April 4, 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. S7-06-04—Supplemental Request for Comment on Point of Sale and Trade Confirmation Requirements

Dear Mr. Katz:

Charles Schwab & Co., Inc. ("Schwab")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's ("Commission" or "SEC") supplemental request for comment on its proposed point of sale and trade confirmation disclosure requirements (the "Supplemental Proposal").[2] On January 29, 2004, the Commission requested comment on proposed rules 15c2-2 and 15c2-3 (the "Proposed Rules"),[3] which would have required brokers, dealers and municipal securities dealers (referred to collectively herein as "broker-dealers") to provide detailed information to their customers at the point of sale and in trade confirmations regarding the costs and conflicts of interest that arise from the distribution of mutual fund shares, unit investment trust interests (including insurance securities), and municipal fund securities ("Covered Securities").[4] The Supplemental Proposal seeks comments on a number of revisions to the Proposed Rules that are intended to more effectively communicate the required information to investors while balancing the benefits of those disclosures against the costs of compliance.

[1] Schwab is a wholly owned subsidiary of The Charles Schwab Corporation ("Schwab Corporation"). Schwab is registered with the Commission as both a broker-dealer and as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"). Schwab Corporation 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 5,000 third party mutual funds. The Schwab Corporation, through its operating subsidiaries, serves approximately 8 million active accounts and is one of the nation's largest financial services firms.

[2] *See* SEC Release Nos. 33-8544; 34-51274; IC-26778 (Mar. 1, 2005).

[3] *See* SEC Release Nos. 33-8358; 34-49148; IC-26341 (Jan. 29, 2004) (the "Proposing Release")

[4] In addition, the Proposing Release would require broker-dealers to include in trade confirmations additional information about the call features of debt securities and preferred stock. The Proposed Rules would also require mutual funds to include in the fund prospectuses improved disclosure regarding sales loads and revenue sharing arrangements. Schwab submitted a previous comment letter on the Proposed Rules. See Letter from David J. Lekich, Vice President and Senior Corporate Counsel, Charles Schwab & Co., Inc., to Mr. Jonathan G Katz, Secretary, U.S. Securities and Exchange Commission, dated April 12, 2004 (the "Initial Comment Letter").

Schwab applauds the Commission's careful consideration of the thousands of comments that it has received from the mutual fund industry and investors. While Schwab (as well as other commentators) generally supported the goals of the Proposing Release, the comments submitted to the Commission raised significant reservations about the effectiveness of the Proposed Rules and the substantial costs of compliance. It is clear that the Supplemental Request seeks to address those concerns in a thoughtful and judicious manner, and, in many respects, this is a much improved effort to achieve the goals set forth in the Proposing Release.[5] However, in Schwab's view, the Proposed Rules as revised under the Supplemental Proposal continue to present considerable challenges to the industry—and a number of the new proposals create entirely additional issues that must be resolved prior to adoption of any point of sale or trade confirmation disclosure requirements.

Schwab continues to believe that investors should be informed and have ready access to information regarding conflicts of interest that can potentially impact the integrity of the investment advice and quality of investment services investors receive from broker-dealers. Schwab therefore supports disclosure of the existence of potential conflicts of interest that result from "revenue sharing"[6] payments, differential compensation practices, and other arrangements or practices that may inappropriately influence broker-dealers or their associated persons to recommend to investors one Covered Security over any comparable Covered Security.[7] Specifically, Schwab generally supports:

- Point of sale ("POS") disclosure of sales fees, based on either a standardized amount or the actual amount invested, and the existence of broker-dealer conflicts of interest,

[5] Most notably, the Supplemental Proposal recognizes that the Internet can be an efficient and cost-effective medium for delivering disclosures and would incorporate web-based disclosure of "revenue sharing" arrangements and other potential conflicts of interest, which can be complex and deserving of additional context that cannot be provided at POS and on trade confirmations. The Supplemental Proposal also includes use of standardized disclosure as a means of illustrating the impact of sales fees (and potentially other expenses) on investments. Further, under the Supplemental Proposal, the rules would no longer require disclosure of portfolio brokerage commissions and comparison ranges on trade confirmations.

[6] The term "revenue sharing" is typically used to describe arrangements between broker-dealers and issuers or their affiliates pursuant to which broker-dealers receive payments for distribution services (e.g., to promote or give preference to one issuer's security over others). But at times, it is used more generally to describe a wide array of other arrangements pursuant to which the broker-dealer receives compensation for services provided. As discussed in greater detail below, Schwab believes that the term "revenue sharing" should be expressly limited to capture only payments received in return for promoting (i.e., actively distributing or marketing) a fund. In Schwab's view, distribution arrangements, and in particular payments for preferential "shelf space" or to appear on "preferred" lists, present the most significant potential conflicts of interest between a broker-dealer and its customers. This definition would help distinguish these types of payments from more customary compensation a broker-dealer may receive from a fund or its affiliates, such as payments for shareholder services and recordkeeping, which do not present the same, if any, potential conflicts of interest.

[7] As noted in Schwab's Initial Comment Letter, Schwab believes the disclosures required by the Proposed Rules should not be limited solely to broker-dealers. Investors are just as likely to purchase Covered Securities through a bank, insurance company or a retirement plan, which may have similar conflicts of interest. And to the extent the Commission expands the Proposed Rules to require disclosure of all expenses associated with an investment in Covered Securities (and not just distribution costs), there is even more of a reason to impose these same requirements on all financial entities (including issuers) and not just broker-dealers.

provided the Commission adopts exceptions for institutional investors, subsequent transactions, and unsolicited transactions.

- Transaction-specific disclosure of sales fees on trade confirmations.

- Comprehensive, web-based disclosure about "revenue sharing" arrangements, associated person compensation practices, and other compensation arrangements on the broker-dealer's website. While each broker-dealer should have flexibility to present this information in a format it believes most effectively communicates the nature of these arrangements, all such disclosures should be written in Plain-English and designed to be readily understood and assimilated by a reasonable investor.

- Narrative disclosure at point of sale and on trade confirmations that refers investors to the broker-dealer's website for information about the broker-dealer's compensation arrangements and potential conflicts of interest.

Schwab nevertheless has significant concerns about some of the remaining requirements under the Proposed Rules, as well as some of the new requirements set forth in the Supplemental Proposal. Specifically, Schwab opposes:

- Disclosure of sales fees or other expenses based on ***both*** a standardized investment amount ***and*** the amount actually invested (even if the latter must be provided only upon request).
- Comprehensive annual cost disclosure at POS and on trade confirmations. Among other things, Schwab questions whether the industry could implement this requirement in a manner that can ensure the accuracy of the information. Simply put, the issuers who establish, maintain and modify these fees are more capable of accurately and efficiently disclosing this information to investors. And given that this information is already disclosed by issuers in the fund prospectus (or other offering document), comprehensive annual cost disclosure at POS and on trade confirmations is of questionable value in light of the substantial costs of compliance.
- Disclosure of the existence of "revenue sharing" arrangements and differential compensation practices on trade confirmations. Under the Proposed Rules, these disclosures will have been provided at POS and therefore will have limited, if any, value to investors once the transaction is complete.

I. Point of Sale Proposal

A. *Content and Format of Proposed POS Disclosure*

1. Presentation of Sales Fee Disclosures. Schwab supports disclosure of sales fees at POS, stated as both a dollar amount and a percentage of the amount invested, based on a standardized $10,000 investment.[8] In lieu of disclosing the sales fee based on a standardized

[8] In the Supplemental Proposal, the Commission proposes instead that sales fees be disclosed based on a standardized $1,000 investment because investors can more easily calculate the sales fee paid on their actual investment using that standardized amount. Schwab does not oppose using a standardized investment amount of $1,000, but we believe it would be more appropriate to use a standardized $10,000 investment because it is consistent with the standardized amounts used in fund prospectuses to disclose

investment amount, Schwab believes broker-dealers should have the option to disclose this information on the amount actually invested. However, Schwab opposes a requirement to disclose sales fees on ***both*** a standardized investment amount ***and*** on the amount actually invested because, as discussed further below, it will impose unnecessary costs on broker-dealers and investors.

Schwab questions the value of disclosing sales fees based on standardized $50,000 and $100,000 investments. Disclosure of sales fees based on a standardized $10,000 payment will allow all investors to easily calculate the maximum amount of sales fees they will pay on the amount invested. In contrast, disclosure of sales fees based on standardized $50,000 and $100,000 investments will provide additional relevant information *only* to those investors investing amounts in excess of $50,000 or $100,000 (assuming the existence of applicable breakpoints, which may not be the case for all funds).[9] Given the substantial initial and on-going costs associated with providing sales fee disclosure on a single standardized investment amount, Schwab believes the Commission should avoid imposing additional costs for disclosures that may be relevant to some, but not all, investors.[10]

In addition to disclosing sales fees at POS based on a standardized investment amount, the Commission is proposing that broker-dealers also be required to disclose *only upon request* the sales fee paid on the actual amount invested. This additional information would be calculated and inserted manually into the POS disclosure form by the associated person effecting the purchase transaction. As an initial matter, Schwab is concerned about the potential for human error when any information is manually inserted into a disclosure document. There is a high likelihood that in some cases the information presented will be incorrect and investors unintentionally misled. And while Schwab appreciates that this requirement is an effort by the Commission to mitigate the compliance costs associated with sales fees disclosures,[11] we fail to see how having to disclose sales fees based on both standardized ***and*** transaction-specific investment amounts for some, but not all, transactions helps minimize compliance costs. In fact, this disclosure only adds to those costs because broker-dealers will need to develop a POS disclosure model that can provide ***both*** standardized ***and*** transaction-specific disclosures. This seems particularly unnecessary given that disclosure of sales fees based on either a standardized

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mutual fund expenses (*See* Item 3 in Form N-1A), and many mutual funds and broker-dealers require initial investments exceeding $1,000.

[9] The existence of potential breakpoints are disclosed in the fund prospectus and many broker-dealers are currently proactively providing additional disclosures about breakpoints to their customers based on the recommendations of the joint NASD/Industry Task Force on Breakpoints. *See* Report of the Joint NASD/Industry Task Force on Breakpoints (July 2003).

[10] For similar reasons, Schwab believes disclosure of any dollar amounts received pursuant to "revenue sharing arrangements," such as dealer concessions, should also be expressed based only on a standardized investment of $10,000 (and not on $1,000, $50,000 and $100,000 standardized amounts as suggested by Attachment 15 to the Supplemental Proposal).

[11] *See* Supplemental Release, note 17 (stating that "the proposed new forms are intended to strike a balance between the use of standardized disclosure and the ability for interested investors to receive more personalized information.").

or transaction-specific amount is sufficient to inform investors about the impact of sales fees on their investment. [12]

As noted above, while the Commission should require disclosure of sales fees at POS based only on a standardized investment amount, Schwab believes that broker-dealers should have the flexibility to provide transaction-specific sales fees in lieu of sales fees based on a standardized investment. For some broker-dealers, it may be more or equally cost-efficient to provide transaction-specific disclosure of sales fees to their customers than disclosure based on a standardized investment amount (for example, if they currently have the capacity to provide transaction-specific disclosure through their existing operating systems). It would be unreasonable to require those broker-dealers to incur costs to provide disclosure on a standardized investment amount, when the broker-dealer can more readily and more cost-efficiently provide sales fee disclosure on the actual amount invested.

2. Comprehensive Annual Cost Disclosure. Schwab strongly opposes comprehensive annual cost disclosure at POS. As an initial matter, it is important to note that the goals of the Proposed Rules have changed under the Supplemental Proposal. In the Proposing Release, the Commission stated that the Proposed Rules were designed to disclose information about the costs and conflicts of interest associated with the *distribution* of Covered Securities.[13] Although disclosure of distribution-related costs at point of sale and on trade confirmations as proposed by the Commission was impracticable and costly, its intention was at least consistent with the goal of enhancing disclosures about potential broker-dealer conflicts of interest.

Based on investor testing conducted by the Commission, the Commission subsequently determined that investors were less concerned about the amount of distribution fees received by the broker-dealer and more concerned about the overall costs incurred in investing in Covered Securities.[14] Consequently, the Proposed Rules would now require broker-dealers to disclose comprehensive information about all the costs of owning the Covered Securities and not just the distribution and servicing costs paid to broker-dealers. This reflects a significant shift from the goals of the Proposing Release as originally stated by the Commission.[15] As revised, the Proposed Rules would now place the onus of disclosing mutual fund expenses (and expenses of other Covered Securities) on broker-dealers—disclosures traditionally, and in Schwab's view more appropriately, the responsibility of issuers.

As an initial matter, Schwab questions how a broker-dealer would obtain and periodically update fund expense information. While certain operating expenses may be available through

[12] The Commission should also note that it is impossible to provide transaction-specific disclosure of sales fees on certain transactions (e.g., "same-day" exchange of mutual fund shares).

[13] *See* Proposing Release at 4, 6-7.

[14] *See* Supplemental Release at 11 and note 61 and accompanying text.

[15] The Supplemental Release includes substantial changes to the Proposed Rules. Schwab is concerned that the 30-day period for commenting on the Supplemental Release will not give the industry sufficient time to fully and carefully consider how the Proposed Rules, as modified, will impact investors, broker-dealers and the industry. Schwab anticipates that in light of these substantial changes, the Commission will officially re-propose the Proposed Rules and allow sufficient time for final comment.

vendors, other components of the annual fee may not be readily available.[16] But even if readily available, information broker-dealers receive from third party data providers (and even the issuers themselves) is sometimes incorrect. Schwab is concerned that if the information the broker-dealer receives or discloses is materially inaccurate, the broker-dealer will be unfairly subject to potential regulatory and civil liability.[17] Moreover, if the data provided to the broker-dealer is inaccurate, there may be a difference between the information provided by the broker-dealer and that provided by a mutual fund in its prospectus, potentially confusing and further misleading investors.[18] The issuer is the definitive authority on expenses and, in Schwab's view, should remain the single source of that information. Imposing an obligation to disclose fund expenses on broker-dealers is impracticable, costly, and may ultimately mislead more than help investors.[19]

The Commission should also take note of the additional consequences and complexities of this requirement. Schwab supports disclosure of sales fees and the existence of potential conflicts of interest at POS because this information is known and certain at the time of sale. However, disclosure of annual costs at POS is, as the Commission recognizes, only an estimate; it is forward-looking and not an actual statement of what fees the investor may in fact incur. Disclosing estimates alongside other known and certain transaction costs only increases the potential for investor confusion. Further, the existence of fee waivers and expense limitation agreements adds another layer of complexity to the proposed disclosures. Should broker-dealers disclose the information net or gross of such fees? What if the expense limitation agreement is due to expire during the first year after purchase? Or a week after purchase? To ensure that

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[16] This is particularly the case with respect to 529 college savings plans and variable annuity products. Schwab is unaware of any industry system that would provide this information in an automated fashion to broker-dealers.

[17] The Commission seeks comment on whether broker-dealer concerns about potential liability for non-fraudulent disclosures should be addressed through the provision of a safe harbor. If any part of the Proposed Rules would place an obligation on broker-dealers to disclose information related to fund expenses, Schwab strongly urges the Commission to adopt a safe harbor to protect broker-dealers from such liability. If the Commission fails to adopt a safe harbor, particularly given the strong likelihood that inaccurate disclosure of fund expenses, despite the best of intentions, will occur from time to time, broker-dealers may be reluctant to make mutual funds available for purchase to their clients.

[18] If the Commission requires broker-dealers to deliver fund expense information, Schwab urges the Commission to develop and require the use of industry standard automation for disseminating the necessary POS data to intermediaries (e.g., through the use of NSCC's Mutual Fund Profile Service) to help ensure the delivery of timely and accurate data. Use of industry standard automation would potentially reduce industry costs and increase the accountability between funds and intermediaries by reducing the dependency on third party vendors who may be able to provide the data, but ultimately cannot be held accountable for the accuracy of the information they provide.

[19] Schwab further questions the value of providing a breakdown of the expenses attributable to management, distribution and other expenses. This adds an unnecessary layer of additional compliance costs and simply clutters the POS document. Disclosure of the total annual fee is by itself sufficient to illustrate the impact of annual expenses on an investment. If an investor wants more information about the components of the total annual fee, the investor can refer to the fund's prospectus. With respect to 529 college savings plans and variable annuity products, Schwab similarly questions the practicality of requiring disclosure of fees and expenses of the underlying securities in which those products invest. Such POS disclosures, which could be extensive depending on the number of funds in which these products typically invest, may ultimately confuse and mislead—rather than inform—investors. Again, if investors want more information about the expenses associated with the underlying securities held by these products, the investor can refer to the offering document.

investors are not misled as to annual fund expenses as a result of such agreements broker-dealers would need to include additional narrative disclosure at POS noting the existence and nature of these agreements—just as issuers already do in their prospectuses—only adding to the logistical challenges and compliance costs associated with implementing the proposed rule.[20]

Even if the above issues can be adequately addressed, Schwab remains concerned about the substantial costs disclosure of annual fund expenses will impose on broker-dealers—costs that will ultimately be borne by investors. Schwab estimates that its one-time implementation costs to provide annual cost disclosure at POS would equal approximately $2 million and that its annual recurring costs would exceed $1.4 million. Schwab believes the value of broker-dealer disclosure of annual costs at POS is questionable in light of the magnitude of these costs, particularly as this information is already made available to investors in the fund prospectus or offering document.

As a matter of policy, Schwab questions whether it is appropriate to emphasize fund expenses at POS. Expenses are not the sole or even primary factor that investors should consider prior to purchasing a mutual fund or other Covered Security. In fact, information about a Covered Security's investment objectives, strategies and risks, as well as historic performance, are equally if not more essential for investors to consider prior to purchase. Because the Commission would require disclosure of annual fund expenses, investors may inappropriately place too much weight on those expenses as a factor in their investment decision. Moreover, disclosure of only fund expenses does not provide adequate context to evaluate whether those expenses are reasonable given the fund's asset category and its investment objectives, strategies and risks.

In recent public statements, the SEC has noted its intent to conduct a comprehensive review of the mutual fund disclosures regime to determine how to maximize the effectiveness of disclosures to investors.[21] Given the substantial costs of compliance with disclosure of annual fund expenses and uncertainty around whether this information can be timely and accurately delivered by broker-dealers, it seems particularly imprudent to adopt this proposal prior to completion of this comprehensive review. It would be unfortunate if the Commission were to impose costly disclosure obligations on broker-dealers now, only to find later that, based on a more comprehensive analysis, those disclosures were not the most effective way to inform investors about mutual fund expenses.

Finally, Schwab strongly opposes disclosure of annual account fees. These fees are not related to the costs of any specific Covered Security transaction. In fact, brokerage account fees are paid regardless of whether any Covered Security is purchased by the investor. In addition, account fees are already disclosed to investors by broker-dealers in account agreements and account applications.

3. Disclosure of "Revenue-Sharing Arrangements" and Other Potential Conflicts of Interest. Schwab supports POS disclosure of the existence of arrangements between

[20] If the Commission nevertheless decides to require disclosure of fund expenses, it should only require disclosure on standardized $10,000 amount, for the same reasons it should use such amount for disclosure of sales fees. *See supra* note 8 and accompanying text.

[21] *See* Remarks Before the Mutual Fund and Investment Management Conference, Chairman William H. Donaldson (Mar. 14, 2005) at 2-3; *see also* Remarks Before the ICI 2004 Securities Law Developments Conference, "Mutual Fund Regulation: What Happens Next," Paul F. Roye, Director, Division of Investment Management, U.S. Securities and Exchange Commission (Dec. 6, 2004) at 5-6.

broker-dealers and mutual funds and their affiliates that create potential conflicts of interest between the broker-dealer and its customers. Under the Supplemental Proposal, it appears that the Proposed Rules would generally achieve this goal by requiring broker-dealers to disclose at POS whether (a) a fund or its affiliates pay the broker-dealer extra to promote the fund over other funds; (b) the broker-dealer pays its personnel more for selling the fund over other funds it makes available; and (c), the broker-dealer pays its personnel more for selling Class B shares than for other shares classes of the same fund. These disclosures would be supplemented and enhanced by the more detailed disclosure about "revenue sharing" arrangements broker-dealers would be required to provide under the proposed rule on their websites.

Schwab recommends, however, that the Commission clarify that the term "revenue sharing arrangements" is intended to cover arrangements pursuant to which broker-dealers receive compensation for promoting—i.e., actively distributing or marketing—a Covered Security, including arrangements where the Covered Security is given preferential "shelf-space" or placed on the broker-dealer's "preferred" securities list. Schwab believes this is consistent with the Commission's intent as the revised POS disclosure templates require disclosure of revenue sharing arrangements that constitute "extra" payments to "promote" one fund over other funds. Further, this distinguishes these types of "revenue sharing" payments, and the potential conflicts of interest they pose, from other types of payments received by broker-dealers that do not create the same, if any, conflicts of interest (e.g., payments for recordkeeping, shareholder services, and other transfer agent-like services, as well as networking fees and similar transaction processing costs). Of course, payments for shareholder and transaction services would nevertheless be disclosed, along with other compensation arrangements, on the broker-dealer's website in accordance with the Proposed Rules.

B. *Exceptions from Proposed POS Disclosure Requirements*. The Commission should revise the Proposed Rules to provide exceptions from the POS disclosure requirements for institutional investors, subsequent purchases and unsolicited transactions.

1. Exception for Institutional Investors. The primary purpose of the Proposed Rules is to protect investors from potential conflicts of interest that could affect the objectivity of recommendations made by the broker-dealer or its associated persons. Schwab believes that institutional investors are sufficiently sophisticated to ask the appropriate questions to identify and understand the nature of any potential conflicts of interest. Consequently, we believe that most institutional investors would find the standard disclosures required by the proposed rule to be unnecessary or of little benefit. Schwab therefore supports an exception from the POS disclosure requirements for institutional investors. For purposes of this exception, the Commission should adopt the definition of "institutional investor" under NASD Rule 2211(a)(3), which includes, among other entities, banks, insurance companies, registered investment companies, and registered investment advisers.[22]

[22] NASD Rule 2211(a)(3) defines "institutional investor" as any person described in Rule 3110(c)(4), regardless of whether that person has an account with an NASD member, any governmental entity or subdivision thereof, any employee benefit plan that meets the requirements of Section 403(b) or Section 457 of the Internal Revenue Code and has at least 100 participants, but does not include any participants of such a plan; any qualified plan, as defined in Section 3(a)(12)(C) of the Securities Exchange Act of 1934, that has at least 100 participants, but does not include any participant of such a plan; any NASD member or registered associated person of such a member; and any person acting solely on behalf of any such institutional investor. NASD Rule 3110(c)(4) includes banks, savings and loan associations, insurance companies, investment advisers registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission, and any other entity (including natural persons) with total assets of at least $50 million.

2. Exception for Subsequent Purchases. POS disclosure of sales fees and potential conflicts of interest (as well as fund expenses) on subsequent purchases provides little benefit to investors, and what little value such disclosure may provide is far outweighed by the substantial costs of providing these disclosures on an on-going basis. A broker-dealer will be required to make these disclosures to the investor when the investor first purchases a Covered Security. In addition, the investor will be referred to the broker-dealer's website for more information about compensation arrangements and potential conflicts of interest and will receive a fund prospectus along with their trade confirmation also containing information about sales fees and fund expenses. Existing investors will receive annual prospectuses and periodic supplements disclosing any changes in the fund sales fees or expenses. Existing investors will also have the opportunity to periodically review the broker-dealer's website. Given the wealth of information already provided to existing shareholders, providing these same disclosures again on subsequent purchases is unnecessary. An exception for subsequent purchases is particularly appropriate where the customer is enrolled in an automatic investment or money market sweep program.

3. Exception for Unsolicited Transactions. Schwab believes that a broker-dealer should be required to disclose at POS conflicts of interest that could influence the objectivity of the recommendations it makes to investors. However, these conflicts of interest do not exist when an investor makes an independent investment decision because the investor's decision to purchase a particular security has not likely been influenced by the broker-dealer.[23] Consequently, Schwab recommends that the Commission revise the Proposed Rules to provide an exception for unsolicited transactions.

In the Supplemental Proposal, the Commission states that even when a broker-dealer does not recommend a particular Covered Security, investors may still benefit from disclosure of fund expenses.[24] Even assuming that disclosure of fund expenses at POS as proposed is feasible, it is questionable whether the benefits of requiring such disclosures outweigh the costs of providing this information at POS to self-directed investors. This is particularly the case given that broker-dealers often provide links to electronic versions of fund prospectuses on their web-sites, or provide certain fund expense information on their websites. Schwab believes that most, if not all, self-directed investors conduct at least some degree of research prior to investing in a mutual fund. As long as unsolicited investors have access to the fund's prospectus or other information reflecting the fund's total expense ratio on the broker-dealer's website, Schwab believes that it is unnecessary to impose burdensome compliance costs on broker-dealers only to provide self-directed investors with access to this information again at POS.[25] And, of course, unsolicited investors will have access to the broker-dealer's website

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[23] As noted in the Initial Comment Letter, it is possible that certain "revenue sharing" arrangements could potentially influence an independent investor's investment choice even when there is no direct interaction with an associated person of the broker-dealer—for example, when a broker-dealer receives payment to include a mutual fund on its "preferred" mutual fund list and makes that list publicly available. In these cases, Schwab believes product-specific disclosure (e.g., disclosure on the "preferred" mutual fund list itself) is the most effective and efficient way to alert all investors about these conflicts. Under the Supplemental Proposal, these conflicts of interest would also be disclosed on the broker-dealer's website.

[24] *See* Supplemental Release, note 40.

[25] If the Commission still has concerns about unsolicited investors not having access to fund expense information prior to purchase, it can condition a broker-dealer's reliance on the unsolicited investor exception on the availability of the fund prospectus or other document reflecting fund expense information on the broker-dealer's website.

which under the Proposed Rules would need to include disclosures about the broker-dealer's "revenue sharing" and other compensation arrangements, and the existence and nature of any potential conflicts of interest.

Schwab also supports the use of narrative disclosure on trade confirmations that refers investors to the broker-dealer's website for more information about broker-dealer potential conflicts of interest. This additional disclosure will alert both unsolicited *and* solicited investors to the existence of this information on the broker-dealer's website.

Finally, we note that an unsolicited investor exception can help mitigate the substantial costs of implementing the proposed POS disclosures and resolves other challenges raised by the proposed rule. For example, costs associated with telephonic transactions will be reduced significantly because broker-dealers will not need to read back lengthy POS disclosures to self-directed investors placing trades through the broker-dealer's call centers. For certain broker-dealers, particularly fund supermarkets, the costs savings will be substantial.[26] In addition, the POS disclosure requirements may make operation of automated telephone systems impracticable for broker-dealers given the complexity of the programming that would be required by the Proposed Rules and the costs associated with that programming. The absence of automated phone channels would adversely impact investors who take advantage of these alternative order entry channels.[27] If the Commission adopts an unsolicited investor exception to the Proposed Rules, however, broker-dealers could avoid costly re-programming of automated phone systems because they are generally used exclusively by self-directed investors.[28]

C. *Disclosure of All Share Classes "Under Consideration".* Schwab strongly opposes requiring POS disclosures for all share classes "under consideration". As an initial matter, the Commission has not clearly defined "under consideration," and the absence of a definitive standard broker-dealers can use to determine when a share class is "under consideration" will create ambiguity and uncertainty in the compliance process. It is also unclear whether this requirement would apply to multiple funds "under consideration," as well as funds with multiple share classes. The fundamental purpose of POS disclosure is to ensure that the investor understands key information about the Covered Security the investor actually purchases. Requiring POS disclosure for multiple share classes or funds may ultimately confuse investors

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[26] Schwab estimates that it could reduce its annual ongoing POS compliance costs by at least $800,000 if the Commission were to adopt an unsolicited investor exception given that a large majority of trades effected through its Marketplace are placed by unsolicited investors.

[27] Schwab urges the Commission to carefully consider how the Proposed Rules will impact a broker-dealer's ability to make Covered Securities available for purchase through different channels (e.g., by phone, web, or through automated telephone systems) given the burdens they impose. If the Commission adopts the rules as currently proposed, Schwab anticipates that many broker-dealers may restrict the channels through which investors can purchase Covered Securities, particularly with respect to purchases effected over the telephone and certain automated channels that, though not widely used by all investors, provide some investors with a valued alternative means to place mutual fund transactions.

[28] Schwab does not believe the unsolicited investor exception will increase the possibility that a broker-dealer will intentionally mark a solicited trade as "unsolicited," or otherwise seek to intentionally avoid providing the required disclosures. First, NASD Rules would prohibit such a mischaracterization. But Schwab also believes the potential regulatory and civil liability that broker-dealers may incur for intentionally mischaracterizing such transactions will serve as a significant deterrent.

rather than clarify their understanding of their mutual fund investments. It will also substantially increase compliance costs because it may unnecessarily prolong interactions between the broker-dealer and the investor, particularly during transactions effected over the telephone.

D. *Timing of POS Disclosures*. The Commission requests comment on the proposed definition of "point of sale"—specifically on whether the timing for delivery of POS disclosures should be "immediately prior" to the acceptance of the order, or earlier in the sales process to allow investors sufficient time to consider the information when making investment decisions. It is important that the definition of "point of sale" provide a measurable standard of compliance so that broker-dealers can be certain they are meeting their obligations under the Proposed Rules. To that end, Schwab recommends that a broker-dealer's obligation be satisfied if the POS disclosure is made any time "prior to" placement of the order, provided the information has not materially changed between when it was initially disclosed and when the order was placed. "Placement" is intended to mean the time at which the order is entered into the broker-dealer's trading system for processing.

F. *Additional General Comments*. Schwab supports disclosure of sales fees and the existence of potential conflicts of interest at POS, but does not believe the Commission should require that these disclosures be paper-based. Paper-based disclosure is not essential to providing effective POS disclosure of sales fees or the existence of conflicts of interest; in fact, with respect to certain types of transactions, investors would likely view paper-based disclosure as an encumbrance (e.g., transactions effected via telephone or the mail). POS disclosure for telephone transactions will need to be provided orally, and consequently tailored to include only its essential components.[29] Again, in Schwab's view these essential components are the sales fee and the existence of conflicts of interest, both of which can be delivered to investors orally in a reasonably cost-effective manner. Schwab sees no reason to differentiate between the ways these disclosures are delivered in oral transactions as opposed to any other transaction. While written disclosure may be the most effective way to deliver the required information through some channels (e.g., the web), it may not be for other channels, or the value of providing that information in writing will not outweigh the costs of doing so relative to the effectiveness and efficiency of providing the same information orally.[30] In any event, the Commission should not require that paper-based disclosures be signed and dated by investors.[31]

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[29] The Commission correctly recognizes the need to streamline disclosures in oral transactions. *See Supplemental Release* at 29. Unfortunately, however, the proposed content of those streamlined disclosures are still too burdensome to provide orally at POS (e.g., disclosure of sales fees based upon a standardized investment amount and, upon request, the amount actually invested).

[30] The costs of providing paper-based disclosure will be particularly substantial for fund supermarkets, which will need to develop different templates for each of the thousands of funds they make available to their customers, as well as for any 529 plans and variable annuity products they also make available. If broker-dealers are not provided with the flexibility to deliver POS information either orally or in writing—to best ensure that the disclosures are delivered efficiently and cost-effectively—Schwab would instead advocate that disclosures of sales fees be provided only on trade confirmations or via the web, and that disclosures regarding the existence and nature of broker-dealer conflicts of interest be provided solely via the web. Otherwise, Schwab believes that most broker-dealers will in some form or another limit the manner in which its customers can purchase mutual funds, or opt to feature alternative investment options in place of mutual funds.

[31] If a broker-dealer establishes and maintains policies and procedures reasonably designed to ensure that the broker-dealer and its associated persons are providing the required disclosures, Schwab believes such procedures should be sufficient to evidence compliance with the Proposed Rules. Absent fraud, an investor

Schwab supports providing broker-dealers with the flexibility to omit non-applicable categories from POS (as well as trade confirmation) disclosures. This flexibility will enable broker-dealers to provide the disclosures relevant to the transactions they effect for their customers, without incurring costs associated with providing irrelevant disclosures.

Schwab also believes that broker-dealers should not be required to deliver POS disclosures to investors purchasing annuity products. Investors have the opportunity to review and cancel the annuity contract within a certain time after purchase (often generally referred to as a "free look period"). Rather than requiring POS disclosure to these investors, Schwab believes it would be equally effective and less costly to require broker-dealers to provide relevant annuity disclosures to these investors along with the annuity contract. This will give the investor ample time to consider the impact of these disclosures on their investment decision. If the investor subsequently decides to cancel the contract, whether based on the information included in the required disclosures or for any other reason, the investor could do so generally with minimal, if any, economic consequences.[32]

II. Trade Confirmation Disclosure

A. *Presentation of Sales Fee Disclosures*. Schwab supports disclosure of transaction-specific sales fees on the trade confirmations, stated both as a dollar amount and as a percentage of the amount invested. Broker-dealers should have flexibility to determine how to disclose this information on the trade confirmations to minimize the costs associated with making this change.[33]

However, Schwab does not support disclosure of the contingent deferred sales charges (CDSC) on the trade confirmation for mutual fund purchases. The CDSC schedule is provided to the investor in the fund's prospectus which is delivered along with the initial purchase confirmation and subsequently via annual updates and supplements. Schwab is also concerned that the potential for inaccuracies between the CDSC schedule stated on the purchase confirmation by the broker-dealer and that set forth in the prospectus by the fund (or ultimately charged to an investor) could confuse and mislead investors. Finally, unlike sales loads which are *actually* incurred on purchases of Class A shares, investors may only *potentially* incur a CDSC on the sale of Class B and other back-end load shares. In Schwab's view, broker-dealers should only be obligated to disclose on trade confirmations fees actually incurred on a given transaction, not

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should not have a right of rescission for a broker-dealer's failure to provide POS disclosures, particularly given that many of the proposed disclosures are already provided in the fund prospectus or will be provided on the broker-dealer's website (to which the investor will be referred via the trade confirmation).

[32] If the Commission nevertheless requires POS disclosure for variable annuities, Schwab would oppose disclosure of surrender charges at POS. As discussed below (*See infra* note 34 and accompanying text), these charges are not incurred at the time of purchase, may not apply at all, and only serve to confuse investors about the fees that are associated with the actual purchase transaction.

[33] Attachment 8 to the Supplemental Release shows the amount invested per share based on net asset value and then discloses the sales fee in both dollars and as a percentage of the amount invested. It is unclear whether the Commission is contemplating eliminating the concept of sales loads being built in to the public offering price (POP) to create greater transparency of the sales charge, and the Commission should seek to clarify whether that is the case. If so, there may be additional costs and complexities to intermediaries, funds, and the industry associated with implementing the Proposed Rules, particularly with respect to the development of automated systems that can deliver the required information.

fees that potentially could be incurred.[34] For similar reasons, Schwab opposes disclosure of surrender charges on a variable annuity purchase confirmation.

B. *Comprehensive Annual Cost Disclosure*. Schwab strongly opposes comprehensive annual cost disclosure on trade confirmations for all of the reasons it opposes disclosure of this information at POS. But, in addition to those objections, the disclosure of annual cost disclosure on trade confirmations is redundant and therefore unnecessary. A fund prospectus accompanies all trade confirmations for initial transactions. The prospectus already includes comprehensive disclosure of fund expenses. As noted in our discussions of the subsequent purchase exception, repeating information in a trade confirmation to existing investors is also unnecessary because these investors have already received a prospectus and all supplements and updates thereto.[35] Schwab also questions the value of disclosing this information to investors after the purchase has already been effected.[36] Simply put, what little benefit this requirement arguably provides to investors is far outweighed by the substantial costs of compliance.[37]

C. *Disclosure of "Revenue-Sharing Arrangements" and Other Potential Conflicts of Interest*. While Schwab supports POS disclosure of the existence of potential conflicts of interest, Schwab strongly opposes disclosure of the existence of these conflicts on trade confirmations because (1) it does not provide any information not already disclosed at POS and therefore would be redundant; and (2) disclosure of potential conflicts of interest is not meaningful or useful when provided to investors after they have made their investment decisions.[38] The Commission should, however, require broker-dealers to include a legend on

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[34] In addition to CDSCs, there are a number of other fund and brokerage fees that an investor could potentially incur the sale of fund shares—for example, redemption fees. Requiring disclosure of some of these potential costs, and not others could mislead investors. Requiring disclosure of all potential costs clutters the trade confirmation with information not necessarily relevant to the investor's purchase transaction—and also unnecessarily adds to the costs of compliance because all of these potential fees are disclosed to the client in the fund's prospectus or in the broker-dealer's disclosure documents (for broker fees), and in some cases on the broker-dealer's website.

[35] If the Commission believes that the prospectus (or other offering document) does not effectively disclose annual expenses, it should seek to enhance the effectiveness of those disclosures rather than shift the obligation to make those disclosures to broker-dealers. To that end, Schwab applauds the Commission's intention to conduct a comprehensive review of the entire disclosure regime to determine ways to implement more effective disclosures. *See supra* note 21 and accompanying text.

[36] There are also logistical and costs concerns about providing the required trade confirmation disclosures with respect to transactions made pursuant to automatic investment or money market sweep programs. These transactions are currently confirmed on the investor's account statement. Re-designing account statements to disclose the information required under the Proposed Rules for these transactions would have substantial cost implications for broker-dealers. Transactions made pursuant to automatic investment or money market sweep programs should be exempt from any trade confirmation disclosure requirements (as they would be under the subsequent purchase exception for POS recommended by Schwab).

[37] Schwab estimates that its one-time implementation costs to provide annual cost disclosure trade confirmations would equal approximately $1.5 million and that its annual recurring costs would exceed $50,000.

[38] Arguably, this disclosure may have some limited value to investors, permitting them to confirm the accuracy of the disclosure made by the broker-dealer at point of sale. However, Schwab does not believe that the value of this redundant disclosure would outweigh the substantial costs of compliance. In addition,

trade confirmations that refers investors to the website for additional information about "revenue sharing," differential compensation and other conflicts of interest.[39]

D. *Additional General Comments*. Under the Supplemental Proposal the Commission would no longer require disclosure of comparison ranges. However, it appears that the Commission may be considering imposing such a requirement at a later time.[40] As discussed in Schwab's Initial Comment Letter, disclosure of comparison ranges would be both difficult and costly to implement, and, depending on the particular disclosure requirements, may ultimately mislead rather than inform investors about mutual fund costs. But if the Commission is still considering whether to require disclosure of comparison ranges or a similar requirement, Schwab strongly urges the Commission to delay adopting any aspect of the Proposed Rules until it makes a final determination. Regardless of what final form the Proposed Rules take, broker-dealers will incur significant costs in implementing those rules. After adopting the Proposed Rules, if the Commission then requires broker-dealers to disclose comparison ranges at POS or on trade confirmations, broker-dealers will very likely incur programming and related costs they could have otherwise avoided had all the POS and trade confirmation disclosure rules been adopted at one time. Schwab urges the Commission to avoid a piecemeal approach to POS and trade confirmation disclosures as such an approach will impose unnecessary costs on broker-dealers—costs that are ultimately borne by investors.

III. Web-Based Disclosure of "Revenue Sharing" and Other Potential Conflicts of Interest

Schwab supports web-based disclosure of broker-dealer "revenue sharing" and other compensation arrangements that pose potential conflicts of interest. However, Schwab does not believe that the Commission should mandate the manner in which those disclosures are made (e.g., by requiring all disclosures in a tabular format). "Revenue sharing" and other compensation arrangements, and the payments made pursuant to them, are often complex. A certain degree of narrative disclosure will be required to put those arrangements in appropriate context so that the investor can clearly and readily understand the nature and extent of the potential conflict of interest. The Commission should allow broker-dealers the flexibility to determine the best way to meet their disclosure obligations.[41] Providing this flexibility would also help broker-dealers control compliance costs.[42] To address concerns that conflict of interest disclosures will

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investors can confirm the information disclosed at POS by reviewing the additional disclosures broker-dealers will be required to maintain on their websites.

[39] In addition, broker-dealers should be required to mail the web-based disclosures to customers upon request, to ensure that investors who do not have computer or Internet access can still obtain this information.

[40] *See* Supplemental Release, note 24.

[41] While we believe the Commission should allow flexibility in the manner in which these disclosures are made, the content of these disclosures should of course be mandated by the Proposed Rules. In addition, Schwab would support provisions requiring the order in which this content should be disclosed (e.g, dealer concessions first, sales-based arrangements next, followed by recordkeeping and other shareholder services arrangements, etc.). Essentially this is similar to the approach taken under Form N-1A, and would provide investors with some uniformity in presentation among different broker-dealer websites.

[42] For example, Attachment 15 to the Supplemental Proposal would require disclosure of the percentage of the sales load retained by the broker-dealer. As proposed, the broker-dealer would be required to create a

potentially be undermined by excess verbiage, the Commission should require that all disclosures be written in Plain-English and designed to be readily understood and assimilated by a reasonable investor.

In general, Schwab does not support disclosure of specific dollar amounts as would be required under the Proposed Rules. Depending on the nature and scope of the broker-dealer's "revenue sharing" or other compensation arrangements, disclosure of specific dollar amounts could be misleading—especially when one type of arrangement presents a greater conflict of interest than others.[43] And, in particular, a requirement to disclose expected payments in specific dollar amounts may misstate the potential conflict of interest (e.g., when such payments received are based on a percentage of fund assets). The primary purpose of the web-based disclosures should be to inform investors about the *existence* and the *nature* of compensation arrangements and practices that create potential conflicts of interest. Given that disclosures of specific dollar amounts have the potential to mislead investors, Schwab is not clear on how disclosure of these amounts for all compensation arrangements helps achieve this purpose.

Instead of requiring disclosure of specific dollar amounts paid for all compensation arrangements, the Commission should require disclosure of only the maximum fee or, alternatively, the range of fees a broker-dealer receives with respect to each type of compensation arrangement it enters into with issuers or their affiliates. This disclosure, along with the additional narrative disclosure describing the arrangements, will effectively inform investors about the nature and degree of any potential conflicts of interest. Additionally, it will be far less costly to maintain and update. The web-based disclosure proposed by the Commission will impose substantial costs on broker-dealers because they must develop web-page specific disclosure for each fund they make available—even if the rate paid to the broker-dealer by a fund does not materially differ from the rate paid by other funds, or any variances in the amount of fees paid present no lesser or greater conflict of interest.[44] In contrast, Schwab's recommendation would provide—on a single, readily accessible web-page—a concise, Plain-English description of

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table for each of the fund's share classes, and maintain a separate webpage for each fund it makes available. A more cost-efficient alternative to presenting this information would be to provide a schedule showing the fees a broker-dealer would retain on all potential sales loads (e.g, 5%, 4.75%, 4.5%, 4.25% and so on, based on a $10,000 standardized investment), and then a separate table showing the percentage retained by the broker-dealer for each of the funds' share classes (e.g., fund names listed in rows, share classes in columns). This approach would also make it easier for investors to compare the dealer concessions received by a broker-dealer across funds. There may be equally efficient alternatives to disclosing dealer concessions and other information. Broker-dealers should have the flexibility to embrace cost-efficient alternatives such as this one, provided the end result effectively communicates the required information.

[43] For example, assume a broker-dealer receives sales based payments from a mutual fund or its affiliates (Fund A). Assume further that the broker-dealer also receives payments from a fund or its affiliates (Fund B) for recordkeeping services. If the specific dollar amount received by the broker-dealer from Fund A is less than that received from Fund B, it may appear to investors that a greater conflict of interest exists when the broker-dealer recommends Fund B—when in fact a greater conflict exists when the broker-dealer recommends Fund A.

[44] For example, many broker-dealers receive industry standard networking and shareholder servicing fees. While the fee rates may vary from fund to fund, such differences are not often substantial, or do not materially change any potential conflicts of interest created by those payments. Again, with respect to such fees, Schwab believes disclosure of the range of fees, or the fee maximum, more than adequately communicates the nature of the potential conflict of interest.

the nature of each compensation arrangement, along with the maximum or range of fees the broker-dealer receives pursuant to that arrangement.

Notwithstanding the foregoing, Schwab recognizes there are certain types of "revenue-sharing" arrangements for which disclosure of specific dollar amounts may be meaningful. For example, payments to receive preferential "shelf-space" or to be placed on a preferred securities list, and payments for other similar "promotional" services. With respect to these distribution and marketing arrangements, it would be in the investor's interest to know from which funds the broker-dealer receives the highest (or higher) fees, even if it provides these same preferential or promotional services to more than one fund. Consequently, disclosure of the range of fees the broker-dealer receives pursuant to these arrangements may be inadequate. Schwab therefore supports dollar specific disclosure of amounts paid to broker-dealers to "promote" or give preferential "shelf-space" to one fund over others pursuant to "revenue sharing arrangements" (as Schwab has recommended defining that term).

V. Comments on the Effective Date of the Proposed Rules

At this time, given the uncertainty regarding the final form of the Proposed Rules, Schwab cannot recommend an effective date for the Proposed Rules. However, we urge the Commission to provide a lengthy period of transition given that, in any event, the Proposed Rules will impact intricate trade and operating systems, and will require the development of comprehensive policies and procedures, as well as thorough training of broker-dealer associated persons.

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Schwab appreciates the opportunity to comment on the Proposed Rules and the questions raised in the Supplemental Proposal. If you have questions about this letter, please contact the undersigned at (415) 636-3649 or at david.lekich@schwab.com.

Sincerely,

/s/ David J. Lekich

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