charles SCHWAB CORPORATION

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May 7, 2019

Via Electronic Delivery

Robert E. Feldman, Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Brokered Deposits and Interest Rate Restrictions (RIN 3064–AE94)

Ladies and Gentlemen:

The Charles Schwab Corporation[1] ("Schwab") is pleased to submit this letter to the Federal Deposit Insurance Corporation ("FDIC") in response to the FDIC's Advance Notice of Proposed Rulemaking ("ANPR") on brokered deposits. We appreciate the opportunity to provide comments on the FDIC's current interpretations of its brokered deposit regulations. The focus of our comment is on programs maintained by registered broker-dealers in which customer funds are automatically deposited, or "swept," into deposit accounts at an affiliated insured depository institution ("IDI") (such programs, "Affiliated Sweep Programs").

In a 2005 Advisory Opinion,[2] the FDIC confirmed that deposits placed through an Affiliated Sweep Program ("Affiliated Sweep Deposits") are eligible for an exception from classification as brokered deposits because the "primary purpose" of sweep programs "is not to provide customers with a deposit-placement service" (the "Primary Purpose Exception"). In that letter, and in subsequent letters to IDIs confirming their eligibility for the Primary Purpose Exception, the FDIC has outlined a number of qualifications needed for an Affiliated Sweep Program to qualify for the Primary Purpose Exception.

As discussed below, these qualifications are unrelated to whether the primary purpose of the Affiliated Sweep Program is to provide a deposit-placement service. Moreover, Affiliated

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[1] The Charles Schwab Corporation (NYSE: SCHW) is a leading provider of financial services, with more than 360 offices and 11.8 million active brokerage accounts, 1.7 million corporate retirement plan participants, 1.3 million banking accounts, and $3.59 trillion in client assets as of March 31, 2019. 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 subsidiary, Charles Schwab & Co., Inc. (member SIPC, https://www.sipc.org), and 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 banking subsidiary, Charles Schwab Bank (member FDIC and an Equal Housing Lender), provides banking and lending services and products. More information is available at https://www.schwab.com and https://www.aboutschwab.com.

[2] FDIC Advisory Opinion 05-02 (Feb. 3, 2005).

Sweep Deposits, as the FDIC itself has recognized, do not have the characteristics attributed to other deposits originated by third parties that have received policy concern.

In light of the recent Interagency Statement Clarifying the Role of Guidance,[3] we request that the FDIC confirm that the qualifications set forth in the 2005 Advisory Opinion merely constitute staff guidance, not a definitive statement of necessary conditions to qualify for the Primary Purpose Exception. In addition, in order to avoid further confusion, we request that the FDIC exercise its rulemaking authority to specify that affiliated broker-dealers that maintain Affiliated Sweep Programs are agents whose primary purpose is not the placement of funds with depository institutions.

I. Overview of Affiliated Sweep Programs

Full-service broker-dealers have offered deposit accounts through sweep programs to customers since 2000, and such programs have become enormously popular. Sweep deposits now exceed an estimated one trillion dollars, of which $724 billion are sweeps from broker-dealers to their affiliated IDIs.[4]

Affiliated Sweep Programs offered by full-service broker-dealers serve an important role for investors in the US markets. These customers invest their money in a wide range of financial products and pursue myriad investment strategies.

Affiliated Sweep Programs offer customers the opportunity to earn interest on funds awaiting investment that reflects prevailing short-term interest rates associated with transactional accounts, withdraw the funds on demand, and, unlike other financial products, enjoy principal stability. The combination of principal stability, liquidity, and the ability to earn interest on deposits, and the administrative convenience of having this occur within the customer's brokerage account, has contributed to the popularity and acceptance of these programs.

As described by a previous commenter,[5] Affiliated Sweep Programs exhibit the following characteristics:

- The majority of brokered sweep deposits are "entirely insured" as defined under the Liquidity Coverage Ratio ("LCR") regulation;[6]
- "[T]he sweep feature is merely a service offered by a broker to support the other financial products offered by the broker to its customers. These customers, therefore,

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[3] Interagency Statement Clarifying the Role of Supervisory Guidance, https://www.fdic.gov/news/news/press/2018/pr18059a.pdf (Sept. 11, 2018).
[4] FDIC, Advance Notice of Proposed Rulemaking, Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate Restrictions, 84 Fed. Reg. 2366, 2369 (Feb. 6, 2019) (hereinafter "ANPR").
[5] Letter from Paul T. Clark to Mr. Robert deV. Frierson et al. commenting on brokered deposits pursuant to EGRPRA (March 22, 2016).
[6] *See* 12 CFR Part 329.

are not going to engage in the expense and effort to terminate their relationship with their broker and move their assets to another broker merely because of the sweep feature."

- Where "the broker and the bank share a common name, or the affiliation is otherwise clear, this may instill a brand loyalty among the broker's customers that enhances deposit stability."
- Many customers prefer to combine their banking and investing into a single relationship, whether for convenience or to obtain pricing advantages.
- It is highly unlikely that a broker would terminate a sweep feature to an affiliated bank, which results in very stable, long-term arrangements.

Affiliated Sweep Programs are structured to comply with Rule 15c3-3(j)(2)(ii) promulgated by the Securities and Exchange Commission ("SEC"), which among other things, requires written disclosure and affirmative written customer consent prior to participation in such programs.[7] In addition, Affiliated Sweep Programs are designed to ensure that each customer, not the broker-dealer, is clearly the beneficial owner of the deposit account and possesses all material indicia of ownership, including the ability to enforce his or her rights in the deposit account directly against the bank, and where operationally feasible, transfer his or her deposit account to another custodian.

II. Definition of "Deposit Broker" and Primary Purpose Exception

a. Statutory Exception

The Federal Deposit Insurance Act ("FDIA") defines brokered deposits by reference to "deposit brokers."[8] The FDIA expressly excludes from the definition of "deposit broker" "an agent or nominee whose primary purpose is not the placement of funds with depository institutions."[9] The FDIA does not impose any conditions, limitations, or qualifications on the Primary Purpose Exception. Under the plain text of the statute, if the primary purpose of a broker-dealer's Affiliated Sweep Program is not to place the funds with an IDI, the broker-dealer is not a deposit broker, and the deposits are not brokered deposits.

The FDIC has not adopted, through notice-and-comment rulemaking, any regulation imposing conditions or requirements on the availability of the Primary Purpose Exception and has not imposed conditions or requirements on other arrangements.[10]

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[7] 17 C.F.R. 240.15c3-3(j)(2)(ii)
[8] 12 U.S.C. §1831f(g).
[9] 12 U.S.C. §1831f(g)(2)(I).
[10] *See, e.g.,* FDIC Advisory Opinion 94-39 (Aug. 17, 1994).

b. Primary Purpose Exception Qualifications

The FDIC confirmed in the 2005 Advisory Opinion that a broker-dealer operating an Affiliated Deposit Program qualified for the Primary Purpose Exception and was thus not a "deposit broker." The FDIC staff found that the primary purpose of such deposits was to "facilitate the customers' purchase and sale of securities," rather than "to provide customers with a deposit placement service."

After finding that the primary purpose of the Affiliated Sweep Program was not to offer a deposit placement service, the 2005 Advisory Opinion went on to include a number of qualifications that do not relate to the purpose for which the deposits are placed, have not been further explained by the FDIC, and may result in unintended consequences for retail investors.

The 2005 Advisory Opinion "qualifications" were as follows:

- The swept funds may not exceed 10% of the total brokerage account assets (the "Permissible Ratio").
- The 10% limit must be applied on a monthly basis.
- The Permissible Ratio may not be exceeded on consecutive months.
- The Permissible Ratio may not be exceeded for three months during any 12-month period.
- The IDI must provide the FDIC with monthly reports reflecting the calculations for each month and daily calculations should be available for inspection.
- The IDI may only pay a "per account" or "per customer" fee to the broker-dealer for recordkeeping and other administrative services rather than for the placement of deposits.[11]

According to the FDIC, such "advisory opinions" are published as guidance "in an effort to help bankers, lawyers, and others having an interest in federal banking law to better understand the statutes and regulations administered by the Federal Deposit Insurance Corporation (including the FDIC's rules for determining deposit insurance coverage)."[12] In fact, the FDIC goes further to disclaim any conclusive or binding nature of such advisory opinions, stating:

> The letters express the views and opinions of individual FDIC staff lawyers and are not binding on the FDIC, its Board of Directors, or any board member; any representation to the contrary is expressly disclaimed. The letters should only be considered advisory in nature, and the reader bears the responsibility for relying on them.

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[11] *Id.*

[12] Introduction to the FDIC Advisory Staff Opinions, 4000- Note, Advisory Opinion, FDIC Advisory Staff Opinions, https://www.fdic.gov/regulations/laws/rules/4000-300.html

And yet, the FDIC supervisory staff has subsequently taken the position that IDIs must obtain written confirmation from the FDIC that the Primary Purpose Exception is available for the Affiliated Sweep Program, and, to our knowledge, the FDIC provides written confirmation only when each qualification is satisfied. This requirement is a de facto application and approval process despite the fact that the FDIC has not adopted any such process through a notice-and-comment rulemaking.

The FDIC examination staff has treated the qualifications set forth in the 2005 Advisory Opinion as necessary conditions for Primary Purpose Exception eligibility carrying the force of law, despite those qualifications not having been formally codified in any statute or regulation. The FDIC's practice with respect to applying the Primary Purpose Exception to Affiliated Sweep Programs is reflected in several FDIC publications. The FDIC's Study on Core Deposits and Brokered Deposits stated that:

> The FDIC has adopted [the factors in the 2005 Advisory Opinion] as *conditions or requirements* applicable to any investment company that 'sweeps' idle client funds into deposit accounts at affiliated banks. If the requirements are satisfied, the company is not a deposit broker under the 'primary purpose' exception with respect to the 'swept' funds. On the other hand, if the requirements are not satisfied, the company is a deposit broker. To determine compliance with the 10% limit, the FDIC requires the submission of monthly reports.[13]

In 2015, the FDIC appears to have tried to soften its description of its practices by stating in its FAQs, "On those rare occasions when this exception may apply, the FDIC also may impose restrictions on the activity involved, routine reporting requirements, and regular monitoring. These conditions may be critical to the primary purpose exception determination. As a result, failure to comply with the conditions may trigger a reassessment of the original determination."[14] However, this sentence was deleted from the updated 2016 FAQs and replaced with: "The FDIC considers each request to review and interpret this exception on a case-by-case basis. In interpreting the application of the primary purpose exception, the FDIC frequently relies upon information provided by the requesting party, and other available information. As a result, changes in the program or in the facts as they had been provided by the requesting party, may trigger a reassessment of the original determination."[15]

Despite the statement in the 2016 FAQs, the current FDIC Examination Manual clearly instructs examiners to enforce both an exception application and approval process for and

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[13] FDIC, Study on Core Deposits and Brokered Deposits 27 (July 8, 2011)(emphasis added), https://www.fdic.gov/regulations/reform/coredeposit-study.pdf. The FDIC's study did not address the issue of whether IDIs must seek written confirmation of the availability of the Primary Purpose Exception.

[14] *See* FDIC, FIL-2-2015 (Jan. 5, 2015).

[15] *See* FDIC, FIL-42-2016 (June 30, 2016).

compliance with the requirements set forth in the 2005 Advisory Opinion. According to the FDIC's Examination Manual, Affiliated Sweep Programs "are generally considered brokered deposits unless the sweep program is specifically structured to meet the primary purpose exception."[16] The Examination Manual further instructs examiners:

> An institution must receive a favorable determination from the FDIC before it can exclude these funds from regulatory reporting of brokered deposits. Exception applications are made through the appropriate regional office. In making this determination, each of the following criteria must be met:
>
> - The brokerage firm is affiliated with the bank.
> - The funds are not swept into time deposit accounts.
> - The amount of swept funds does not exceed 10 percent of the total amount of program assets handled by the brokerage firm (permissible ratio) on a monthly basis. When the brokerage also sweeps funds to nonaffiliated banks, which is typically done when the deposit exceeds the $250,000 deposit insurance limit, these deposits are added to the amount of swept funds for purposes of calculating the permissible ratio.
> - The fees in the program are flat fees (i.e., equal per account or per-customer fees representing payment for recordkeeping or administrative services and not representing payment for placing deposits).[17]

c. 2005 Advisory Opinion Qualifications Are Not Mandatory Conditions

Recently, the FDIC and the other federal banking agencies issued an interagency statement clarifying the role of such guidance ("Interagency Statement").[18] The Interagency Statement specifies that only laws and regulations have the force and effect of law, and that "[u]nlike a law or regulation, supervisory guidance does not have the force and effect of law." In addition, the Interagency Statement explained that the "agencies intend to limit the use of numerical thresholds or other 'bright lines' in describing expectations in supervisory guidance," and that where such thresholds are used, they are "exemplary only and not suggestive of requirements." Continuing, the Interagency Statement provides that examiners may "not criticize a supervised financial institution for a 'violation' of supervisory guidance."

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[16] FDIC Examination Manuel, Liquidity and Funds Management, 6.1-10.

[18] Interagency Statement Clarifying the Role of Supervisory Guidance, https://www.fdic.gov/news/news/press/2018/pr18059a.pdf (Sept. 11, 2018).

The FDIC's treatment of the qualifications set forth in the 2005 Advisory Opinion as conditions having the force of law contravenes the clear dictates of the Interagency Statement. Per the Interagency Statement, these qualifications should instead be read as exemplary dicta, and not requirements for Primary Purpose Exception eligibility.

By contrast, other FDIC Advisory Opinions interpreting the Primary Purpose Exception have not added additional qualifications. For example, a 1994 Advisory Opinion[19] found that the placement of customer funds by a broker-dealer into a Special Reserve Bank Account at a bank was eligible for the Primary Purpose Exception because the purpose of placing the funds was to comply with an SEC regulation. The FDIC's sole focus in that Advisory Opinion was the purpose for the placement of funds, and once the purpose was established, eligibility for the Primary Purpose Exception was also established. No ongoing conditions were imposed in order for eligibility for the exception to be maintained.

The FDIC has never engaged in any notice-and-comment rulemaking with respect to the FDIC confirmation requirement or the qualifications contained in the 2005 Advisory Opinion, and repeated in other FDIC guidance. The FDIC's practices with respect to the Primary Purpose Exception are thus in stark contrast with the requirements of the Administrative Procedure Act[20] and the Interagency Statement.

d. 2005 Advisory Opinion Qualifications Are Uncorrelated with Primary Purpose Exception

The qualifications set forth in the 2005 Advisory Opinion not only do not have the force of law, they are not salient exemplars of whether a broker-dealer's "primary purpose is the placement of funds with depository institutions."

To begin, Affiliated Sweep Programs operated by full-service broker-dealers involve continuing customer relationships that are anchored in the customer's desire to purchase and sell securities through the customer's brokerage account. Customers do not open brokerage accounts at a full-service broker-dealer, such as Schwab's broker-dealer subsidiary, Charles Schwab & Co., Inc., in order to take advantage of an Affiliated Sweep Program. The 2005 Advisory Opinion recognizes this fact in finding that the primary purpose of full-service brokerage accounts is to facilitate securities transactions, not deposit placements.

The Permissible Ratio has no bearing on whether the primary purpose of an Affiliated Sweep Program is to place deposits with an IDI. The Permissible Ratio is, by definition, sensitive to market volatility. During periods of market declines, retail customers tend to reduce their risk exposure by selling their securities and holding more cash. The result is to increase the

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[19] FDIC Advisory Opinion 94-39 (Aug. 17, 1994).

[20] *See, e.g.,* 5 U.S.C. 553. The Administrative Procedure Act sets forth the notice-and-comment process by which agencies must promulgate "rules," which are defined as "an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy."

swept funds numerator and decrease the brokerage account assets denominator, which can create significant swings in the ratio. A broker-dealer has little, if any, control over this customer-driven activity, which by its very nature is entirely unrelated to the broker-dealer's primary purpose.

In the event of prolonged or precipitous market declines, strict application of the 2005 Advisory Opinion's qualifications may require a broker-dealer to unenroll certain customers from the Affiliated Sweep Program in order to reduce the ratio. In such a case, the broker-dealer's primary purpose in establishing the Affiliated Sweep Program would not have changed. The converse is also true: if the ratio were above the 10% threshold and positive market forces resulted in a movement of the ratio below 10%, the broker-dealer's primary purpose would not have shifted from placing deposits with an IDI to not placing deposits with an IDI.

Moreover, the requirement that IDIs file monthly reports with the FDIC on the ratio is untethered from the broker-dealer's primary purpose in placing the deposits. The *ex post* report has no logical connection to the broker-dealer's *ex ante* purpose.

Likewise, the calculation of the fee paid from the IDI to the broker-dealer does not bear on the broker-dealer's purpose in placing the deposits. To the extent the FDIC is concerned that fees paid by IDIs in connection with Affiliated Sweep Deposits might be improper in some way, those fees are fully subject to the requirements of Section 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation W,[21] which mandate that such fees be on market terms.

III. Affiliated Sweep Deposits Do Not Present Risks Justifying the Qualifications

Affiliated Sweep Deposits demonstrate highly stable behaviors in both stressed and un-stressed economic markets.[22] The FDIC itself agreed with this characterization in adopting the regulations governing the LCR with the other Federal banking agencies, stating that:

> The agencies believe that affiliated brokered sweep deposits are more reflective of an overall relationship with the underlying retail customer . . . . Affiliated brokered sweep deposits generally exhibit a stability profile associated with retail customers, because the affiliated sweep providers generally have established relationships with the retail customer that in many circumstances include multiple products with both the covered company and the affiliated broker-dealer. Affiliated sweep deposit relationships are usually developed over time. Additionally, the agencies believe that because such deposits are swept by an affiliated company, the

[21] 12 U.S.C. 371c-1 and 12 C.F.R. Part 223.
[22] Letter from Peter Morgan to Mr. Robert deV. Frierson et al. commenting on the Federal banking agencies proposed liquidity coverage ratio rule (Jan. 31, 2014).

> affiliated company would be incented to minimize harm to any affiliated depository institution.[23]

As a result, the LCR regulation applies lower outflow assumptions to Affiliated Sweep Deposits than to unaffiliated sweep deposits.

In fact, Affiliated Sweep Deposits exhibit countercyclical behavior, meaning that such deposit balances typically and predictably grow during times of volatility. This is a result of customers "de-risking" by holding deposits until the securities market improves, at which time they can use their funds to purchase securities.

Because Affiliated Sweep Deposits do not present greater risks to IDIs than deposits otherwise considered "core," there is no need for the FDIC to impose restrictions and conditions on the availability of the Primary Purpose Exception for such deposits. The qualifications in the 2005 Advisory Opinion unnecessarily constrain Affiliated Sweep Programs without a legal or factual basis.

IV. Our Recommendations

Despite the size and stability of the Affiliated Sweep Deposit market, and the fact that the FDIC has confirmed in the 2005 Advisory Opinion and subsequent guidance that such deposits are eligible for the Primary Purpose Exception,[24] the qualifications listed in the 2005 Advisory Opinion are a source of risk, confusion and frustration for IDIs and their affiliated broker-dealers.

We therefore request that the FDIC clarify that the qualifications in the 2005 Advisory Opinion are merely exemplary, and are not necessary conditions for Affiliate Sweep Programs to be eligible for the Primary Purpose Exception. We further request that the FDIC advise its examination staff that the qualifications in the 2005 Advisory Opinion must not be read as having the force of law and are not necessary for an Affiliate Sweep Program to be eligible for the Primary Purpose Exception, either initially or on an ongoing basis.

In addition, for the avoidance of doubt, we request that the FDIC exercise its rulemaking authority under Section 29 of the FDIA to specifically identify affiliated broker-dealers operating Affiliated Sweep Programs as "agents whose primary purpose is not the placement of funds with depository institutions." We have proposed language as an attachment to our letter that we believe would craft a very narrowly tailored and appropriate exception.

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[23] 79 Fed. Reg. 61440, 61493 (Oct. 10, 2014).
[24] *See* ANPR at 2369.

Lastly, if the FDIC does not believe it has the authority to enact rulemaking for such a narrow exception, we request that the FDIC request of and recommend to Congress such a narrow exclusion.

Thank you again for the opportunity to comment on the ANPR.[25] We are available to address any questions and welcome the opportunity for further dialogue to discuss or clarify the issues discussed herein.

Sincerely yours,

[redacted]

Peter L. Morgan III
Senior Vice President & Deputy General Counsel

Attachment

cc (w/att.): Jelena McWilliams, Chair FDIC
Nick Podsiadly, General Counsel, FDIC

[25] Our letter has focused on one area where there exists clear statutory authority for the FDIC to act through a change to its supervisory program or clarification through rulemaking. We also agree with the other commenters that there are a number of additional aspects of Section 29 of the FDIA that should be modernized through rulemaking or legislative action. In particular, the statutory definition of "employee" should be updated to reflect modern methods of doing business and meeting the service expectations of clients.

Attachment

LIMITED EXCEPTION FOR AFFILIATED BROKER-DEALER SWEEP DEPOSITS

''(1) IN GENERAL.— An Affiliated Broker-Dealer depositing Affiliated Broker-Dealer Sweep Deposits into an Affiliated Insured Depository Institution through an Affiliated Sweep Program is an agent whose primary purpose is not the placement of funds with depository institutions.

''(2) DEFINITIONS.—For the purposes this subsection:

(A) AFFILIATED BROKER-DEALER SWEEP DEPOSITS. — The term 'affiliated broker-dealer sweep deposits' means deposits received through an affiliated sweep program from an affiliated broker-dealer.

(B) AFFILIATED BROKER-DEALER. — The term 'affiliated broker-dealer' means a broker-dealer registered with the Securities and Exchange Commission that is a consolidated subsidiary of bank holding company or savings and loan holding company of which the affiliated insured depository institution is also a consolidated subsidiary.

(C) AFFILIATED INSURED DEPOSITORY INSTITUTION. — The term 'affiliated insured depository institution' means an insured depository institution that is a consolidated subsidiary of bank holding company or savings and loan holding company of which the affiliated broker-dealer is also a consolidated subsidiary.

(D) AFFILIATED SWEEP PROGRAM. — The term 'sweep program' means a service provided by an affiliated broker-dealer where it offers to its customers a service to automatically transfer free credit balances in the securities account of the customer to an affiliated insured depository and operated in accordance with the customer protection and other regulations of the Securities and Exchange Commission.

(E) FREE CREDIT BALANCES. — The term 'free credit balances' shall have the meaning as defined by the Securities and Exchange Commission pursuant to its rules adopted under the authority of the Securities Exchange Act of 1934.