May 9, 2005

Via Electronic Filing

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. S7-11-04— Mutual Fund Redemption Fees

Dear Mr. Katz:

Charles Schwab & Co., Inc. ("CS&Co"), along with its affiliates Charles Schwab Investment Management, Inc. ("CSIM"), Schwab Retirement Plan Services, Inc., and The Charles Schwab Trust Company (collectively, "Schwab")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission" or "SEC") Mutual Fund Redemption Fee Rule (the "Rule").[2] The Rule authorizes fund directors to impose a redemption fee of up to two percent when they determine that a fee is in their fund's best interest. The Rule also requires that each fund or its principal underwriter enter into written agreements with its financial intermediaries providing the fund with access to information about transactions by fund shareholders and requiring the intermediary to execute the fund's instructions to restrict or prohibit transactions by any shareholders identified by the fund as having engaged in trading that violates the fund's market timing policies. The Commission seeks comment on whether it should impose uniform redemption fee standards for those funds that decide to impose such a fee, and if so, what those standards should be.

[1] CS&Co and CSIM are wholly-owned subsidiaries of The Charles Schwab Corporation (NYSE: SCH) ("Schwab Corporation"). CS&Co, member SIPC, is registered with the Commission both as a broker-dealer and as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"). CSIM is registered with the Commission and serves as investment adviser to the SchwabFunds®, a family of over 40 mutual funds, with more than $130 billion in assets under management, and the Laudus Funds, a family of 11 mutual funds with more than $2.5 billion in assets under management, both of which are also registered with the Commission under the Investment Company Act of 1940 (the "Investment Company Act"). Schwab offers to customers a wide range of mutual fund investments and information through its family of proprietary funds and its Mutual Fund Marketplace® (the "Marketplace"). The Marketplace allows brokerage customers to purchase and redeem shares of approximately 4,500 third party mutual funds. Schwab also offers customers a selection of variable annuity products that include affiliated and third party funds. The Schwab Corporation, through its operating subsidiaries, serves over 7 million active accounts and is one of the nation's largest financial services firms. The Charles Schwab Trust Company and Schwab Retirement Plan Services, Inc., are wholly owned subsidiaries of Schwab Corporation, and, through Schwab Plan® and third-party administrators, part of Schwab Corporate Services, serve over 2 million retirement plan participants.

[2] Investment Company Act Release No. IC-26782 (the "Adopting Release").

Schwab Applauds the Commission's Adoption of Rule 22c-2

By adopting Rule 22c-2, the Commission struck an appropriate balance by discouraging abusive market-timing through the expanded use of redemption fees, while at the same time avoiding a "one-size-fits-all" approach that would have mandated redemption fees across the board – including when they were neither necessary nor appropriate. The Commission carefully weighed numerous comment letters from investors and various participants in the mutual fund, brokerage and retirement plan industries, and crafted a rule that will go a long way toward diminishing the harmful impact that short term trading can have on long-term investors.

One of the most important benefits of Rule 22c-2, which is discussed by the Commission in the Adopting Release, is the fact that it provides a workable, unambiguous system for allocating responsibility between a mutual fund and its financial intermediary to detect, deter, and prohibit market timing activity by shareholders who invest through financial intermediaries.[3] The Rule allocates responsibility to the intermediary for providing transaction information and transparency to the funds. It assigns responsibility to the fund for monitoring trading activity, identifying any shareholder who violates a fund's market-timing policies and procedures, and instructing the intermediary to prohibit that shareholder from engaging in further harmful activity. The intermediary is then contractually obligated to implement those trading restrictions. As noted in our Original Comment Letter, this is the only practical way to structure a system of enforcing market timing policies and procedures, because intermediaries cannot reasonably be expected to make subjective determinations about whether a particular fund's policies have been violated. Similarly, it would be virtually impossible for an intermediary to keep track of literally thousands of funds' individual policies and procedures.

Schwab Believes that the Commission Should Adopt Uniform Standards with Respect to Redemption Fees in Certain Critical Areas and Maintain Flexibility in Others

There are areas in which uniform standards will enable mutual funds and intermediaries to apply redemption fees in a cost-effective, efficient and fair manner, while at the same time not unduly diminishing the effectiveness of the fees in deterring market-timing and other costly short-term trading. In order to achieve these objectives, uniform standards should enable intermediaries to leverage their existing systems, rather than requiring them to create new, costly ones. In addressing whether uniform standards promote the objectives of efficiency, fairness and clarity, it is important to acknowledge that mutual fund transactions are processed across different types of systems (record keeping, trust, broker-dealer, etc.). Each type of system across different types of intermediaries as well as each system within each type of intermediary has different capabilities and limitations.

In some areas, as the Commission correctly noted in the Adopting Release, uniformity is neither necessary nor advisable. In such areas, uniformity could have the unintended consequence of actually increasing the complexity and cost of implementing redemption

[3] Adopting Release at 16-17.

fees. We address below the Commission's request for comments in the order set forth in the Adopting Release.

a. Share Accounting: Redemption Fees Must Be Assessed On a "First In, First Out" ("FIFO") Basis

Rule 22 c-2 should require that in calculating the mandatory redemption fee, funds treat the shares held in the investor's account the longest as the first redeemed, i.e., on a FIFO basis. This is by far the superior approach for a number of reasons. First, as the Proposing Release[4] and Adopting Release[5] point out, FIFO treatment will minimize the negative unintended consequences when unsuspecting small, long-term investors are charged redemption fees on transactions unrelated to market-timing. This could occur in the context of an automatic investment program, or when a sudden change in circumstances leads to a redemption.

Second, as reflected in the Adopting Release, redemption fee systems currently in place at many broker-dealers and transfer agents assess fees on a FIFO basis. Using FIFO is necessary to calculate the tax impact of redemptions, and to address contingent deferred sales charges ("CDSCs"), which generally are required to be assessed assuming the shares redeemed first are the ones held the longest. Having a separate FIFO system to address tax lot accounting and assess CDSCs, on one hand, and a separate "last in, first out" ("LIFO") system for purposes of assessing a redemption fee on the other hand, will create significant investor confusion, especially because these investors may not be able to distinguish these share lots for themselves. Redesigning these systems to accommodate LIFO would also be very expensive.

Third, the only major benefit of LIFO is that it purportedly would capture more short term trading activity. This assumes that market timers would exploit FIFO systems by making large, long term investments in a fund and then rapidly turn over smaller amounts in order to have a reserve of "aged" shares on hand to use for timing purposes. We question whether that assumption reflects actual market-timing trading patterns, given that a market-timer would have to put at risk a large sum of money in order to engage in smaller market-timing transactions in the same fund. More importantly, funds always have the ability to discourage such activity through other policies and procedures to police market-timing. In addition, funds can discourage that activity by adopting a redemption fee with a holding period of sufficient length.

b. De Minimis Waivers

Schwab supports the Commission's efforts to minimize the potential negative impact of redemption fees on smaller investors when they redeem for purposes unrelated to market-timing activity. We believe, however, that the proposed de minimis exception is not the optimal way to avoid these unintended consequences. Moreover, we are concerned that a

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[4] Proposed Rule: Mandatory Redemption Fees for Redeemable Securities, Release No. IC-26375A ("Proposing Release") at footnote 32.
[5] Adopting Release at footnote 65 and page 24; Proposing Release at footnote 32.

broad de minimis exception presents an opportunity for market timers to "structure" their transactions in smaller amounts over multiple days to avoid being assessed the redemption fee. Adopting a FIFO approach to accounting for share holding periods should significantly reduce the likelihood of inadvertent application of the redemption fee to non-market timing related transactions. We think that some of the other methods discussed below should further minimize the potential for inadvertent application of redemption fees to transactions that are beyond the control of the investor.

The de minimis exception is also problematic because most redemptions at Schwab are based on the number of shares without knowing the price at which the redemption will be made. Consequently, neither the client nor the intermediary would know until after the price was received whether a redemption fee was applicable to a given transaction. Clients should know at the point of sale whether they will be assessed a fee, and charging the redemption fee after the fact is problematic for intermediaries, funds and most importantly, clients.

c. Amount of Redemption Fee; Length of Holding Period

Schwab agrees with the Commission's approach in the Adopting Release that would allow funds flexibility to determine the amount of the redemption fee and the length of the holding period, which are the most important features of a redemption fee. As noted in the Adopting Release, Rule 22c-2 wisely eschews a system that would have permitted multiple tier redemption fees on a single fund, a result that would have been extremely difficult and costly to implement, and very confusing to shareholders.[6] In Schwab's experience, many intermediary systems currently in use are able to address different redemption fee amounts for different funds, but Schwab believes that most if not all systems are unable to assess multiple levels of redemption fees on a single fund. Therefore, we believe that the Commission should impose a uniform standard that would prohibit multiple tier redemption fees on a single fund.

Schwab recommends that the Commission adopt a uniform standard requiring that redemption fee holding periods be calculated based on calendar days, rather than business days, because different funds define business day differently, and investors may be confused as to what constitutes a business day versus a non-business day. For example, some funds that invest in the securities of a foreign country are closed on days that are holidays in the local foreign market. Similarly, most funds are open only on days that the New York Stock Exchange ("NYSE") is open, but some funds are open only on days when both the NYSE and the Federal Reserve Bank are open. For these reasons, counting business days rather than calendar days would make it very difficult for intermediaries to implement a redemption fee and would create a substantial administrative burden.[7] The Commission should also require uniformity with respect to

[6] This would have resulted, for example, if the Proposed Rule had required a two percent redemption fee for five days, and the fund's board voluntarily imposed a lower redemption fee for a longer period of time.
[7] This is consistent with the Commission's approach in Rule 22c-2(a)(1)(i), which requires that the redemption fee period be "no less than seven *calendar* days."(Emphasis added) See also Adopting Release at footnote 37.

calculating the holding period starting and ending on on Trade Date, rather than on Settlement Date. This is consistent with how holding periods are measured for tax purposes. Measuring the holding period from Trade Date provides more certainty and is less likely to result in application of the redemption fee in a situation where an investor mistakenly believes that the holding period has expired.

d. Investor-Initiated Transactions: Schwab Believes that the Proposed Rule Should Exempt Transactions That Are not Within the Control Of The Investor and Therefore Do Not Present Any Opportunity For Abusive Market-timing

The Adopting Release solicits comment on whether redemption fees should be excluded with respect to (i) shares purchased with reinvested dividends or other distributions, and (ii) shares that are purchased or redeemed pursuant to a prearranged contract, instruction or plan, such as purchases, redemptions, transfers or exchanges that are not discretionary transactions for employee benefit plans. Schwab supports the first proposed exception both with respect to shares held in taxable accounts as well as those held in retirement plan accounts, and it supports the second exception with respect to retirement plan accounts. Schwab believes that they are necessary even if the Commission provides for FIFO accounting for share holding periods and a de minimis exception. While the latter two provisions reduce the likelihood of penalizing investors where there is little or no short-term trading risk, they do not by themselves avoid potentially serious unintended consequences. As discussed further below, there are situations where an innocent transaction could be large enough to exceed a de minimis exception, and the FIFO standard would not be available to exclude the transaction from a redemption fee.

Schwab believes that the draconian impact of applying a redemption fee to non-investor initiated transactions argues in favor of a uniform approach in the retirement plan area. At a minimum, the Commission should permit funds on a voluntary basis to exclude non-investor initiated transactions in retirement plans from redemption fees. The Commission requested comment on how such transactions would be identified under a mandatory exception approach. We believe that the retirement plan recordkeeper or custodian would initiate coding of these transactions on their systems, which already can handle some of the exceptions we propose but will need to be upgraded to handle the full range of non-investor initiated transactions contemplated below.[8]

The argument for limiting redemption fees to investor initiated transactions is strongest in the retirement plan context. Many retirement plan transactions are completely unrelated to market-timing because they are automated, outside the control of the participant, or subject to a different regulatory scheme that ensures their integrity, such as hardship withdrawals, which must be determined in accordance with the provisions of the plan document and applicable law. In addition, pretax salary deferral contributions under a 401(k) plan may only be distributed on account of certain conditions, including hardship,

[8] We believe that broker-dealer systems, on the other hand, generally are not equipped to capture the source of buy or sell activity, with the exception of reinvested dividends and other distributions. Developing this capability in broker-dealer systems will be costly and complex, and Schwab does not recommend adopting a uniform exemption for non-investor initiated transactions outside the retirement plan context at this time.

as defined under Treas. Reg. Sec. 1.401(k)-1(d). This regulation imposes a number of criteria to determine whether such a hardship exists, including whether an employee has an immediate and substantial financial need and whether the distribution is necessary to satisfy such need.

Schwab believes that the Commission should clarify that limiting the application of the redemption fee to investor initiated transactions in retirement plans should exclude redemption fees as set forth below:

- **Automated Transactions.** Automatic rebalancing, fee collection, qualified domestic relations orders, redemptions related to automated payroll contributions, and dividend reinvestment transactions should be exempt from redemption fees. The participant generally does not specify which funds are sold when the above transactions are processed. Using these transactions to market time would be very difficult if not impossible.

- **Hardship Withdrawals, Loans and Distributions**. Other customer directed transactions that may produce sale orders, such as a hardship withdrawal, loan request, or a distribution in a retirement plan, should be exempt from redemption fees. These transactions are governed by the applicable plan, the terms and operation of which must be consistent with the Internal Revenue Code and ERISA. Furthermore, the participant typically cannot specify which funds are sold when requesting the above transactions. Using these transactions to market time would be very difficult if not impossible.

- **Independent Advice Provider**. Investment changes that are made by an independent advice provider, outside of the control of the participant and provided as part of a Plan's advice offering, should be exempt from the redemption fee.

- **Service Provider Changes**. The redemption fee holding period should not be reset when a plan sponsor moves its retirement plan assets from one provider to another. For example, if a retirement plan sponsor changes its record keeper, trustee or custodian, the holding period requirement for the funds should be waived for those assets. The decision to change service providers is made by the plan sponsor or other fiduciary, not the participants. Resetting the holding period upon transfer and reinvestment of plan assets would penalize investors through no actions of their own, and such a transfer of assets would be completely unrelated to market-timing activity.[9] Such a change in service providers typically already involves a "blackout period", during which participants in individual account plans are limited in or restricted from the ability to implement trades and to receive loans, distributions and in-service withdrawals. Implementation of a holding period would only serve to

[9] For similar reasons, Schwab believes that clients who transfer their accounts from one broker-dealer to another ("transfer of account" or "TOA") should not have to reset their holding period after the transfer to the new broker-dealer is complete. This situation does not lend itself to market-timing because the timing of completion of the TOA process, which usually exceeds seven calendar days, is outside the control of the investor. In addition, the cost to the investor of the TOA process would discourage abuse.

further disadvantage these retirement plan participants. Similarly, if participants sell out of funds after a plan conversion, they should not be assessed a redemption fee, because the purchase or sale of those funds was outside of their control.

- **Changes in Fund Availability**. If a plan sponsor determines that a specific fund should be liquidated and replaced, or if a retirement plan service provider is no longer able to maintain a specific fund on its platform, requiring liquidation and reinvestment of account assets, the sale should not trigger a redemption fee, because the plan participants did not direct the fund liquidations. Further, the corresponding purchase into the new fund should result in the holding period being waived. The holding period should not be reset because this would penalize investors for actions outside of their control.[10]

e. Unanticipated Financial Emergency. Schwab believes that this exception will be extremely difficult to implement, and therefore it introduces uncertainty and potentially unfairness in the application of the exception. In addition, as with the de minimis exception discussed above, it may present the opportunity for market timers to circumvent redemption fees. This exception would introduce a very labor-intensive process into what should ideally be as automated as possible. Without an objective, specific definition of what constitutes an unanticipated financial emergency, and how an investor should be required to establish that their situation meets that definition, we believe that the exception would be unworkable.[11]

f. Other Exceptions. Schwab supports an exception for funds of funds that rely on section 12(d)(1)(F) of the Act as well as collective trust funds that invest in underlying mutual fund securities on behalf of retirement plans. Such funds engage in periodic rebalancing activity that is designed to provide a targeted asset allocation tied to participants' forecasted retirement date. This type of rebalancing activity is not tied to market-timing, is not subject to participant direction and control, and should not be subject to redemption fees.

g. Variable Insurance Contracts

Schwab agrees with the Adopting Release statement that the rule should not permit assessment of redemption fees on the redemption, pursuant to partial or full contract withdrawals, of shares issued by insurance company separate accounts. Requiring that redemption fees should apply only to transactions initiated by an investor is also appropriate in the variable insurance contract context. This would include automated

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[10] For similar reasons, we believe that discretionary wrap program participants should not be penalized with a mandatory redemption fee if the wrap program sponsor decides to remove a fund from the wrap program and causes a liquidation of the participant's investment.

[11] If the Commission decides to adopt the financial emergency exception, we recommend that the Commission define the exception narrowly to correspond to waivers due to death or disability (as defined in the internal Revenue Code) currently applicable to contingent deferred sales charge waivers.

transactions as a result of periodic redemptions to pay the cost of insurance charges and systematic withdrawal plans.[12]

2. Intermediaries

Schwab Supports the Proposed Rule's Provision for Alternative Methods of Assuring that the Appropriate Redemption Fees Are Imposed

Schwab supports the provision for alternative means of ensuring that redemption fees are assessed properly on transactions conducted through omnibus accounts. In particular, we believe that the third alternative discussed in the Adopting Release provides the most accurate, efficient and cost-effective way for assessing the redemption fee on sub-accounts held at an intermediary. Under that approach, the intermediary would be responsible for assessing the redemption fee and remitting the fee to the fund.

Information-Sharing Between Intermediaries and Funds

Rule 22c-2 requires that each fund or its principal underwriter enter into written agreements with each financial intermediary of the fund. Under these agreements, the intermediary must agree to (1) provide promptly upon request by the fund certain transaction and taxpayer identification information, and (2) execute any instructions from the fund to restrict or prohibit further purchases or exchanges by a shareholder who has been identified by the fund as having engaged in transactions of fund shares in violation of the funds policies regarding short-term trading.

The Commission's approach may impose a significant burden on fund companies in the retirement plan context when numerous small retirement plans hold accounts through one or more intermediaries, not all of which contract directly with a fund or are known by the fund. Some intermediaries contract directly with the fund ("direct intermediaries"), but retirement plans or other entities may only maintain a contract with the direct intermediary rather than the fund. Each of these entities appears to fall within the definition of "intermediary" because it holds securities of record issued by the fund in nominee name or accepts and directs trade instructions on behalf of the plans to the fund directly or through the direct intermediary. One way to address this issue in the retirement plan context is to require that the fund enter into the agreements specified in the rule with the first intermediary in the chain of trade order delivery. In its contract, the fund would require the intermediary to enter into similar agreements that meet the requirements of Rule 22c-2 with any other subsequent intermediaries, or, if any subsequent intermediary refused to execute the agreement, that intermediary would be restricted from transacting in fund shares.

Intermediaries should be required to carry out their contractual duties under Rule 22c-2 in good faith and with reasonable care, but they should not be held to a standard of strict liability. Schwab believes that the Commission should provide some safe harbor guidance in this area. If an intermediary has adopted procedures reasonably designed to

[12] Adopting Release footnote 82.

restrict further purchases by an investor after receiving instructions from a fund, and the investor through fraud or deceit evades those restrictions, then the intermediary should not be liable for that activity unless it knew, or was reckless in not knowing about the investor's evasion of the intermediary's trading restrictions.

3. Recordkeeping

We do not believe that it is necessary for the Commission to adopt an additional recordkeeping requirement that a fund retain copies of the materials provided to the board in connection with the board's approval of a redemption fee. Because Rule 22c-2 explicitly requires that fund boards either approve a redemption fee or determine that the fee is either not necessary or not appropriate, fund companies will have board minutes and resolutions that should provide a clear record of whether they are complying with the rule. In any event, as a practical matter, fund companies typically preserve board of directors or trustees materials already pursuant to the minute book recordkeeping requirement of Rule 31a-1(b)(4).

Conclusion

Schwab supports the Commission's efforts to provide uniform standards for the application of redemption fees. If you have questions about this letter, please contact the undersigned at (415) 667-3461 or at koji.felton@schwab.com.

Sincerely,

Koji E. Felton
Senior Vice President and Deputy General Counsel
CHARLES SCHWAB & CO., INC.

cc: Meyer Eisenberg
Robert E. Plaze