June 13, 2023

Submitted electronically via SEC.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Regulation Systems Compliance and Integrity
(Release No. 34-97143; File No. S7-07-23)

Dear Ms. Countryman:

Charles Schwab & Co., Inc.[1] ("Schwab") appreciates the opportunity to provide comments on the proposed amendments to Regulation Systems Compliance and Integrity[2] ("Regulation SCI") under the Securities Exchange Act of 1934 ("Exchange Act"). Schwab recognizes the importance that technological resilience plays in maintaining fair and orderly markets and in meeting the needs of our clients. Schwab also understands that Regulation SCI is a key element of the Commission's regulation and oversight of critical participants and infrastructure in the U.S. securities markets.

[1] The Charles Schwab Corporation (NYSE: SCHW) is a leading provider of financial services, with 34.2 million active brokerage accounts, 2.4 million corporate retirement plan participants, 1.8 million banking accounts, and $7.6 trillion in client assets as of April 30, 2023. Through its operating subsidiaries, the company provides a full range of wealth management, securities brokerage, banking, asset management, custody, and financial advisory services to individual investors and independent investment advisors. Its broker-dealer subsidiaries, Charles Schwab & Co., Inc., TD Ameritrade, Inc., and TD Ameritrade Clearing, Inc., (members SIPC, https://www.sipc.org), and their 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. Its primary banking subsidiary, Charles Schwab Bank, SSB (member FDIC and an Equal Housing Lender), provides banking and lending services and products. More information is available at https://www.aboutschwab.com.

[2] Exchange Act Release No. 97143, 88 FR 23146 (April 14, 2023) ("Proposed SCI Amendments").

The proposed amendments would substantially broaden the number and types of entities that would become subject to Regulation SCI. Although we do not believe that Schwab would be covered by the proposed amendments as it operates today, we nevertheless wish to raise concerns in the way that a rule designed principally for self-regulatory organizations ("SROs") and disseminators of consolidated market data would be extended to cover broker-dealers.[3]

Application of Regulation SCI to Broker-Dealers

Under the proposed amendments, a broker-dealer would be an "SCI broker-dealer" if it meets one of two standards: (1) a total assets threshold, or (2) a transaction activity threshold.

1. Total Assets Threshold

The proposed total assets threshold would encompass broker-dealers with total assets in an amount that equals or exceeds 5% or more of the total assets of all security brokers and dealers in any two of the four previous calendar quarters. According to the Commission, based on recent data, that threshold is approximately $250 billion.

Schwab believes that a total assets threshold is inconsistent with the stated aims of Regulation SCI and should be removed from any final rule for the following reasons. First, the total assets threshold is unnecessary. The Commission acknowledges in the proposing release that "all of the firms that satisfy the proposed total assets threshold also satisfy at least one of the proposed trading activity thresholds."[4] Second, the assumptions upon which the assets test is based are flawed or unrelated to the purposes of Regulation SCI. In support of an assets test, the Commission states the broker-dealers with total assets above a certain arbitrary threshold occupy multiple roles in the securities markets.[5] The Commission states that such firms: (i) "generate liquidity in multiple types of securities," (ii) "operate multiple types of trading platforms," (iii) "take risk that they seek to hedge, in some cases using 'central risk books,'" and (iv) "engage in routing substantial order flow to other trading venues."[6]

From the SEC's proposal it is unclear whether each of these items alone supports an assets threshold, or the fact that a broker-dealer above the total assets threshold engages in all of them justifies the threshold. The presumption that firms above a certain total assets threshold are engaged in certain types of activities ignores the diversity of business models in the financial services industry. Moreover, these activities are not associated with the purposes of Regulation SCI, which was adopted to facilitate the oversight of the systems of national

[3] Today, only broker-dealers that operate as an Alternative Trading System ("ATS") above a certain market share threshold are covered by Regulation SCI. *See* Exchange Act Rule 1000 (definition of SCI alternative trading system). Although an ATS is registered as broker-dealer, its operations and role in the national market system is more akin to an exchange. Registration as a broker-dealer was made available to an ATS as an alternative to registration as a national securities exchange. *See generally* Regulation of Exchanges and Alternative Trading Systems, 63 FR 70844 (Dec. 22, 1998).
[4] *See* Proposed SCI Amendments at 23162 note 190.
[5] *Id*. at 23162.
[6] *Id.*

securities exchanges and other critical entities that market participants rely upon for the orderly functioning of the U.S. securities markets.

The fact that a broker-dealer manages or hedges its risk should not be a factor in making a firm an SCI broker-dealer. Similarly, the fact that a broker-dealer may generate liquidity in multiple types of securities or operate multiple types of trading platforms should not be a factor in making a firm an SCI broker-dealer. Lastly, the act of *routing* substantial order flow to other trading venues should not be a factor in making a firm an SCI broker-dealer. Rather, Regulation SCI was designed to ensure the resilience of the principal venues *to which such order flow is routed*.

A total assets threshold would literally create a one-size fits all approach – if a firm crosses an assets threshold, it becomes subject to Regulation SCI, irrespective of its business model, customer base or whether its activities implicate the concerns Regulation SCI is designed to address.

The Commission should understand that a firm's level of total assets is not a proxy for the types of activities for which Regulation SCI is intended. A firm such as Schwab - which currently is below the total assets threshold - does not generate liquidity through the operation of a single-dealer platform, or have significant dealing activity, or operate one or more ATSs. Yet, if the Commission adopts a total assets threshold, a firm like Schwab could be inadvertently swept into the Regulation SCI regime at some future date. There is no reason for the Commission to expose itself and its registrants to the potential for these unintended consequences, particularly when the total assets threshold is unnecessary.[7] If in the future, the Commission believes that the set of broker-dealers covered by Regulation SCI under a transaction activity threshold is inadequate, it should initiate a separate rulemaking, with a clear understanding and articulation of how its rule would be applied, along with a comprehensive analysis of the costs and benefits. The effort to "future-proof" the rule today for some unforeseen business model is a recipe for unintended consequences.

2. Transaction Activity Threshold

The proposed amendments define a broker-dealer as an "SCI broker-dealer" if its transacted average daily dollar volume equals or exceeds 10% in any one of in four asset classes: (i) NMS stocks, (ii) exchange-listed options, (iii) U.S. Treasury Securities, and (iv) Agency Securities. The Commission's rationale for these activity thresholds is that each of these markets has a dependency on certain broker-dealers, whose systems "contribute to the orderly functioning of the U.S. securities markets encompassing, for example, systems for trading and quoting, order handling, dissemination and processing of market data, and the process of clearance and settlement."[8]

[7] *See supra* note 4.
[8] Proposed SCI Amendments at 23161.

On balance, it is evident that the proposed transaction activity threshold would not apply to a firm such as Schwab with respect to orders it routes to other broker-dealers. This point is abundantly clear in some of the examples provided in the proposing release.

> As specific examples, when broker-dealer A routes a customer order to broker-dealer B for routing and execution, and broker-dealer B executes the customer order as principal or crosses it against another order it is holding, the volume for that order would contribute towards the threshold for broker-dealer B *but not for broker-dealer A*. Similarly, if broker-dealer A sends an order to the single-dealer platform operated by broker-dealer B, and broker-dealer B executes a trade against that order, the volume would contribute towards the threshold for broker-dealer B *but not for broker-dealer A*.[9]

However, these examples are written in such a way that could imply that these examples are illustrative only for NMS stocks, or inapplicable where broker-dealer B executes an order on a national securities exchange. Schwab does not believe that this is Commission's intent[10] and recommends that any final rule more precisely define the scope of the covered trading activity.

In the proposed definition of "SCI broker-dealer" the Commission uses the term "transactions" to identify the relevant level of activity. As the Commission is aware, the term "transactions" can be read very broadly. For example, the term "broker" means "any person engaged in the business of effecting *transactions* in securities for the account of others."[11]

Schwab understands that the Commission has sought to narrow the proposed transaction activity thresholds as discussed above to exclude transactions for which a broker-dealer is not the "executing party," however, it has not done so consistently and the term "executing party" is not defined in the rule.[12] Accordingly, in any final rule incorporating an activity threshold, Schwab urges the Commission to make clear that a broker-dealer's routing activity to an executing broker-dealer, who then effects a transaction on its behalf, is excluded from the numerator for the routing firm's average daily dollar volume trading calculation.

3. Regulation SCI is Incompatible with Public Customer Facing Entities and the Uncertainty Created by the SEC's Market Structure Initiatives

In proposing to expand Regulation SCI to the largest and most active broker-dealers, the Commission is reaching into business models for which Regulation SCI is ill designed. Regulation SCI was designed "to address the technological vulnerabilities, and improve Commission oversight, of the core technology of key U.S. securities markets entities, including

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[9] *Id*. at 23165 note 208 (emphasis added).

[10] This is further substantiated by statements in the proposed amendments about the number of firms that would be covered by each transaction activity threshold.

[11] Securities Exchange Act Section 3(a)(4) (emphasis added).

[12] Compare paragraphs (2)(i) and (ii) with paragraphs (2)(iii) and (iv) of the proposed definition of "SCI broker-dealer."

national securities exchanges and associations, significant alternative trading systems, clearing agencies, and plan processors."[13] In general, these SCI Entities are those whose services are market utilities or must be broadly accessible to market participants as a matter of law.[14] These entities also generally operate pursuant to rule books which have been approved by the SEC in accordance with Sections 6, 15A, 15B, 17A, and 19 of the Exchange Act, as applicable.

Given the unique attributes of SCI Entities, it is not appropriate to expand Regulation SCI to broker-dealers simply by amending the definition of SCI Entity as the SEC proposes. SCI Systems are those that directly support: (i) trading, (ii) clearance and settlement, (iii) order routing, (iv) market data, (v) market regulation, and (vi) market surveillance. These terms have well-defined meanings in the SRO and exchange context and pertain to a narrow and segregable business function. However, when applied to broker-dealers, these terms quickly reveal their incompatibility.

A stated goal of Regulation SCI is for SCI Entities to have their SCI Systems be physically or logically isolated. As the Commission has observed, "[t]he distinction between SCI systems and indirect SCI systems seeks to encourage SCI entities physically and/or logically to separate systems that perform or directly support securities market functions from those that perform other functions…."[15] This goal is achievable for an SRO or ATS, but is not practical for large, customer-facing financial services providers.

The Commission's proposal emphasizes that when it adopted Regulation SCI, it left open the possibility of future expansion to reach other entities.[16] The fact that the Commission signaled the potential for expansion of the rule at the time of its adoption does support such a change by merely broadening the definition of SCI Entity. In acknowledging that any future expansion would be accompanied by a separate release discussing the proposal, the Commission committed to undertake a thorough analysis of the expansion to such new entities, something that the Commission failed to do in the instant proposal.

Finally, Schwab is concerned that current Commission market structure rulemaking initiatives[17] may force such radical changes to the brokerage industry and existing order routing and wholesaling practices. The interconnectedness of the proposed SCI amendments with

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[13] Regulation Systems Compliance and Integrity; Final Rule, 79 FR 72252, 72397 (Dec. 5, 2014) ("SCI Adopting Release").

[14] *See*, *e.g.*, Exchange Act Section 6(b)(7) (the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or member thereof) and Exchange Act Section 15A(b)(8) (the prohibition or limitation by the association of any person with respect to access to services offered by the association or member thereof).

[15] Proposed SCI Amendments at 23150.

[16] *Id.* at 23149. See also SCI Adopting Release, at 72365 ("if the Commission were to decide to propose to apply the requirements of Regulation SCI to [registered broker-dealers other than SCI ATSs or other types of entities], the Commission would issue a separate release discussing such a proposal")

[17] *See* Exchange Act Release No. 96496, 88 Fed. Reg. 5440 (Jan. 27, 2023) (Regulation Best Execution); Exchange Act Release No. 96495, 88 Fed. Reg. 128 (Jan. 3, 2023) (Order Competition Proposal); Exchange Act Release No. 96494, 87 Fed. Reg. 80266 (Dec. 29, 2022) (Tick Sizes Proposal); Exchange Act Release No. 96493, 88 Fed. Reg. 3786 (Jan. 20, 2023) (Rule 605 Proposal). *See also* Letter from Jason Clague, Managing Director, Head of Operations, The Charles Schwab Corporation, to Vanessa Countryman, Secretary, SEC, dated March 31, 2023.

other SEC rulemaking initiatives has been given insufficient attention and consideration, not only as a matter of policy, but also in terms of their economic effects. In short, the SEC is proposing to expand Regulation SCI to an unknown set of market participants and practices.

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Schwab greatly appreciates the opportunity to submit this comment letter on the Proposed SCI Amendments. If you have any questions or require additional information, please do not hesitate to contact us.

Sincerely,

Jason Clague
Managing Director, Head of Operations
The Charles Schwab Corporation

Cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioner
The Hon. Jaime Lizárraga, Commissioner
Haoxiang Zhu, Director, Division of Trading & Markets
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