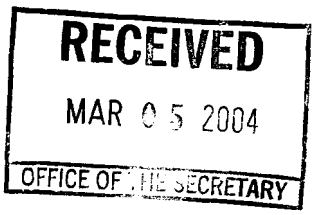
S7-21-03

Office of Corporate Counsel
101 Montgomery Street San Francisco CA 94104
tel (415) 627 7000

SCHWAB

19



March 2, 2004

BY OVERNIGHT MAIL AND ELECTRONIC DELIVERY

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: File No. S7-21-03; Proposed Rule: Alternative Net Capital Requirements For Broker-Dealers That Are Part Of Consolidated Supervised Entities, 69 Federal Register 62872 (November 6, 2003)

Dear Mr. Katz:

The Charles Schwab Corporation ("Schwab") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed rule to provide alternative net capital treatment to broker-dealers that are part of consolidated supervised entities ("Proposed Rule"). Through its subsidiaries, Schwab engages in a range of financial activities, including retail brokerage, capital markets and trading, institutional research, mutual funds, and services to investment advisers and retirement plans. Schwab, a registered bank holding company, controls three insured depository institutions through which it engages in retail and private banking as well as trust and fiduciary activities.

Schwab commends the Commission for its efforts, as reflected in the Proposed Rule, to modernize the broker-dealer net capital requirements. We support the Commission's view that modernized net capital treatment should be available to broker-dealer subsidiaries of holding companies that are both subject to consolidated supervision and which use advanced risk management techniques as a measurement tool for capital risk.

The Proposed Rule contains a framework for holding company consolidated supervision, which would subject holding companies and their affiliates to reporting and examination requirements as a condition to the grant of net capital relief. We are concerned that the holding company supervision contemplated in the Proposed Rule would result in duplication of fundamental elements of bank holding company supervision. The Proposed Rule could

unfortunately lead to an unnecessary and burdensome increase in compliance costs for bank holding companies and potentially subject bank holding companies to overlapping and inconsistent regulatory directives and requirements.

We recognize that the Commission is justifiably interested in ensuring that it will have sufficient information to understand the risks posed by the affiliate group of a broker-dealer operating under the alternative net capital requirements. Schwab believes that the most effective and efficient approach for bank holding companies would be for the SEC to work with the Board of Governors of the Federal Reserve System ("Federal Reserve") in obtaining the information regarding these risks. Such an approach would be consistent with the congressionally mandated system of bank holding company supervision, the principle of functional regulation, and the Commission's interest in minimizing duplicative regulatory burdens on holding companies. As discussed below, Schwab's suggested revisions are intended to incorporate such an approach in the Proposed Rule. In summary, Schwab respectfully suggests that the Proposed Rule be amended to:

- Eliminate the distinctions in treatment between categories of bank holding companies;
- Utilize reports and other information available to the Federal Reserve regarding the financial, operational, and reputational risks in a broker-dealer's affiliate group; and,
- Recognize that bank holding company subsidiaries are subject to supervision by the Federal Reserve or a functional regulator.

Finally, we suggest that the SEC and the Federal Reserve establish a process for coordinating evaluations of risks within bank holding companies that have subsidiary broker-dealers operating under the alternative net capital requirements. Such a process could eliminate the potential for inconsistent regulatory directives and supervision, particularly with regard to holding company internal risk management systems, and contribute to both agencies' assessment of the risks within the holding company.

Suggested revisions to the proposed rule

Eliminate the distinctions in treatment between categories of bank holding companies.

The Proposed Rule would subject bank holding companies that are not "primarily in the insured depository institutions business" to SEC examination of the companies' books and records. All other bank holding companies would not be required to agree to such an examination. The result would be a significant increase in regulatory burden for a particular class of bank holding companies. These bank holding companies are subject to the same level and type of Federal Reserve supervision as all other bank holding companies. This supervision is comprised of an active examination program and reporting requirements designed to provide the Federal Reserve with information about a holding company's operations, financial condition, financial and operational risks, systems for monitoring and controlling risks, as well as

compliance with the laws and regulations that the Federal Reserve enforces. [1] As such, Schwab believes that there is no reason for treating bank holding companies that are not "principally engaged in the insured depository institutions business" differently from other bank holding companies.

Moreover, imposing duplicate examination requirements based on a company's ratio of banking and nonbanking businesses will be difficult to administer, costly to the companies, and result in the inconsistent treatment of similarly situated banking organizations. Using such a definition will require the SEC to determine the appropriate measure for assessing whether a company is "primarily" engaged in an activity. Further, a determination will have to be made as to the frequency of calculating the ratio and the period of time that will be covered. Bank holding companies that are not "primarily in the insured depository institutions business" will face additional compliance costs resulting from the need to monitor the size of their banking and nonbanking businesses as well as from the additional staff time that will be devoted to responding to a second holding company examination. Finally, using such a ratio to determine the applicability of examination requirements will result in holding companies with very similar ratios being treated differently depending on which side of the calculation they fall.

Schwab believes a better approach would be to treat all holding companies subject to U.S. consolidated capital regulatory requirements in the same manner. The holding companies that would fall within this definition are bank holding companies subject to the Federal Reserve's jurisdiction. Using such a formulation is more consistent with the statutory framework for supervising bank holding companies.

Utilize reports and other information available to the Federal Reserve.

The Proposed Rule would require a holding company to submit information concerning its financial condition, capital, and internal risk management control system as part of a subsidiary broker-dealer's application to operate under the alternative net capital requirements. In addition, a holding company would be required to submit monthly reports containing balance sheet and income statements, consolidated risk information, and regular internal risk reports as the SEC requests. A holding company would also have to submit quarterly reports that would include the monthly information plus a consolidating balance sheet and income statement, the results of internal model back testing, a description of material pending legal proceedings, a capital assessment, and the aggregate amount of borrowings.

The Federal Reserve collects and/or has access to the same information for bank holding companies. We suggest that the SEC use the reports provided to the Federal Reserve by bank holding companies rather than impose new reporting requirements. If the SEC concludes that additional information is necessary, the SEC should work with the Federal Reserve to

[1] Bank holding company examinations "focus to a large degree on assessing the types and extent of risk to which a bank holding company and its subsidiaries are exposed, evaluating the organization's methods of managing and controlling its risk exposures, and ascertaining whether management and directors fully understand and are actively monitoring the organization's exposure to those risks." Bank Holding Company Supervision Manual, Section 2124.0. The types of risks include credit, market, liquidity, operational, legal, and reputational. Id., Section 1000.

determine whether the required information is available. In the event that the information is not available or the Federal Reserve is unwilling to request such information, the SEC should then require a broker-dealer to obtain the information from its parent holding company as a condition to the broker-dealer continuing to operate under the alternative net capital requirements. This approach is consistent with the principle of functional regulation and with the current structure in section 17(h)(3) of the Securities Exchange Act [2] pursuant to which the SEC may obtain information regarding affiliates of broker-dealers.

Recognize that bank holding company subsidiaries are subject to supervision by either the Federal Reserve or a functional regulator.

Under the Proposed Rule, a bank holding company would be required to agree to SEC examination of its subsidiaries that do not have a "principal regulator." The only holding company subsidiaries that are deemed to have a "principal regulator" in the Proposed Rule are insured depository institutions, insurance companies, and futures commissions merchants. Any other subsidiary of a holding company would be subject to SEC examination.

Imposing SEC examination requirements on holding company subsidiaries would add an additional unnecessary layer of regulation. Subsidiaries of bank holding companies are subject to supervision by either the Federal Reserve or a functional regulator. Under section 5 of the Bank Holding Company Act[3], the Federal Reserve has the authority to examine each subsidiary of a bank holding company. The Federal Reserve regularly examines significant subsidiaries of a bank holding company that are not otherwise examined by a functional regulator.[4] As part of evaluating the risk profile of a holding company, the Federal Reserve staff also assesses risk for each nonbank subsidiary. [5] With regard to functionally regulated subsidiaries, the Federal Reserve is required to defer to the fullest extent possible to examinations prepared by the functional regulator[6], although it retains authority to conduct examinations under certain conditions. Therefore, all holding company subsidiaries are subject to regulatory supervision and oversight. As such, we strongly recommend that the SEC amend the Proposed Rule to except all bank holding company subsidiaries from SEC examinations other than those which are functionally regulated under the securities laws by the SEC or a self-regulatory organization.

Additional Recommendation

Establish a joint agency process for coordinating reviews and evaluations of holding company risks.

Given the duplication of effort that would result from the SEC seeking to separately review and assess financial, operational, and reputational risks within bank holding

[2] 15 U.S.C. 78q(h)(3).
[3] 12 U.S.C. 1844(c)(2).
[4] Bank Holding Company Supervision Manual, Section 5000.0.4.5.1.
[5] Bank Holding Company Supervision Manual, Section 4030.02.
[6] 12 U.S.C.1844 (c)(2)(D) and (E).

companies as well as the potential for inconsistent regulatory directives, we believe that it would be more efficient and effective for the SEC to work with the Federal Reserve to evaluate these risks and the systems for managing these risks. First, as discussed, the types of holding company risks that the SEC would seek to review and assess are the same as those that the Federal Reserve focuses on in its role as the umbrella supervisor for bank holding companies. A joint process would allow the agencies to avoid duplicative efforts.

Second, a joint process would help to reduce the potential for inconsistent supervision as both the Federal Reserve and the SEC assert regulatory review over the same bank holding company systems. For example, under the Proposed Rule, the Commission reserves the ability to adjust the capital calculations under the alternative net capital requirements applicable to a particular broker-dealer in response to changes in its parent holding company's group-wide internal risk management control procedures. The Federal Reserve also has the authority to review and approve these procedures for bank holding companies. A joint process would provide a mechanism for the agencies to address differences in regulatory approach. Each agency would benefit from the expert supervisory methods and risk management abilities resident in the other agency, which would lead to a more complete understanding of the holding company.

Conclusion

Schwab recommends that the SEC modify the Proposed Rule as suggested above. We look forward to continuing a dialogue with the Commission and its staff regarding the Proposed Rule.

Very truly yours,

Laurie S. Schaffer
Vice President and Associate General Counsel

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation