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November 5, 2010

By e-mail to: rule-comments@sec.gov

Ms. Elizabeth Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-15-10—Mutual Fund Distribution Fees; Confirmations

Dear Ms. Murphy:

Charles Schwab & Co., Inc., along with its affiliates, Charles Schwab Investment Management, Inc., and Charles Schwab Trust Company, a division of Schwab Bank (collectively "Schwab"),[1] appreciates the opportunity to respond to the Securities and Exchange Commission's ("Commission" or "SEC") request for comment on the above-referenced rule proposal (the "Proposed Rules").[2]

Schwab supports the Commission's goals of improving fee transparency, modernizing the role and responsibilities of mutual fund boards, protecting investors from unfair practices, and

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[1] Charles Schwab & Co., Inc ("CS&Co") and Charles Schwab Investment Management, Inc. ("CSIM") are affiliates of each other and are each wholly-owned subsidiaries of The Charles Schwab Corporation ("Schwab Corporation"). Schwab Corporation is a leading provider of financial services, with more than 300 offices and 7.9 million client brokerage accounts, 1.5 million corporate retirement plan participants, 665,000 banking accounts, and $1.47 trillion in client assets (as of 9/30/2010). Through its operating subsidiaries, Schwab Corporation provides a full range of securities brokerage, banking, money management and financial advisory services to individual investors and independent investment advisors. CS&Co is registered with the Commission as both a broker-dealer and as an investment adviser under the Investment Advisers Act of 1940, and offers a complete range of investment services and products, including making available thousands of mutual funds (corresponding to over 15,000 share classes) through its Mutual Fund Marketplace®. CSIM is registered with the Commission and serves as an investment adviser to over 84 registered mutual funds within the Schwab Funds, Laudus Funds and Schwab ETFs, with more than $186 billion in assets under management (as of 9/30/2010). Schwab Corporation's banking subsidiary, Charles Schwab Bank (member FDIC and an Equal Housing Lender), provides banking and mortgage services and products. Schwab Corporation provides services to retirement and other benefit plans and participants through its separate but affiliated companies and subsidiaries, Schwab Retirement Plan Services, Inc.; Schwab Retirement Plan Services Company; and Charles Schwab Trust Company, a division of the Charles Schwab Bank.

[2] *See* Mutual Fund Distribution Fees; Confirmations, SEC Release Nos. 33-9128; 34-62544; IC-29367) (July 21, 2010) (hereinafter, the "Proposing Release").

promoting competition. In furtherance of those goals, Schwab supports the following aspects of the Proposed Rules:

- Rescission of Rule 12b-1 and its related procedural requirements, and adoption of a marketing and service fee pursuant to Proposed Rule 12b-2. We believe that renaming of fees paid out of fund assets for distribution and other service-related activities will benefit investors. In connection with this, we propose that the Commission codify the amount of the marketing and service fee in Proposed Rule 12b-2.
- The investor protection sentiments embodied in the Proposed Amendments to Rule 6c-10, which would prevent an investor from being charged an "excessive" sales charge by requiring conversion of share lots once the ongoing sales charge reaches the maximum sales load (or reference load).

While Schwab supports the investor protection sentiments of the Proposed Amendment to Rule 6c-10, we nevertheless are concerned about certain aspects of the proposal. Specifically, we are concerned about the operational complexity of the Proposed Amendments to Rule 6c-10, and the potential that such complexity will (i) lead to investor confusion; (ii) impose significant costs on financial intermediaries and funds; and (iii) adversely impact retirement plans and participants. We believe the Commission should reconsider the definition of an "ongoing sales charge" and consider the merits of establishing a single reference load.

Further, we oppose certain requirements of the Proposed Amendments to Rule 10b-10. Specifically, we oppose any requirement that a broker-dealer include fee or expense information on a mutual fund trade confirmation that is not directly implicated by the transaction and that is disclosed to the investor in the fund prospectus, such as the marketing and service fee or ongoing and other sales charges. Such disclosure would be unnecessarily duplicative of disclosures delivered to an investor through the mutual fund prospectus and would emphasize only certain costs of investing over other equally important costs. It would also emphasize these costs over other factors important to an informed investment decision, such as the fund's investment objectives, strategies and risks. In addition, we believe that the costs of implementation will be significant, and that the Proposed Amendments to Rule 10b-10 are premature to any point of sale proposal being considered by the Commission.

Finally, Schwab seeks clarification on several provisions within the Proposing Release.

- We seek assurances from the Commission that it remains the Board's responsibility to determine whether it is appropriate to use fund assets to pay for services provided by a mutual fund supermarket or other platform provider, and whether such payments are for distribution or non-distribution services.
- We request clarification from the Commission on the scope of the guidance the Commission has indicated that it intends to provide to Boards in the adopting release. In particular, we request clarification as to whether such guidance would be applicable to the Board's consideration of a marketing and service fee, or applicable only to consideration of an ongoing sales charge.

I. Marketing and Service Fees

In adopting Section 12(b) of the Investment Company Act of 1940 (the "1940 Act")[3], Congress sought to protect open-end companies against excessive sales and promotional expenses[4] and gave the Commission the authority to implement regulations to prevent such abuses.[5] Rule 12b-1 as adopted reflects the Commission's concern regarding the use of fund assets to finance distribution, given the potential conflicts of interest such use may create between a fund and its investment adviser.[6] As a result, the final Rule 12b-1 included procedural requirements and conditions intended to minimize conflicts of interest between the fund's adviser and the fund, and placed a great deal of responsibility on a fund's board of directors or trustees (the "Board"), especially disinterested directors, to monitor these potential conflicts.[7]

Schwab believes that the factors that many Boards consider in approving a plan of distribution under Rule 12b-1 today (a "Rule 12b-1 Plan"), and the ongoing procedural requirements related to a Rule 12b-1 Plan, are outdated and offer little guidance to a Board in reviewing the use of fund assets for distribution-related activities. However, we also believe that a fund's ability to use fund assets to pay for distribution (as well as shareholder) services pursuant to a Rule 12b-1 Plan is of great benefit to fund shareholders, and vital to the current economic realities of the mutual fund industry. Funds should be allowed to continue to make payments out of fund assets for distribution-related activities, so long as such payments are not excessive. The Proposed Rules relieve the Board of its obligation to approve a Rule 12b-1 Plan—and hence the issues currently associated with reliance on outdated guidance—while still permitting the use of fund assets for distribution as well as shareholder services. Therefore, we largely support the rescission of Rule 12b-1 and adoption of Proposed Rule 12b-2.[8] As discussed below, rescission of Rule 12b-1 nevertheless raises some issues that we believe warrant further consideration by the Commission.

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[3] 15 U.S.C. § 80a-1 et seq.

[4] Proposing Release at 10.

[5] Securities and Exchange Commission, Final Rule: Bearing of Distribution Expenses by Mutual Funds ("12b-1 Adopting Release"), 45 Fed. Reg. 73898 (Nov. 7, 1980) at text following "The Legal Authority to Adopt Proposed Rule 12b-1."

[6] *Id.* at text following "Discussion". Specifically, the Commission was concerned with "1) conflicts which may exist between the interests of a fund and those of its investment advisor in deciding whether a fund should pay its distribution costs; 2) the likelihood that the fund would benefit from paying for such costs; and 3) the fairness to existing shareholders." *See also* Remarks by Andrew Donohue, Director, Division of Investment Management, at the Commission's Division of Investment Management Roundtable on Rule 12b-1 ("12b-1 Roundtable") (June 19, 2007) at 7 (as published in the unofficial transcript available at http://www.sec.gov/news/openmeetings/2007/12b1transcript-061907.pdf) ("Unofficial Roundtable Transcript").

[7] 12b-1 Adopting Release at text following "Background". *See also* Proposing Release at 13-15.

[8] Alternatively, we suggest that the Commission consider whether the goals of the Commission could be achieved simply by amending Rule 12b-1, rather than rescinding Rule 12b-1 and adopting an entirely new rule (Rule 12b-2). Specifically, the Commission could amend Rule 12b-1 to remove the procedural requirements from Rule 12b-1, provide interpretive guidance as to the effect of such changes, and make conforming amendments to achieve the same plain English disclosures it has proposed in Proposed Rule 12b-2. Adoption of a new Rule 12b-2 would involve a complete change in terminology for the industry and impose significant costs on financial intermediaries, as we describe in Section I.B.1 below. We believe that amending Rule 12b-1 as described above may achieve this same end while mitigating some of these costs.

A. Schwab supports the rescission of Rule 12b-1.

We agree with the Commission that neither the procedural conditions established by Rule 12b-1 nor the factors a Board might consider in approving or renewing a Rule 12b-1 Plan is particularly necessary or useful today in light of the evolution of the uses of such fees and the current economic realities of the mutual fund marketplace, nor do these conditions and procedural requirements best serve the interests of fund investors.[9]

When the Commission initially proposed Rule 12b-1, it contemplated including nine different factors that a Board might consider in approving a Rule 12b-1 Plan. The Commission, however, declined to include these factors in the final rule, stating that it was deleting the list of factors "to avoid the appearance of either unduly constricting the directors' decision making process or of creating a mechanical checklist."[10] Instead, the Commission included these nine guiding factors for Boards in the 12b-1 Adopting Release. While these guiding factors may have been helpful to a Board when Rule 12b-1 was first adopted—and particularly with respect to the adoption of a Rule 12b-1 Plan rather than continuation of a Plan—they have not been updated since the adoption of Rule 12b-1 in 1980, and do not reflect current distribution practices. Rescinding Rule 12b-1 relieves Boards of their obligation to approve Rule 12b-1 Plans based on guidelines that are no longer relevant, helpful or necessary.

The Commission has recognized in the Proposing Release that a Board should oversee the use of fund assets for distribution expenses in the same manner that it oversees the use of fund assets to pay for other operating expenses.[11] Instead of the procedural conditions imposed by Rule 12b-1 and the use of a "checklist" of factors that a Board might consider, we agree that a Board's fiduciary duty under the 1940 Act and duty of loyalty and care under applicable state laws provides a sufficient framework under which such fees should be considered in light of Congressional intent in adopting Section 12(b)—that is, protecting funds and their shareholders from paying excessive sales charges or promotional expenses. The removal of these procedural requirements allows the Board to use its business judgment to make a determination as to the appropriate use of fund assets, regardless of whether such assets are used for distribution-related activities or other activities.

Finally, we agree with the Commission that adoption by the Board of a formal plan or other formal Board role is no longer necessary to address the underlying concerns of Section 12(b)—namely conflicts of interest—given the limitations on fees imposed by the Proposed Rules.[12] Since the adoption of Rule 12b-1 in 1980, the Commission has taken steps to ensure that inherent conflicts between an adviser and the fund are minimized by encouraging a heightened role for independent directors through fund governance reform.[13] This evolution of fund governance

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[9] Proposing Release at 8.

[10] *See* 12b-1 Adopting Release at text following "Factors".

[11] Proposing Release at 42-43.

[12] Proposing Release at 64.

[13] *See., e.g.,* Securities and Exchange Commission, Final Rule: Role of Independent Directors of Investment Companies, Release Nos. 33-7932; 34-43786; IC-24816 ("Independent Directors Rules") (January 2, 2001) at 1. *See also* Proposing Release at note 157, discussing the role of independent directors in overseeing fund operations and protecting the interests of shareholders.

further serves to protect the interests of shareholders, and serves to address concerns about potential conflicts between the fund and the adviser in using fund assets for distribution purposes.

B. Schwab supports adoption of proposed Rule 12b-2, pursuant to which a "marketing and services fee" may be paid from fund assets.

Schwab supports the concept of allowing a fund to use fund assets to pay a marketing and services fee ("MSF") pursuant to proposed Rule 12b-2 because we believe that it is vital to investors that funds continue to be able to use fund assets to pay for the types of activities that Rule 12b-1 Plans now encompass. Fees paid to a financial intermediary pursuant to a Rule 12b-1 Plan ("Rule 12b-1 Fees") are used today for any number of purposes, such as paying for services associated with a fund's inclusion on a mutual fund supermarket or as an investment alternative for qualified retirement plans. The fees paid by the funds support the service infrastructure of these platforms and are necessary to ensure the continued availability of the funds through mutual fund supermarkets—which we believe are immensely beneficial to investors[14]—and other intermediary platforms, such as retirement plan recordkeeping or custody platforms. In addition, paying for servicing on these platforms out of fund assets has helped funds to reach economies of scale more quickly, and as a result, the use of funds assets for this purpose has benefited investors in those funds by reducing relative costs for other fixed fees, like transfer agency fees.[15]

1. Renaming of the fees paid out of fund assets for distribution and other service-related activities will benefit investors.

Schwab agrees with the Commission that references to a "Rule 12b-1 Fee" in fund documents may not be readily understood by all investors, and in fact, may be confusing to some. In the Commission's Division of Investment Management Roundtable on Rule 12b-1 held in 2007 (the "12b-1 Roundtable"), participants questioned whether the requirement that the prospectus fee table disclose "Rule 12b-1 fees" achieved the desired purpose of assisting investors in making an educated choice among various investment alternatives, or whether the disclosure simply confuses

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[14] *See* Letter from John Morris, Senior Vice President, Charles Schwab & Co., Inc., to Ms. Nancy Morris, Secretary, U.S. Securities and Exchange Commission, dated July 16, 2007 (available at www.sec.gov/comments/4-538/4-538.shtml) at 2-3. Mr. Morris described the benefits of a mutual fund supermarket as follows:

> Mutual fund supermarkets like Schwab Mutual Fund Marketplace® and OneSource® have dramatically revolutionized and democratized investing. Supermarkets have provided investors with a vast array of investment choices that previously were not available, including funds that specialize in every conceivable sector. Supermarkets have allowed investors the ability to comparison shop among thousands of different funds from different fund families and to compare funds across a wide variety of categories, including among other factors performance, risks, fund expenses, investment strategy, portfolio turnover rates, and fund manager tenure. . . . Mutual fund supermarkets have also been very important to the health of the mutual fund industry. Smaller, entrepreneurial funds and fund families have flourished in the last decade because supermarkets have given them access and exposure to millions of investors—potential shareholders that they simply never would have reached on their own. Fund companies leverage the fund supermarket's existing and often superior shareholder servicing and other processing infrastructure, providing shareholders with a far better investor experience than can be provided directly.

[15] *See, e.g.*, Remarks by Mellody Hobson, Ariel Funds, at the 12b-1 Roundtable, as published in the Unofficial Roundtable Transcript at 67.

investors.[16] Describing these fees in plain English based on the services for which the fees are intended to be used will greatly improve investors' understanding of the use of fund assets for these purposes.

While we support this aspect of the proposed rules, we note that this apparently simple change in terminology from a Rule 12b-1 Fee to a "Marketing and Service Fee" will nevertheless impose significant costs on financial intermediaries, which we believe have been largely ignored in the Proposing Release.[17] Intermediary firms currently store and use Rule 12b-1 Fee data for a variety of purposes, for example, to display the Rule 12b-1 Fee on their firm websites, which allows investors to compare funds when making investment decisions. The 12b-1 Fee information is captured for other purposes as well, for example, to support internal billing systems or other reporting functions.

Upon adoption of the Proposed Rule, a financial intermediary will likely need to change many aspects of its systems, from the data feed(s) and internal database fields used by the intermediary firm to track and store the amount of the Rule 12b-1 Fee, to its firm website and other displays and interfaces. Schwab estimates that the system changes and testing necessary to remove references to the Rule 12b-1 Fee and implement the new MSF terminology will likely take nine months to complete, at an estimated cost of $500,000.[18] In addition, Schwab will also need to modify its fund billing systems and invoices to account for the change. We estimate that these changes to Schwab's billing system will cost an additional $500,000.[19]

Further, any agreements between a fund and a financial intermediary that reference a Rule 12b-1 Plan or Rule 12b-1 Fees will have to be amended to reflect the new terminology. We estimate that Schwab will have to amend over 1,000 contracts as a result. We expect that these amendments will take a minimum of six months to accomplish, at a cost to Schwab of approximately $200,000 (for contract administration and legal resources).[20]

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[16] *See* Proposing Release at 32 ("Several participants suggested that the term "12b-1 fee" causes confusion because it encompasses so many different activities. Most roundtable participants agreed that greater transparency and better communication of what 12b-1 fees are and how they are used are vital to enabling investors to make optimal choices among the alternatives offered to them.").

[17] The discussion in the Proposing Release focuses on the benefits a fund and its Board may receive by adopting a MSF, and concludes that there will be very little cost to implement this change, other than in updating disclosure documents. Proposing Release at 172-174. We do not disagree with this analysis, but suggest that the Commission has overlooked costs borne by not only the financial intermediaries mentioned above, but also mutual fund service providers, including fund transfer agents and distributors, in making system and file changes to account for the change in terminology.

[18] This estimate is based on all aspects of the integration of the new MSF terminology. This integration may be particularly challenging and more costly if the Commission adopts the proposed five-year grandfathering period, as systems may need to be modified to accommodate the fields necessary to support both the Rule 12b-1 and Rule 12b-2 terminology for the proposed grandfathering period.

[19] This assumption includes those changes that would be required to support billing and invoicing under both Rule 12b-1 and Rule 12b-2 for the proposed five-year grandfathering period.

[20] To manage these contract amendments, we likely would use existing internal resources, which would be redeployed from their day to day work to support these changes. In addition, the amendment of a contract requires resources from the counterparty's firm as well. Therefore, the cost associated with these contract amendments is not easily quantified. In addition, this estimate does not include the possibility that we may have to bring in additional resources to back-fill positions that are required to work on this project.

2. A marketing and service fee of 25 basis points (0.25%) should not be considered "excessive" and the rate should be codified in Rule 12b-2.

We agree that 25 basis points (0.25%) is not an excessive fee for marketing and service related expenses. We would not advocate that the Commission set the rate at any amount less than 25 basis points,[21] recognizing that the actual costs of distribution and shareholder servicing for many funds, and especially for smaller funds, may be higher than 25 basis points.[22]

As an initial matter, regardless of the MSF rate on which the Commission settles, we request that the actual rate of the MSF be codified in Rule 12b-2 and not by reference to NASD Rule 2830 ("Rule 2830"). The amount of the MSF is an integral part of this proposal—in fact, it provides the foundation on which other definitions in the Proposing Release are based. For example, the amount of the ongoing sales charge is set by reference to the maximum rate permitted under Rule 12b-2.[23] Because of this, we believe that it is exceedingly important that the amount of the MSF not be delegated to a self-regulatory agency.

In addition, any changes to the MSF will have far reaching implications. Consequently, we advocate that the amount of the MSF, both initially and as it may change in the future, be subject to the Commission's thorough and well-publicized rule proposal process, and not to the limited exposure sometimes received by a rule proposal of a self-regulatory organization. While we recognize that the Commission would have to approve any changes to Rule 2830, we are concerned that amendments to the rules of a self-regulatory organization, such as FINRA, may not receive the level of industry attention and scrutiny warranted by a rule change that could so significantly impact the mutual fund industry.

Separately, we note the inconsistency in the definition of the activities paid for under Rule 12b-2, which is focused on promotional-type activities, and the definition under Rule 2830 of a "service" fee, which includes personal and account maintenance services.[24] By contrast, Rule 2830

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[21] In fact, the Commission may wish to consider whether an amount greater than 25 basis points is more appropriate, particularly with respect to fund shares made available solely through retirement plans, which typically entail a greater degree of servicing. If a fund is not able to make offsetting payments to a plan's service providers, such costs likely would be shifted to plan participants to bear as direct expenses. *See infra* Section II.D for a further discussion of the Proposing Release's impacts on retirement plans.

[22] *See, e.g.,* Remarks by Mellody Hobson, Ariel Funds at the 12b-1 Roundtable as published in the Unofficial Roundtable Transcript at 69.

[23] Proposed Rule 6c-10(d)(11) ("*Ongoing sales charge* means any charges or fees deducted from fund assets to finance distribution activity in excess of the maximum rate permitted under § 270.12b-2(b)").

[24] Rule 2830(b)(9). Under Rule 2830, "service fees" are described as "payments by an investment company for personal service and/or the maintenance of shareholder accounts." The service fee, under NASD interpretations, is "essentially intended to compensate members for shareholder liaison services they provide, such as, responding to customer inquiries and providing information on their investments." *See* Questions and Answers About New NASD Rules Governing Investment Company Sales Charges, NASD Notice to Members 93-12 at Question #17 (available at www.finra.org) ("NTM 93-12"). Importantly, the NASD has also specified those types of fees that fall outside of the definition of a service fee, for example, sub-transfer agency and sweep administration fees. *Id.* ("In broad categories, the term does not include subtransfer agency services, subaccounting services or administrative services."). *See also* SEC Approval of Amendments to Article III, Section 26 of the NASD Rules of Fair Practice Regarding Limitations on Mutual Fund Asset-Based Sales Charges, NASD Notice to Members 92-41 (available at www.finra.org) ("Service

references promotional activities solely in the Rule 2830 definition of "sales charges."[25] The Proposing Release refers to the NASD "service fee" as a "limited distribution fee",[26] when in fact, Rule 2830 makes a very clear distinction between an asset-based sales charge and a service fee.[27] Given that the NASD service fee definition does not include payment for any type of promotional activity, we are concerned that these inconsistencies might cause significant confusion both for a Board in considering adoption of a MSF, and an intermediary receiving such a fee.[28]

We urge the Commission to consider codifying the amount of the MSF in Proposed Rule 12b-2. Further, we suggest that the Commission gather additional comment on the appropriate rate of the MSF.

II. Excessive Sales Charges/Maximum Sales Loads

Investors have many mutual fund share classes from which to choose when making an investment decision. Often, the investment decision as to the appropriate share class is driven by how an investor prefers to pay for investing in the fund—either up front at the time the shares are purchased, over the time the shares are held by the investor, or at the time shares are redeemed.[29] Unfortunately, a multiple share class structure can at times be confusing to investors. The multiple class structure also raises potential conflicts of interest and can be subject to potential abuse, such as when a broker recommends an investment in a share class that imposes a back-end load when an investor might qualify for a reduced sales charge if investing in another share class.

The Commission's proposal seeks to ensure that an investor not pay more than other shareholders in the same fund, regardless of share class in which the investor has elected to invest. Schwab agrees that individual shareholders should be protected from paying excessive sales charges, and therefore, generally supports the characterization of any distribution-related expenses

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fees, therefore, do not include recordkeeping charges, accounting expenses, transfer costs, or custodian fees.")

[25] Rule 2830(b)(8) ("[A]ll charges or fees paid to finance sales or sales promotion expenses, including front-end, deferred and asset-based sales charges.").

[26] Proposing Release at 44. ("We chose to propose this limit because it would permit, without change, the continuation of many important uses of 12b-1 fees that may benefit investors. It also represents the line the NASD sales charge rule draws between a *limited distribution fee* and a sales charge – 25 basis points currently is the limit that a fund may deduct and still call itself a "no-load" fund.") (emphasis added).

[27] NTM 93-12 at Question #23 (Q: "Is there a clear distinction between asset-based sales charges and service fees?"; A: "Yes.") and Question #24 (Q: "If an item is a service fee, is it outside the scope of the Rule's limits on sales charges?"; A: "Yes".).

[28] By this discussion we do not intend to suggest that the Commission should explicitly define those activities that constitute "distribution" activities. As we discuss more fully in Section IV.A *infra*, we believe that this is a decision that is best left to a Board.

[29] The Commission has recognized the trend away from ownership of share classes that impose the highest sales loads and Rule 12b-1 Fees, and toward no-load and load waived share classes. *See, e.g.*, Proposing Release at 24-25. This trend is clearly echoed in Schwab's retail client base. Year to date (through September 30, 2010), retail investors have placed net new mutual fund purchases of over $3 billion in no-load, no transaction fee funds ("NTF Funds"), while load funds have seen net redemptions of over $700 million. Even registered investment advisors using Schwab's custody services have placed net purchases of almost $2 billion into NTF Funds year to date, while load funds have seen net redemptions of almost $1.7 billion.

greater than the amount specified under Rule 12b-2 as an ongoing sales charge, which would then be capped at the maximum front-end (or reference) load. We are nevertheless concerned that certain aspects of the proposal may confuse investors, involve significant costs, and adversely impact retirement plan participants and plan service providers, such as plan record-keepers. We urge the Commission to carefully consider the impact of the Proposed Rules in light of these concerns.

A. The Commission should reconsider the definition of an "ongoing sales charge".

As discussed earlier, Rule 2830 distinguishes "sales charges" from "service fees."[30] A FINRA member is prohibited from selling shares of a fund with an ongoing sales charge exceeding 75 basis points (0.75%) because such fee would be deemed excessive.[31] This proposal would expand these investor protections beyond FINRA member firms by imposing the restrictions at the source of the fees—the mutual fund.[32]

In addition to distinguishing sales charges from service fees, we note that Rule 2830 treats service fees and sales charges independently, and the existence of one does not presume the existence of the other. By contrast, the ongoing sales charge as proposed in Rule 6c-10 is set by reference to the MSF described in Rule 12b-2. In other words, Rule 6c-10, as proposed, assumes that the first 25 basis points taken from fund assets for distribution or shareholder servicing purposes should always be characterized as a MSF, regardless of the Board's characterization.[33] It is unclear, however, what this means for funds that adopt a "Shareholder Services Fee" or "Administrative Services Fee" (instead of a MSF under Rule 12b-2) and that also adopt an ongoing sales charge component. This type of fee structure may also create uncertainty for FINRA

[30] Rule 2830(b)(8) and (9). *See also supra* note 25.

[31] Rule 2830 (d)(2)(E).

[32] Realistically, a firm must be registered as a broker-dealer to receive an ongoing sales charge from a fund company, and the likelihood is that all broker-dealers are already FINRA members, so are already operating under these restrictions. However, whether a bank in receipt of Rule 12b-1 fees must be registered as a broker-dealer has not been always been clear, as was debated at the time of adoption of Regulation R under the Securities Exchange Act of 1934, which provides exceptions to or otherwise exempts banks from broker-dealer regulation. In the adopting release for the final rules, jointly published by the Commission and the Federal Reserve, a Rule 12b-1 asset-based fee was described as "relationship compensation" (distinguishable from non-relationship compensation, such as front-end or back-end sales loads) that would allow banks receiving this compensation to fall within the trust and fiduciary exception to the registration requirement. *See* Definition of Terms and Exemptions Relating to the Broker Exceptions for Banks, Federal Reserve System 12 CFR Part 218 [Regulation R; Docket No. R-1274]; Securities Exchange Commission, Release No. 34-56501; File No. S7-22-06 (September 24, 2007). The Commission has indicated that it does not intend that the Proposed Rules impact these exceptions or exemptions. *See* Proposing Release at 41. However, we believe that the characterization of a fee greater than the marketing and service fee as an alternative to a sales charge may suggest a contrary outcome, and in connection with the Commission's request for comment, we suggest that the Commission provide clarification of its intent in the adopting release.

[33] This structure implies that the Commission intends that the marketing and service fee be treated as a "safe harbor" for Boards in setting aside fund assets to be used for distribution-related expenses.

members as to how that fee structure might implicate the sales practices of those FINRA member firms desiring to make available shares of these funds to their clients.[34]

We suggest that the Commission consider rewriting the definition of the ongoing sales charges to remove reference to Rule 12b-2 from the definition. This would allow an ongoing sales charge to be paid from fund assets independent of other fees that may be paid out of fund assets for distribution-related and other expenses.

B. The Commission should consider the merits of establishing a single reference load.

We recognize the challenges of ensuring that investors pay sales charges in line with other investors in the fund. We appreciate that the Commission did not suggest individual calculations for each shareholder, but rather, that the fund establish a conversion schedule such that at the time of purchase a mutual fund investor would know precisely when the investment would convert to a share class with no ongoing sales charge. Rule 6c-10, as proposed, nevertheless raises a number of complex operational challenges that intermediaries may struggle to overcome.

Under the Proposed Rule, where a fund's maximum sales load is indeterminable because the fund charges both a front-end load and an ongoing sales charge, or it does not have a share class that imposes a front-end load, the maximum sales charge that may be imposed is set by reference to the limits set in Rule 2830 (currently 6.25% of total gross new sales). The Commission has suggested that linking the reference load to Rule 2830 sales charge limits might ease the operational burden on funds and financial intermediaries because funds, underwriters and broker-dealers are already familiar with these limits and have structured their systems accordingly.[35]

We discuss operational burdens of the ongoing sales charge and conversion more fully in Section II.C below, but are of the opinion that such linking is not particularly useful. The limits set forth in Rule 2830 are applied to "new sales" of the fund, and as recognized in the Proposing Release, are fund-level caps, not individual shareholder caps.[36] Therefore, the Commission's proposal that shares held by an individual shareholder convert once the ongoing sales charge reaches this reference load is a new and different concept.[37] As such, the systems and technology necessary to support these conversions generally do not exist and would have to be created at considerable cost.

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[34] In fact, we believe that FINRA might be forced to address these concerns through modification of Rule 2830 to bring it into closer harmony with the fee structure proposed by the Commission in this Proposing Release. This creates further uncertainty for FINRA members as members likely will delay implementation of any changes until such clarification is provided by FINRA, so as to not incur duplicative costs of any necessary enhancements.

[35] Proposing Release at 56.

[36] *See* Proposing Release at 21 discussing the aggregate sales charge cap imposed by Rule 2830 ("Because it is calculated at the fund level based on the amount of aggregate new fund shares sold, the aggregate cap does not limit the actual amount of sales charges that a particular investor may pay.").

[37] We are also concerned that the lot level accounting and related conversions will significantly increase the likelihood of investor confusion. An investor that buys in smaller increments over time will have multiple fund holdings, multiple lots and multiple conversion schedules.

While this proposition will be complex and costly regardless of the approach, the Commission may be able to simplify the implementation to some degree by codifying within Rule 6c-10 a standard reference load across all funds regardless of the maximum front-end sales charge.[38] A standard fee across all funds may help to limit investor confusion and reduce the operational complexity of the systems work that will be required to support it, as we discuss below. We respectfully suggest that the Commission consider soliciting additional comment on the amount of the reference load and whether such reference load should be set at a standard level across all funds, so as to simplify the concept of a reference load for investors and relieve some of the operational complexity and associated burdens for industry participants.

C. Financial intermediaries will incur significant costs to build share lot tracking systems to account for the conversion of share lots and enhance related systems.

The Commission has suggested that existing technology built by the mutual fund industry to process B-share to A-share conversions can be leveraged to support the conversions required under Rule 6c-10. Although the mutual fund industry has built functionality to track certain conversions, such functionality was built on the assumption that B-share class positions held at a broker-dealer or other financial intermediary are fully networked (sub-accounted) with the funds, and the fund company is responsible for tracking share aging and triggering the share class conversion. In addition, the Proposed Rule greatly expands beyond B-share classes the share classes that might be subject to a conversion, by pulling in any share classes with an ongoing sales charge. Finally, the Proposed Rule would require that funds have a share class that does not impose an ongoing sales charge into which the shares can convert, potentially leading to a proliferation of new share classes.[39]

We remind the Commission that many firms, including Schwab, maintain omnibus relationships with fund companies if a fund does not charge a front-end sales load or deferred sales load; these positions are not fully networked (sub-accounted) with the funds.[40] Some of these funds held in omnibus accounts currently have Rule 12b-1 Fees greater than 25 basis points. To the extent these funds restructure their Rule 12b-1 Plans to adopt a MSF and recharacterize any amount above 25 basis points as an ongoing sales charge,[41] financial intermediaries will have to

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[38] We also refer the Commission to our discussion in Section I.B.2 of the benefits of subjecting future amendments to fee limits and other aspects of the Proposed Rules to the Commission's thorough and thoughtful rule proposal process.

[39] While we believe this is generally the case at Schwab, due to the large number of funds that have elected to make shares available either through no-load or load-waived share classes, we expect that additional work will be required to add funds and share classes to our platform to accommodate the necessary conversions. We expect that Schwab would incur one-time initial costs of $250,000 to add these fund share classes, with ongoing annual costs of servicing those symbols at $500,000.

[40] Schwab supports a load omnibus model for several of its mutual fund clearing correspondents, with the sub-accounting function and related sales charge tracking performed on a separate sub-accounting system. To process B-share to A-share conversions in this environment, Schwab replicates the fund share class conversion model on the internal sub-accounting system. However, this model is not immediately transferrable to the broader investor base at Schwab without significant systems integration work to support it.

[41] The Commission has suggested in the Proposing Release that funds may determine that the portion of the Rule 12b-1 Fee in excess of the MSF might be recharacterized as for non-distribution services, such as sub-accounting or recordkeeping (*see, e.g.,* Proposing Release at 179-180, 205 and note 515). However, a Board may be reluctant to recharacterize certain fees previously paid pursuant to a Rule 12b-1 Plan as for other than

build or enhance lot level accounting systems internally to support these funds on their mutual fund platforms, rather than relying on current industry technology. This becomes increasingly operationally complex given the additional tiers of omnibus accounts that may be held within a fund omnibus account and the related systems supporting the sub-accounting of those positions, such as those held by retirement plan record-keepers that maintain a plan level account within a financial intermediary's omnibus account, but do their own participant-level record-keeping.

As an example, and as recognized in the Proposing Release, most record-keepers generally do not currently have in place the technology to support lot level accounting at the participant level.[42] The Commission has estimated that the cost for record-keepers to update their record-keeping systems will be approximately $1.0 million as a one-time cost and $1.5 million, annually, to manage ongoing sales charges for the plans that they service.[43] We believe this estimate significantly understates the up-front costs for record-keepers that develop and maintain proprietary systems. Schwab estimates that the up-front costs of updating proprietary record-keeping systems to support participant lot accounting could range from $1.2 million to as high as $3 million for our record-keeping systems.

The Commission also states that only record-keepers that provide services to retirement plans that make available funds imposing distribution-related fees in excess of 25 basis points would be required to make changes to their systems.[44] However, a record-keeper does not always have the luxury of determining which funds it must support; the menu of funds offered is driven by demand of the plans that have selected the record-keeper as a service provider to the plan. It is not clear that record-keepers would be able to limit the universe of funds selected by the plans that they service and still be in a position to competitively maintain their business. As a result, we believe that many record-keepers will likely incur these costs to remain competitive.

In addition, the Commission has recognized several of the operational challenges presented by the proposed lot level tracking for conversion purposes, such as for transfers of positions between firms and exchanges of positions. We are not sure that the Commission fully appreciates the magnitude of these challenges or associated costs in building and updating systems to support them. For example, if an investor exchanges from one fund into another fund (or engages in an elective share class exchange), it will be exceedingly complex for a fund or financial intermediary to map the transaction history of the redeeming fund to the individual share lots of the acquired fund. Under proposed amendments to Rule 11a-3, at the time of an exchange, the investor must be given credit for the ongoing sales charge,[45] and the ongoing sales charge must be taken into account in the calculation of a contingent deferred sales charge.[46] The proposed amendment further requires that if an investor is exchanging between funds that charge different reference loads, the

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distribution-related activities because it could subject a Board to claims alleging that the Board's recharacterization of those services post-Rule 12b-1 is inconsistent with its previous characterization of the services under Rule 12b-1, in conflict with its fiduciary duty to shareholders.

[42] Proposing Release at 130, 204. *See infra* Section II.D for a further discussion of the Proposing Release's impacts on retirement plans.

[43] *Id.* at 206.

[44] Proposing Release at 204 and notes 512.

[45] Proposed Rule 11a-3(b)(4) and 11a-3(5)(i)(A).

[46] Proposed Rule 11a-3(b)(4)(i) and 11a-3(5)(ii)(A).

highest reference load should apply for purposes of determining the conversion schedule.[47] This means that systems will have to be programmed to compare reference loads, subtract ongoing sales charges already paid by the investor, and set new conversion dates for various lots of the acquired shares. All of these calculations do not even take into consideration any variations in the sales charge schedule that might be applicable if the investor is entitled to certain breakpoints in the sales charges for the acquired fund. In finalizing the rule, we ask the Commission to give these operational challenges further consideration, and, as necessary, seek further comment on potential means to help minimize the complexities and costs associated with implementing Rule 6c-10.

Finally, we expect the costs will be significant to change dividend functionality to enable a fund to allocate a dividend distribution to the appropriate share lot on which it has been declared if the share class has an ongoing sales charge. Today, Schwab complies with Rule 2830's prohibition on the imposition of a sales charge on reinvested dividends.[48] Any divergence from that rule will cause Schwab to have to remediate its dividend systems, at an estimated cost of $1.5 million. As an alternative, we ask the Commission to consider allowing the reinvestment of dividends in the share class with an ongoing sales charge (and, consistent with current NASD rules, a sales charge could not be assessed on those reinvested shares). The reinvested shares could then be converted on the next monthly conversion cycle to a share class that does not assess an ongoing sales charge. We believe this solution would be much less costly to implement, as it would not require a full remediation of the dividend system, and the functionality could be built into the conversion process (which will need to be built regardless, should the Commission proceed with these Proposed Rules).

We urge the Commission to consider the operational challenges faced by financial intermediaries and to seek alternatives to minimize the financial burden of implementing the Proposed Rule. We would be pleased to discuss these and other operational challenges more fully with the Commission prior to the Commission's publication of a final rule.

D. The Proposed Rule may substantially impact retirement plan participants, as well as the sponsors and service providers of those plans.

There are certain established costs inherent in a retirement plan business. Today, these costs often are paid by funds that are made available as investment alternatives for a plan, and not borne directly by the plan sponsor or by the plan participants. The funds that are selected as investment alternatives enter into contractual arrangements with plan administrators and other service providers to pay for recordkeeping, transaction processing, account servicing and participant education, among other plan related fees. As with fund supermarkets, some funds use a Rule 12b-1 Fee to pay all or a portion of these servicing fees.

If a fund is no longer able to pay a plan administrator or other service provider out of fund assets to offset the costs of the services that are being provided to the plan participants and the plan, for example, because the fund has determined that such compensation arrangements are not allowable under the Proposed Rules or because the current Rule 12b-1 Fee exceeds 25 basis points, the servicing costs will by necessity need to be absorbed by other parties, such as the plan sponsor or plan participants directly. The actual costs of servicing such plans and the plan participants will not change.

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[47] Rule 11a-3(b)(4)(ii).

[48] Rule 2830(d)(6)(B).

We request that the Commission reconsider the application of this new asset-based distribution fee framework to share classes made available only to qualified retirement plans because of the disruption these changes will cause to the retirement plan landscape, as described above, and the additional protections and disclosures available to plan participants. First, we point to the Department of Labor's ongoing efforts to improve transparency to plans and participants regarding indirect compensation being paid by funds to the plans' service providers. We suggest that the concerns of the Commission related to compensation paid out of fund assets to a plan's service provider are being addressed through increased transparency and disclosures to the plans[49] and their participants.[50] Second, forcing these limitations on mutual funds, and not applying it to all types of products offered as investment alternatives in retirement plans, may cause plans to elect to use other types of products that are not subject to the same regulatory oversight as mutual funds, to the possible detriment of plan participants—the very investors the Commission seeks to protect.

III. Rule 10b-10

As stated in the Proposing Release, the proposed amendment to Rule 10b-10 is intended to "help make the confirmation a more complete record of the transaction, help investors in mutual fund securities be more fully aware of the sales charges they pay, and assist investors in verifying whether they paid the correct sales charge set forth in the prospectus."[51] The trade confirmation is a critical component of the overall mutual fund disclosure framework. While the Commission has recognized that it is the prospectus disclosures that an investor looks to when making an informed investment decision,[52] once the investment decision has been made and the transaction completed, the investor looks to the trade confirmation to verify that the transaction was handled correctly, including verification of any sales charges or fees charged.

Schwab supports inclusion on the trade confirmation of transaction-specific fees and sales charges incurred when purchasing or redeeming shares of a fund that imposes such fees or charges. However, we generally oppose the inclusion on trade confirmations of information that is not specific to the transaction being confirmed and that is included in the mutual fund prospectus because (i) it unnecessarily duplicates information that is already available to investors;[53] and (ii) it

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[49] Department of Labor, Annual Reporting and Disclosure; Revision of Annual Information Return/Reports; Final Rule and Notice; 72 Fed. Reg. 64710, 64742 (Nov. 16, 2007).

[50] Final Rule to Improve Transparency of Fees and Expenses to Workers in 401(k)-Type Retirement Plans, Employee Benefits Security Administration News Release, dated October 14, 2010, available at http://www.dol.gov/opa/media/press/ebsa/EBSA20101432.htm.

[51] Proposing Release at 72.

[52] *See, e.g.,* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies; Final Rule, 74 Fed. Reg. 4546 (Jan. 26, 2009) (hereinafter the "Summary Prospectus Rule").

[53] In connection with this, Schwab opposes withdrawal of previous Commission no action relief that allows a broker-dealer to meet certain of its obligations under Rule 10b-10 by delivery of a mutual fund prospectus along with the trade confirmation. *See* Proposing Release at note 218, describing the relief granted. ("In this letter, the staff of the Commission's Division of Market Regulation (now known as the Division of Trading and Markets) stated that it would not recommend enforcement action against broker-dealers that did not provide transaction-specific disclosure about mutual fund loads and related charges, so long as the customer received a prospectus that 'disclosed the precise amount of the sales load or other charges or a formula that would enable the customer to calculate the precise amount of those fees.'") We are concerned that

emphasizes certain mutual fund costs over other equally important fund costs, as well as other important investment considerations. With respect to the proposed amendment, we believe that the costs of compliance are understated and greatly outweigh the benefits the additional disclosures arguably provide to investors.

Further, the Commission has indicated that it is considering proposing new point of sale disclosures, to assist investors in making better informed investment decisions.[54] We believe it is more appropriate that the Commission consider amending Rule 10b-10 in the larger context of the mutual fund disclosure regime, and not adopt changes now that may prove to be duplicative of requirements imposed by point of sale disclosures. At a minimum, any proposed amendments to Rule 10b-10 should be considered in parallel with any point of sale proposal, to reduce the chance of a firm incurring duplicative costs.

A. The proposed trade confirmation disclosure unnecessarily duplicates information displayed in the fund prospectus, requires disclosure of fees and charges not incurred in connection with the transaction, and is received after an investor makes an informed investment decision.

We believe that the trade confirmation is the appropriate document to deliver information regarding fees or sales charges directly incurred in connection with the transaction. The industry has taken steps to address appropriate disclosures of transaction-specific fees. In 2003, a Joint NASD/Industry Task Force (the "Task Force") convened to recommend industry-wide changes to address errors and missed opportunities to provide discounts in the calculation of sales loads. The report of the Task Force, issued in July 2003, recommended that "[c]onfirmations should reflect the entire percentage sales load charged to each front-end load mutual fund purchase transaction. This information would enable investors to verify that the proper charge was applied."[55] As a result, today Schwab includes on mutual fund purchase confirmations the sales charge actually charged to the investor when purchasing a fund with a front-end sales charge, not only in percentage terms but also the dollar amount. Further, we explicitly notify the customer that breakpoints may apply, and refer the customer to the fund prospectus to determine whether the appropriate breakpoints have been calculated. We also indicate on a mutual fund redemption confirmation the dollar amount of the contingent deferred sales charge imposed, if applicable.

However, we are concerned the proposed amendments to Rule 10b-10 go far beyond these transaction-specific disclosures, and would require a trade confirmation to repeat certain information contained in the fund prospectus that is unrelated to or not otherwise implicated by the transaction. Therefore, we oppose any modifications to Rule 10b-10 that would require a financial intermediary to include information on a trade confirmation related to the costs of investing in a mutual fund unless such costs are incurred directly in connection with the transaction and are not otherwise disclosed in the fund prospectus.

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withdrawal of this guidance will be interpreted more broadly than intended and will call into question aspects of the mutual fund disclosure regime that have proven to be relatively effective in delivering information to investors without being overly repetitive or redundant.

[54] *See* Proposing Release at note 222 ("In this regard, the staff is considering recommendations for future consideration to enhance the information provided at the point of sale.")

[55] *See* July 2003 Report of the Joint NASD/Industry Task Force on Breakpoints at 10, available at http://www.finra.org/Industry/Issues/Breakpoints/P006422.

First, we oppose inclusion of the annual rate of the MSF and ongoing sales charge on the trade confirmation.[56] Fees paid by all investors in a share class of a fund, such as the MSF and ongoing sales charge, are not transaction-specific and are instead incurred over time and paid out of fund assets. These fees are included in the fund's total annual operating expenses, as disclosed in the fund's fee table published in the fund prospectus, which is made available to the investor. Inclusion of the MSF and ongoing sales charge on the trade confirmation highlights these fees over other fees incurred by all mutual fund investors. Finally, including the MSF and ongoing sales charge on the trade confirmation, and not including other mutual fund fees such as shareholder services plans or administrative services fees, will also lead to disparate disclosures.[57]

Second, we also oppose including on a purchase confirmation the amount of the deferred sales charge that an investor might pay in the future, and the aggregate amount of an ongoing sales charge that might be incurred over time and the maximum number of months or years that the customer might incur the ongoing sales charge, if the shares are not sold prior to the conversion date. Again, such information (i) is duplicative of information provided to the shareholder by prospectus, (ii) does not disclose fees incurred in connection with the transaction but rather what an investor "might" incur in the future, and (iii) is received after the investor has made an investment decision.

On a related note, we are concerned that requiring a financial intermediary to include information on the trade confirmation that is contained in the fund prospectus may expose a financial intermediary to legal risks. As Schwab outlined in a previous letter to the Commission, a financial intermediary might be subject to potential regulatory and civil liability if there are inaccuracies in the fund data that the financial intermediary has obtained from the fund or a vendor and that it subsequently reports on a trade confirmation.[58] A fund must be the definitive, single source of fund data.

If the Commission believes that the proposed sales charge disclosures are necessary in *both* the prospectus and on the trade confirmation, and is determined to proceed down this path prior to

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[56] The Commission appears to echo its agreement with this approach. *See, e.g.,* Proposing Release at note 229 ("We are not proposing to require that purchase confirmations disclose management fees or other operating expenses, as those costs are disclosed in the prospectus fee table and are not directly implicated by the transaction."). In this regard, we see no material difference between the MSF and ongoing sales charge and other equally important fund fees—such as the management fee or other expenses—none of which are directly implicated by the transaction.

[57] For example, one fund could charge a MSF, and another fund could charge a 25 basis point shareholder service fee, both of which are used to pay for the same services. Including the MSF on the trade confirmation, while not including the shareholder service fee, could mislead investors.

[58] Letter from David J. Lekich, Vice President and Senior Corporate Counsel, Charles Schwab & Co., Inc., to Mr. Jonathan Katz, Secretary, U.S. Securities and Exchange Commission, dated April 4, 2005 at 5-6 (in response to the Supplemental Request for Comment on Point of Sale and Trade Confirmation Requirements, File No. S7-06-04) (available at http://www.sec.gov/rules/proposed/s70604.shtml) ("Schwab Point of Sale Letter."). Consistent with Schwab's position in the Schwab Point of Sale Letter, should broker-dealers be obligated under a revised Rule 10b-10 to disclose information related to fund expenses on the mutual fund trade confirmation—which would include sales charge schedules and conversion schedules contained in the fund prospectus—we request that the Commission provide a safe harbor for broker-dealers, so long as the broker-dealer is relying in good faith on information provided directly by a fund, its service providers or an independent third-party service provider (e.g., Morningstar) in preparing such disclosures for inclusion on the trade confirmation.

proposing point of sale disclosures, we request clarification on the requirement that the purchase confirmation include the "amount of any applicable breakpoint or similar threshold used to calculate the sales charge."[59] This requirement, as drafted, might be interpreted to require that the mutual funds' load breakpoint schedule be reproduced, in its entirety, on the purchase confirmation. An alternative interpretation might be that the confirmation display the current running total of shares purchased by the shareholder—not just the shares purchased at the time the trade confirmation was generated—so that the shareholder can confirm that the appropriate breakpoints have been applied. We request clarification of this required element. We further request that the Commission specify the format and presentation on the trade confirmation of this as well as any other required elements should Rule 10b-10 be amended as proposed.

Finally, we recommend that the conversion schedule for shares subject to the ongoing sales charge be included as a required element of the summary prospectus, rather than relegated to the back of the statutory prospectus, as proposed by the amendments to Form N-1A.[60] We believe this is important information for investors and that it should be prominently disclosed in the prospectus fee table applicable to that share class.

B. We oppose the inclusion on a trade confirmation of the proposed standardized disclosure because it focuses on the costs of investing in a mutual fund over other equally important factors.

The Commission has proposed the inclusion on mutual fund trade confirmations of standardized disclosure that highlights the fees and expenses associated with an investment in a mutual fund.[61] There are many factors that go into an investor's investment decision, including a mutual fund's investment objectives and strategies, risks, costs, and performance.[62] While we agree that fees and expenses are important factors to be considered by a mutual fund investor, they are not the only considerations, and not necessarily the most important. Inclusion of this standardized disclosure specific to the fees associated with investing in a mutual fund highlights the costs of investing in a mutual fund over other equally important factors, such as the fund's objectives, management and performance.

The Commission, in adopting the summary prospectus, made huge strides toward ensuring that investors receive the information most relevant to their mutual fund investment decision. Investors are now able to compare summary sections of a fund prospectus—in standardized format and written in plain English—to evaluate funds and their features side by side. We see little

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[59] Proposed Rule 10b-10(a)(10)(i).

[60] Proposing Release at 271, Item 12 to Form N-1A.

[61] Proposed Rule 10b-10(a)(10)(iii)(B).

[62] The Commission recently reinforced these factors in adopting the new summary prospectus regime. Summary Prospectus Rule at 4552. ("The summary section of a mutual fund statutory prospectus will consist of the following information: (1) Investment objectives; (2) costs; (3) principal investment strategies, risks, and performance; (4) investment advisers and portfolio managers; (5) brief purchase and sale and tax information; and (6) financial intermediary compensation.") In addition, the factors cited here are factors that should be considered by the investor at the time the investment decision is made. The trade confirmation is generated by the brokerage firm and received by the investor after the investor has purchased shares of the fund.

benefit in repeating such information on a trade confirmation when it is already effectively communicated to investors in the summary prospectus.[63]

C. Costs of compliance are understated.

Adding fields to the trade confirmations to support the Commission's proposals will be very costly. First, the Commission's estimates assume that the data is already being made available by fund companies in a way that is easily captured by intermediary firms.[64] Today, most fund supermarkets and other intermediary firms either pull fund data from an industry-recognized data source, or request that a fund company provide updated information on an ongoing basis. We do not believe that all of the required data is or can be made available by mutual funds without substantial changes to the systems and manner in which the required information is provided. Second, a financial intermediary will have to store this information for the trade confirmation systems to access these particular data fields, which are not stored today by a financial intermediary, and which will require additional systems work.

The Commission's estimates do not appear to fully consider these factors. The Commission estimates that the average cost for a firm to update its proprietary trade confirmation systems will be approximately $1.1 million. We estimate Schwab's cost for one-time updates to the trade confirmation systems to be closer to $2.5 to $3.0 million, with ongoing costs of $500,000 annually.[65] For similar reasons, we also oppose inclusion of this information on the quarterly statement in those situations where a trade confirmation is not generated. It does not appear that the Commission has considered the costs associated with related account-statement changes. We estimate that the costs of such changes to the account statement systems would be significant, possibly even greater than the proposed trade confirmation enhancements.

IV. Request for Further Clarification

A. Schwab requests clarification that the proposed rules would not impact the Commission's 1998 letter to the Investment Company Institute regarding the use of fund assets to pay mutual fund supermarket fees.

The Commission, in adopting Rule 12b-1, declined to define the types of activities that would be considered "distribution" activities.[66] Instead, the Commission recognized that it is the

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[63] In lieu of this proposed trade confirmation disclosure, we would not object to inclusion of a more general legend on the trade confirmation that refers customers to the prospectus for additional factors related to investing in the fund. We suggest a cautious approach, however, as inclusion of additional disclosures on a trade confirmation that are applicable only to mutual funds may disadvantage mutual fund securities over other types of securities for which similar types of disclosures are not required on trade confirmations.

[64] *See* Proposing Release at note 436.

[65] The Commission has not identified any ongoing costs. We believe that there will be costs incurred on an ongoing basis, such as additional full-time employees to maintain the data, the costs of ongoing data feeds, and potentially increased printing and mailing costs.

[66] 12b-1 Adopting Release at discussion following "General Requirements" ("Recognizing that new distribution activities may continuously evolve in the future, and in view of the impracticability of developing an all-inclusive list, the Commission maintains that the better approach is to define distribution activities in conceptual terms.").

role and responsibility of the Board to determine the nature of the services that are paid from fund assets, in the exercise of its reasonable business judgment.[67]

In 1998, the ICI, on behalf of several of its members, requested clarification from the Commission's Division of Investment Management (the "Division") on certain legal issues arising from the participation of mutual funds in fund supermarkets, including the use of fund assets to pay financial intermediaries for the services provided to fund shareholders through a fund supermarket.[68] In response, the Division affirmed the Commission's previous position set out above, and clarified the Division's position relative to the use of fund assets to make payments to mutual fund supermarkets (the "Supermarket Letter").[69]

We are concerned, however, that the Proposing Release could be read to imply that the Commission believes that payment to a mutual fund supermarket *always* contains a distribution component[70] and that such language might undermine a Board's determination as to the characterization of the fees paid to fund supermarkets, and whether such payments are for

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[67] 12b-1 Adopting Release at discussion following "Reasonable Business Judgment." Similarly, we appreciate that the Commission has not attempted to delineate permissible distribution expenses in this Proposing Release, recognizing that the Commission's experience with Rule 12b-1 has shown that distribution methods continually evolve. *See* Proposing Release at 46. We are in no way implying that the Commission must diverge from its past reticence to describe with any level of specificity those activities that constitute "distribution". As set out further in this Section IV.A, we believe that is a decision best left to a Board, after considering all of the facts and circumstances.

[68] *See supra* note 14 for a discussion of the benefits of mutual fund supermarkets. Schwab receives compensation from fund companies for the shareholder, sub-accounting and administrative services that Schwab provides to the fund shareholders that transact in mutual fund shares through the Mutual Fund Marketplace. In connection with these services, Schwab generally receives fees from fund companies or their affiliates. These payments are for recordkeeping, shareholder, and other administrative services that Schwab provides as broker and agent for its customers that purchase and hold shares of the funds; these payments are not for, or in any way conditioned on, the performance of promotional, marketing, or similar distribution-related activities on behalf of the fund. Nevertheless, many fund companies currently elect to pay a portion of the servicing fees to Schwab pursuant to a Rule 12b-1 Plan.

[69] Investment Company Institute, SEC No-Action Letter, available at www.sec.gov at 16-17 (October 30, 1998) ("Supermarket Letter"). ("The board of directors of a fund that participates in a fund supermarket plays a critical role. The board is responsible for determining whether any portion of a fund supermarket fee paid (or to be paid) by the fund is for distribution, i.e., services primarily intended to result in the sale of fund shares. Whether or not any particular payment of a fund supermarket fee by a fund is for distribution services or non-distribution services is primarily a question of fact for the fund's board of directors to determine.")

[70] *See, e.g.*, Proposing Release at 43 ("Funds may use the proceeds of the marketing and services fee to pay for, for example, the ongoing costs associated with participation on a *distribution* platform, such as a fund supermarket."). *See also* Proposing Release at 71 ("We anticipate that proposed rule 12b-2 would benefit investors by permitting funds to continue to pay for: (i) follow-up services provided to investors by brokers and other intermediaries after the sale has been made; and (ii) a fund's participation in *distribution channels* that offer investors a convenient way of buying shares, such as fund supermarkets and retirement plans.") (Emphasis added.) *But see id.* at note 153 ("As discussed above, we have previously stated that funds may pay for non-distribution expenses under rule 12b-1 plans. ... Fund expenditures under current 12b-1 plans often pay for a mixture of distribution and administrative services. ... However, to the extent that funds need not rely on proposed rule 12b-2 to charge expenses that can clearly be identified as not distribution related (e.g., sub-transfer agency fees), funds could instead characterize those expenses as administrative expenses and thus keep total asset-based distribution fees within the 25 basis point limit of the marketing and service fee.").

distribution activities or not. In particular, the implied distribution component contained in the language in the Proposing Release may cloud the Board's role in determining the purpose for which such payments are made and the guidance set out in the Supermarket Letter on the use of fund assets to pay for participation in a fund supermarket.

Further, we are concerned that the Proposing Release may call into question a Board's past determination that it is appropriate to pay fees to a fund supermarket or other mutual fund platform out of fund assets *without* adopting a Rule 12b-1 Plan, such as through a shareholder servicing plan or administrative services fee, because at least some part of the services provided may appear, under the language of the Proposing Release, to be for distribution. We appreciate that the Commission has attempted not to jeopardize the use of fund assets for payments to fund supermarkets and other mutual fund platforms (recognizing the disruption that might cause)[71] but are concerned that the implied distribution component in a fund supermarket stated in the Proposing Release may call into question the Board's determination to use fund assets to pay a supermarket fee absent the adoption of a Rule 12b-1 Plan.

Absent clarification from the Commission that the language in the Proposing Release will not affect the views the Division set forth in the Supermarket Letter, a Board may be concerned that a fund is prohibited from using fund assets to pay a supermarket fee unless paid pursuant to newly proposed Rule 12b-2. As a result, a Board might adopt a "defensive" marketing and service fee when considering new funds, or for funds that have already adopted a shareholder services plan or administrative service fee, the Board may feel the need to convert such fee or plan to a MSF. Under the Proposed Rules, any such conversion would require a shareholder vote, regardless of the rate of the current shareholder services plan, at considerable expense to the fund and fund shareholders.

For these reasons, we request that the Commission clarify in the adopting release that it remains the Board's responsibility to determine the nature of the services that are paid for using fund assets, consistent with the Supermarket Letter. We further suggest that the Commission consider allowing conversion of a plan that a Board has determined is not for distribution activities (such as a shareholder services, administrative services or similar plan) to a MSF without a shareholder vote, if the non-distribution plan is no greater than 0.25% and no greater than the fee under the previous shareholder services plan or administrative services plan. This will enable a Board to convert these servicing plans to a MSF without imposing the substantial cost of a shareholder vote on the fund, if the Board determines tat such conversion is appropriate, given the nature of the services.

B. We request clarification on the scope of the guidance the Commission has indicated that it intends to provide to assist a Board.

The Commission has indicated in the Proposing Release that it intends to provide additional guidance in the adopting release to assist Boards considering adoption of an ongoing sales charge. In doing so, the Commission should seek to ensure that any such guidance is consistent with, and does not unintentionally expand, a Board's current duties under Section 15 of the 1940 Act and its general fiduciary obligations, which we believe are sufficient to guide a Board

[71] *Id.* at note 459 and at 37 ("Therefore, we are proposing a new approach to asset-based distribution fees (i.e., 12b-1 fees) that is designed to benefit fund shareholders while minimizing disruption of current arrangements.")

in its review of the use of fund assets for distribution purposes. Further, it is unclear from the Proposing Release whether the guidance proposed by the Commission would be applicable to the Board's consideration of the use of fund assets under Rule 12b-2, or whether such guidance would be applicable only to a Board's consideration of the ongoing sales charge contemplated by Proposed Rule 6c-10. We request clarification as to the scope of any Board guidance the Commission provides in the adopting release.

V. Transition

A. If the new Rule 12b-2 and proposed amendments are adopted as proposed, Schwab requests additional time for transition.

We believe that the eighteen-month time frame proposed in the Proposing Release is unrealistically short, given the scope of the proposal and significant systems work that would be involved in complying with the new requirements. Therefore, Schwab requests that the Commission extend the compliance date to a minimum of twenty-four months.

VI. Conclusion

We appreciate the opportunity to provide comments and thank the Commission for its consideration of the points raised in this letter. If you have any questions about this letter, please feel free to contact the undersigned at 415.667.0660 or Audra Mai at 415.667.0633.

Sincerely,

David J. Lekich
Vice President and Associate General Counsel
Charles Schwab & Co., Inc.

Cc: Andrew J. Donahue, Director, Division of Investment Management
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