May 10, 2004

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-- Proposed Rule: Mandatory Redemption Fees for Redeemable Fund Securities

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") recent proposed rule regarding mandatory redemption fees for redeemable fund securities (the "Proposed Rule").[2] The Proposed Rule would require mutual funds (with certain limited exceptions) to impose a two percent fee on the redemption of shares purchased within the previous five days, with the redemption fee retained by the fund. The Proposed Rule is designed to force short-term shareholders to reimburse the fund for the direct and indirect costs incurred by the fund when they redeem their shares and to discourage short-term trading.

---

[1] CS&Co and CSIM are wholly-owned subsidiaries of The Charles Schwab Corporation (NYSE: SCH) ("Schwab Corporation"). CS&Co, member SIPC/NYSE, 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, 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 approximately 8 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., through Schwab Plan® and third-party administrators, part of Schwab Corporate Services, serve over 2 million 401(k) plan participants.

[2] Investment Company Act Release No. 26375A (the "Proposing Release").

Schwab Supports the Commission's Goal of Discouraging Abusive Market-timing through the Expanded Use of Redemption Fees

Market-timing – the practice of short term buying and selling of mutual fund shares in order to exploit inefficiencies in mutual fund pricing – can harm long-term investors in a mutual fund. In some types of funds – particularly smaller funds that invest in relatively illiquid securities with high trading costs – it can hurt performance to have to establish and then unwind positions to account for rapid flows in and out of a fund. In addition to disrupting portfolio management and increasing transaction costs it also increases the administrative costs of processing short-term trades. Small-capitalization and international funds historically have had the greatest concerns with market-timing activity.

While there is no one magic solution that will prevent market-timing, Schwab believes that redemption fees in combination with fair value pricing and other tools such as round trip limitations and delayed settlement provide a potent and effective combination of tools to discourage abusive market-timing. We believe all funds that experience material market-timing activity should be required to implement both fair value pricing and mandatory redemption fees.[3] Some fund companies, however, are reluctant to impose redemption fees on their funds, even though they experience detrimental market-timing activity. As noted in the Proposing Release, these fund companies may feel competitive pressures not to impose redemption fees. Yet the investors these fund companies are concerned about turning away are the very investors whose activity imposes costs on long-term investors.

The Commission Should Require Mandatory Redemption Fees On All Funds Unless the Fund Board Determines Annually That Such Fees Are Not Required With Respect to a Particular Fund

Schwab believes that the Commission should require expanded use of redemption fees in order to address abusive market-timing. All funds that experience market-timing activity should be required to implement redemption fees and other appropriate measures to minimize the costs these activities impose on long-term shareholders. Schwab recommends, however, that the Commission modify the Proposed Rule to include an exception to the mandatory redemption fee for a fund if the board of the fund determines annually that the fund has not experienced, and is not reasonably likely to experience, market-timing activity that generates material costs to the fund. Rather than mandate an across the board two percent fee with a minimum five-day holding period, we recommend that the Commission require the fund board to annually review the holding period and level of the fee and determine the effectiveness of each in combating market-timing.

---

[3] While a redemption fee is a good deterrent against investors arbitraging stale prices, it is important to attack stale pricing head-on through fair value pricing. We encourage the Commission to continue its efforts in this regard and provide funds with clear guidance about how to implement fair value pricing.

This modification to the Proposed Rule would avoid a one-size fits all approach that imposes mandatory redemption fees on all mutual funds, including those that are not susceptible to abusive market-timing. We believe that such an exception could significantly reduce the unintended application of redemption fees to transactions by smaller investors who redeem shares of funds not susceptible to market-timing for reasons unrelated to market-timing. We also believe that mandatory redemption fees on funds that are not susceptible to market-timing would be counterproductive, and might discourage retail investors from investing in mutual funds for no perceived benefit. On the other hand, boards of some funds may decide that redemption fees are appropriate for all of their funds, whether or not they experience market-timing, in order to compensate the fund for the cost of all short-term trading. The proposed modification would require boards to decide what is most appropriate for each of the funds they oversee.

Schwab recommends that the Commission assist fund boards by requiring that the investment adviser or administrator to a fund make all material information available annually to the board in order to enable it to determine whether a fund should be exempted from the redemption fee requirement. A fund board should consider factors such as whether the fund, or similar funds, has had a history of market-timing activity, and whether that activity has had a detrimental effect on the fund and its long-term investors.[4] To the extent that the board concludes that the fund or similar funds have not experienced detrimental market-timing activity, and are not reasonably likely to experience such activity, the fund would not be required to implement a mandatory redemption fee. In our view, the board should have to make such a determination at least annually in order for a fund to continue to be exempt from the mandatory redemption fee.

The Proposed Rule Must Avoid Creating Multiple Tier Redemption Fees on a Single Fund

From a systems and implementation standpoint, it is absolutely essential that the Proposed Rule not inadvertently create multiple tiered redemption fees on a single fund. This would result, for example, if the Proposed Rule 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. Imposing on a single fund different levels of redemption fees that vary based on the holding period would create significant confusion on the part of investors. The costs and complexity of implementing such a system would be substantial. Most 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. The Commission should require boards to set the appropriate level of redemption fee for each

[4] The Commission should provide guidance in the adopting release about what level of short term trading would be considered to be material. For example, in addition to any patterns of rapid trading demonstrating market-timing intent, boards could consider the transactional and other costs absorbed by the fund on all redemptions within seven calendar days of purchase. If the amount of these costs exceeded one half of one penny per share, it should be considered material. The one half of one penny per share test is already widely used in the context of net asset value pricing errors and adjustments

fund, and that fee should be set at a rate that is uniform during the entire period of the fund's redemption fee, which should be no less than seven calendar days.

Schwab recommends that the Commission clarify that the mandatory redemption fee apply to redemptions made within at least seven calendar days of purchase, rather than five 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 mandatory redemption fee and would create a substantial administrative burden.

The Proposing Release in footnote 26 indicates that for redemption fees with holding periods in excess of five days, the fund would continue to be limited to the lesser of actual costs of redemptions or two percent, consistent with previous SEC staff guidance. Schwab believes that the Commission should provide funds with flexibility to impose redemption fees of up to two percent for periods longer than seven calendar days without regard to whether the fee approximates the actual trading costs that the funds incur as a result of frequent trading. Requiring that redemption fees in excess of seven calendar days be tied to actual costs would in effect mandate a multi-tier redemption fee on many funds, particularly on large capitalization domestic equity funds that tend to have lower trading costs. The Proposing Release recognizes the advantages of a two percent fee during the initial five day period: two percent approximates the transaction costs associated with frequent trading; it is in widespread use today; and it presents a meaningful deterrent to most frequent traders. For these reasons, the Commission relaxed the staff's prior position requiring that the amount of the fee be reasonably related to the actual costs of frequent trading incurred by a fund. These reasons apply equally to redemption fees of up to two percent extending beyond the initial five day period.

In addition, requiring funds to tie their redemption fee to the actual costs associated with frequent trading in their particular fund penalizes those funds that do a better job of lowering transactional costs through, for example, negotiating lower brokerage commissions, obtaining better execution, and negotiating lower custodian and other fees. Requiring these funds to set their redemption fees at their actual transaction cost level could make them more susceptible to market timers because they would have a less effective deterrent than funds with higher transactional costs, even though they may have similar investment objectives and invest in similar securities. Requiring that the redemption fee approximate the actual costs of frequent trading in a particular fund may also make it less likely that funds will impose the fee beyond the five day period, even when doing so would deter frequent trading activity that occurs beyond the initial five day period. For these reasons, we recommend that the Commission provide a safe harbor for fund boards to impose a redemption fee of up to two percent during and beyond the initial seven calendar day period without regard to actual transaction costs.

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

The Proposed Rule requires 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 points 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. Conversely, the most harmful market-timing occurs when an investor makes a large purchase for no other reason than to exploit stale pricing. These transactions can be virtually without risk, and the profit they generate comes almost entirely at the direct expense of long-term shareholders in the fund.[5]

Second, 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 mandatory 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 maintaining a voluntary redemption fee beyond the initial five day period. For those longer period redemption fees, FIFO would certainly be preferable to avoid even more draconian negative unintended consequences that a LIFO approach would entail, for example, for a 60-day period. Trying to set up a system that applied LIFO during the first five days, and

[5] All reinvested dividends and capital gains should be exempt from the redemption fee because it would be difficult to use such transactions to facilitate market-timing. Reinvested dividend shares should be sold first, and then all other lots should be sold on a FIFO basis. This has the benefit of further minimizing the redemption fees paid by clients.

then switched to FIFO for the remaining 55 days would be too confusing to investors and too complicated for funds and intermediaries to implement.

Any Exceptions to the Mandatory Redemption Fee Should Be Designed to Minimize the Potential for Abuse by Market Timers

De minimis exception. Schwab supports the Commission's efforts to minimize the potential negative impact of mandatory 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 broad de minimis exception presents an opportunity for market timers to "structure" their transactions in $2,500 amounts to avoid being assessed the redemption fee. We think that a better approach, discussed below, would exempt certain transactions that are beyond the control of the investor, and therefore do not present any opportunity to engage in market-timing.

Unanticipated Financial Emergency. The Proposed Rule provides an exception to the mandatory redemption fee for mutual fund investors who are faced with unanticipated financial emergencies. Schwab believes that this exception will be extremely difficult to implement because the Proposed Rule does not define unanticipated financial emergency, and therefore 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.[6] Moreover, we believe that a permissive exception above the $10,000 mandatory exception would be inappropriate because it would confer on fund companies even greater discretion than the mandatory exception, thus creating more potential unfairness in its application and more opportunity for exploitation by abusive market timers who trade in amounts over $10,000.

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

Retirement plans are a cornerstone of long-term investing for the majority of investors who save for their retirement. Unfortunately, a small number of retirement plan investors have engaged in abusive market-timing to the detriment of mutual funds. Retirement plans may provide an attractive forum for timing activity because of their tax advantages, as well as the fact that most mutual funds exempted them from redemption fees because

[6] 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.

many retirement plan administrator systems could not apply redemption fees to transactions at the participant level.

For redemption fees to be effective in the context of intermediaries that use omnibus accounts, including retirement plans, the fees must be applied at the underlying investor or participant level. We recommend that the Proposed Rule be amended to clarify that the mandatory redemption fee applies at the investor or participant level, and does not apply at the omnibus account or plan level.

At the same time, the Proposed Rule must recognize that 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 hardships as defined under Treas. Reg. Sec. 1.401(k)-1)(d). This regulation imposes a number of criteria to determine whether 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 recommends that the Commission provide the following exceptions to the application of the mandatory redemption fee:

- Redemption fees in a participant directed retirement plan should apply to customer directed sell transactions only. These transactions are defined as participant directed exchanges, nonautomated re-balances, and fund transfers.

- 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.

- Other non-customer initiated transactions, such as automatic rebalancing, fee collection, qualified domestic relations orders, 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.

- Non-customer directed transactions, such as investment changes that are made by an independent advice provider, that are outside of the control of the participant and provided as part of a Plan's advice offering, should be exempt from the redemption fee.

- The five day or longer holding period should not be reset when a plan sponsor moves its retirement plan assets from one provider to another. For example, if a plan sponsor of a retirement plan 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 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.[7] 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 further disadvantage these retirement plan participants.

- If a plan sponsor determines that a specific fund should be liquidated and replaced, 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.[8]

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

Schwab supports the Proposed Rule's 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 in the Proposed Rule provides the most accurate, efficient and cost-effective way for assessing the redemption fee on sub-accounts held at an intermediary.

Information-Sharing Between Intermediaries and Funds

The Proposed Rule would also require that each intermediary provide the fund or its transfer agent a complete set of transaction information and taxpayer identification numbers at least weekly to enable the fund to ensure that the redemption fee was properly assessed. We support the Proposed Rule's goal of providing funds greater transparency to enable them to enforce their redemption fees, as well as enforcing their other market-

[7] 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 also discourage abuse.

[8] 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.

timing policies and procedures under Rule 38a-1.[9] Requiring a weekly transfer of all of this information, however, may not be useful to fund companies, especially in the retirement plan context where there can be a large number of transactions in relatively small amounts. Funds are unlikely to find this information useful on a weekly basis. We believe that a better solution would be to require funds to enter into agreements that require intermediaries to provide this information upon request. In any event, the final rule should clarify that it does not violate the privacy rights of a client for an intermediary to provide information about that client to a fund for the purpose of monitoring redemption fees.

The Commission should clarify that the intermediary's duty is to provide information to fund companies, and to assist the fund in collecting redemption fees, but not to enforce the funds' other policies regarding market-timing, such as enforcing round trip limits, delaying settlement, or deciding when someone should be banned from a fund. Different fund families (and different funds within a fund family) may have different policies and procedures relating to market-timing. Intermediaries may not be able to enforce market-timing policies on behalf of hundreds of different fund families and thousands of different funds because the complexity of doing so would make the task prohibitively expensive. It is neither feasible nor cost-effective for funds to shift this burden to intermediaries. Some fund market-timing policies and procedures require subjective judgments; the fund should make those decisions because it is likely to be more consistent in applying the policies and procedures and to base its decision on what is best for the fund.

Schwab also believes that the Commission should clarify that funds may not use the taxpayer identification and transaction information provided on a weekly basis or on request to reject retroactively purchases made in good order. This clarification is necessary to prevent funds (and their portfolio managers who focus on performance and the negative effects of cash drag) from rejecting orders that were received immediately before a significant upward market movement.

Delaying Mutual Fund Orders As Suggested By Some Commenters Is Not Necessary to Address Market-Timing

Some commenters on the Proposed Rule have suggested delaying mutual fund orders, either for a few hours by an early order cut-off or by executing at next-day prices, as an alternative solution to market-timing issues. However, we believe this is an overly broad solution when equally effective but less intrusive alternatives are available. Delaying all orders will adversely impact a majority of investors, while only a few investors engage in

[9] With the adoption of the Proposed Rule, the Commission should encourage the industry to enhance standardized automation to better support processing of redemption fees. Currently NSCC Fund/SERV does not allow intermediaries to specify aggregated orders as being subject to the redemption fee. As a result, today these orders are either communicated outside of Fund/SERV or alternatively communicated as a single aggregate order that is not subject to the fee. This requires intermediaries then to return the fee to the fund separately. While this is one method by which fees could be charged, the industry standard automation needs to support the other methods as well.

detrimental market-timing. Better transparency from intermediaries to funds will enable fund companies to address market-timing most effectively, by focusing on those investors who are actually engaging in market-timing.

Moreover, as discussed above, our experience is that redemption fees in combination with fair value pricing and enforcement of funds' market-timing policies are the best deterrent to market-timing. More active use of fair value pricing will also help deter market-timing by reducing opportunities for arbitrage across markets. We believe these steps will be adequate to address market-timing without taking the more drastic step of delaying the execution of all investors' orders for several hours or even an additional day. Market-timing is only an issue for certain types of funds and fund companies; others are not susceptible to, or are not harmed by, short-term trading. A regulatory response that delays execution of orders for all mutual funds (even those not susceptible to timing abuses) is much too broad. Such an overbroad regulatory response could push clients toward investment alternatives other than mutual funds.

Conclusion

Schwab supports the Commission's efforts to curb short term trading activity through the expanded use of redemption fees. With the comments above, we support the adoption of the Proposed Rule. 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: Paul F. Roye
Cynthia M. Fornelli
Robert E. Plaze