees and other sources of income.²⁵

In addition, Schwab suggests that FINRA consider improving transparency related to the use of fine monies. FINRA's "Fines Policy" states:

Staff reports to the FINRA Board of Governors at the end of each fiscal year on the projects and purposes for which fine monies have been used. Furthermore, FINRA Internal Review periodically performs an audit as to whether FINRA's use of fine monies complies with these guidelines, with results being reported to the FINRA Audit Committee.²⁶

It would enhance public confidence if FINRA could share publicly a meaningful summary of the reports to the Board and the Audit Committee referenced in the "Fines Policy" or, alternatively, provide substantially similar information in FINRA's "Year in Review and Annual Financial Report."

Information on Examination and Enforcement Programs - As noted in the "2017 Regulatory and Examination Priorities Letter:"

FINRA has enhanced its risk-based surveillance and examination programs to apply a nationally consistent approach to identify and focus on material conduct at firms based on our assessment of specified sales practice, financial, operational and market-integrity risks. This approach has improved our understanding of each firm's business, permitting us to better tailor examinations and other regulatory responses to conduct that poses the greatest threats to investors or the market.²⁷

Schwab suggests that FINRA share the results of the surveillance and examination programs risk assessments with member firms. Schwab believes that having an awareness and understanding of FINRA's perspective on the member firm's risks will enhance engagement between FINRA and member firms, promote accountability and improve the dialogue and transparency necessary to address and possibly mitigate the risks identified by FINRA.

Schwab also supports SIFMA commentary that to further enhance the quality of examinations, FINRA consider that examiners "[a]dhere to the reasonableness standard by correcting examiners' common misconception that perfection is required of a reasonably designed supervisory system[.]"²⁸ and "[i]nstill in examiners that a reasonably designed supervisory system is not one-size-fits-all; rather, it is fundamentally tailored to the firm's size and business."²⁹ Further, Schwab suggests that to increase internal and external understanding of the reasonableness standard, FINRA consider issuing guidance on the key

²⁵ Ibid. 8, 8.

²⁶ FINRA "Fines Policy," available at <http://www.finra.org/industry/fines-policy>.

²⁷ FINRA "2017 Regulatory and Examination Priorities Letter," available at <http://www.finra.org/industry/2017-regulatory-and-examination-priorities-letter>.

²⁸ Ibid. 8, 9.

²⁹ Ibid. 8, 9.

elements or criteria both member firms and examiners should consider in assessing reasonableness.

Schwab is encouraged by FINRA's engagement efforts and we hope we have provided thoughtful, relevant and actionable feedback for FINRA's consideration. We thank FINRA for the opportunity to comment and being receptive to our feedback. We welcome the opportunity to further discuss our suggestions.

Sincerely,



Bari Havlik
Senior Vice President and Chief Compliance Officer
The Charles Schwab Corporation