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August 3, 2009

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street
Washington, DC 20006-1506

**Re: FINRA Regulatory Notice 09-34
Investment Company Securities**

Dear Ms. Asquith:

Charles Schwab & Co., Inc. ("Schwab") appreciates the opportunity to comment on the proposed consolidated FINRA Rule 2341 ("Proposed Rule") governing members' activities in connection with the distribution and sale of registered investment company securities ("mutual funds"). Schwab generally supports the provisions of the Proposed Rule regarding conditions for discounts to dealers and sales of exchange traded funds, as these provisions of the Proposed Rule codify past FINRA guidance in these areas.

As discussed in more detail below, however, Schwab is concerned that the provisions of the Proposed Rule relating to cash compensation and related disclosures may be inconsistent with and potentially duplicative of similar investor protection initiatives that are currently being contemplated by the Securities and Exchange Commission ("Commission"), Congress, and the current Administration. To avoid potentially conflicting obligations, investor confusion, and the imposition of unnecessary costs on member firms and funds alike, we believe FINRA should delay implementation of these disclosure obligations and coordinate with the Commission and other lawmakers to develop a holistic and meaningful approach to mutual fund conflict of interest disclosures. We also question whether the disclosures outlined in the Proposed Rule will provide meaningful information to investors, and believe they will present practical compliance challenges for member firms, with correspondingly significant costs. We are concerned that FINRA does not appear to have analyzed these costs relative to the limited benefits we suggest the Proposed Rule will offer to investors. Finally, Schwab requests that FINRA add language to the non-cash compensation provisions of the Proposed Rule that expressly permits member firms to estimate the value of goods and services for which a receipt or other documentation of value is unavailable.

I. Receipt of Cash Compensation by a Member Firm

A. The Proposed Rule is Premature

We applaud FINRA's desire to address investor protection concerns. However, we are concerned that the Proposed Rule may not fully take into account other reforms being considered by federal regulators and legislators. We note in particular the Commission's efforts to adopt a point of sale rule to address perceived conflicts of interest in the sale of mutual funds.¹ Although the adoption of a point of sale rule by the Commission has been delayed, the Commission has recently indicated that a new point of sale rule proposal may be forthcoming.² Further, the Treasury Department has recently delivered draft legislation to Congress that would, among other things, amend the Investment Company Act of 1940 to clarify the Commission's authority to promulgate rules designating documents or information that must precede a sale of mutual funds.³

In addition, as part of the current Administration's overall regulatory reform agenda, legislation recently has been introduced in the U.S. Congress to create the Consumer Financial Protection Agency (the "Agency") ("HR 3126").⁴ While the Agency would not supplant Commission authority over broker-dealers and other firms subject to Commission oversight,⁵ HR 3126 authorizes the Agency to prescribe regulations related to compensation practices in connection with providing a consumer financial product or service directly to the consumer, and directs coordination and cooperation between the Commission and the Agency to promote consistent regulatory treatment of investment products and services.⁶ In short, HR 3126 recognizes that similar rules must apply to the sale of similar investment products, regardless of the regulatory framework to which the selling firm is subject. Requiring the type of disclosure contemplated by the Proposed Rule for member firms, while non-member firms are not subject to such disclosure requirements, could confuse investors in that they might be led to believe that non-member firms do not receive similar types of compensation, and that therefore, purchasing a mutual fund from a non-member firm does not present a similar conflict of interest.

We are concerned that adoption of the Proposed Rule might run counter to efforts of the Commission and potentially the Agency, and impose on member firms and offerors multiple—

¹ See Commission Release No. 33-8358, dated January 29, 2004, and Commission Release No. 33-8544, dated February 28, 2005.

² Commission Release No. 33-8998 at p. 64 ("We intend to consider additional steps in the future that would further enhance investors' access to the Summary Prospectus, other information about the fund, and enhanced information about broker and intermediary compensation and conflicts of interest before the investment decision. For example, we continue to consider appropriate disclosures at the point of sale by financial intermediaries..."). See also Agenda for the Initial Meeting of the Commission's Investor Advisory Committee of July 27, 2009, at <http://www.sec.gov/spotlight/invadvcomm/iacmeeting072709-agenda.pdf>.

³ Investor Protection Act of 2009 at Section 914. See U.S. Treasury press release of July 10, 2009, at <http://www.treas.gov/press/releases/tg189.htm>.

⁴ H.R. 3126, introduced June 30, 2009.

⁵ Id. at Section 122(f)(2).

⁶ Id. at Section 116(a).

and possibly conflicting—disclosure requirements and substantially duplicative compliance costs.⁷ We urge FINRA to reconsider the Proposed Rule in light of these potentially competing regulatory initiatives.

B. The Objective of the Proposed Rule is Unclear

Other than to state the Proposed Rule is part of the process to develop a new consolidated rulebook, FINRA Regulatory Notice 09-34 does not articulate the intended purpose of the proposed changes. We note significant similarities between the Proposed Rule and amendments proposed by National Association of Securities Dealers, Inc. (“NASD”) to NASD Rule 2830 in 2003.⁸ The stated intent of the proposed 2003 amendment to Rule 2830 was to address possible conflicts of interest created by a member receiving payments from a mutual fund offeror, which then might encourage members and their associated persons to recommend certain funds to maximize their own compensation, rather than to meet an investor’s long-term investing needs.⁹ Given this background, Schwab’s comments are based on the assumption that the purpose of the Proposed Rule is to enhance investor awareness of potential conflicts of interest in the sale or distribution of mutual funds.

Schwab supports disclosure of the existence of potential conflicts of interest that may inappropriately influence broker-dealers or their associated persons to recommend to investors one mutual fund over a comparable mutual fund. However, if the Proposed Rule is intended to address conflicts of interest, we do not believe the disclosure required under the Proposed Rule will meet that objective for the reasons stated below.

1. The Proposed Disclosure Will Not Provide Meaningful Information to Investors

Over the past several years, both the Commission and FINRA (NASD) have commissioned investor studies in connection with point of sale proposals to determine how best to provide meaningful conflict of interest information to investors. Through those studies, investors consistently indicated that disclosure of dollar amounts paid to a brokerage firm to promote a mutual fund was not useful in determining the actual conflicts presented, as investors had no frame of reference in which to assess the amount reported.¹⁰ In addition, investors

⁷ The Commission has implicitly recognized that conflicts of interest are generally the disclosure obligation of the financial firm receiving such payments. In the recent adoption of the mutual fund summary prospectus rule, the Commission requires a mutual fund to include general disclosures that payments may be made by the fund company or its affiliates for sales of the mutual fund and related services. The investor would be directed to his or her financial intermediary for further specifics about such arrangements. We are concerned that the Proposed Rule shifts additional disclosures to the fund prospectus under the new definitions discussed above.

⁸ See NASD Notice to Members 03-54 (September 2003).

⁹ Id.

¹⁰ See “Results of Investor Interviews to Test and Refine Point of Sale Disclosure Forms”, dated May 31, 2005 (Report of Siegel & Gale, LLC and Gelb Consulting Group, Inc.), at p. 3 (“The dollar amount paid to the brokerage firm to promote the product was deemed important, but not useful, as investors had no frame of reference in which to assess the amount reported. Several simply commented that the number was ‘big.’”) (Available at <http://www.sec.gov/rules/proposed/s70604/siegel053105.pdf>.)

indicated they were primarily concerned with the overall costs of their investment in a mutual fund, and that therefore, they did not find a differentiation between the types of fees paid by a fund meaningful.¹¹

The Proposed Rule requires member firms that have within the previous twelve months received any form of cash compensation, excluding sales charges or service fees disclosed in the prospectus fee table, to disclose a list of offerors making such payments in descending order based upon the amount of compensation received from such offeror. In Schwab's view, however, the value of the proposed disclosure would not be meaningful or helpful to investors because the list of offerors would be based on only a portion of the fees the member firm receives from offerors. As a result, the proposed listing may confuse investors and lead investors to an incorrect conclusion about the aggregate payments received by a member firm from an offeror and the scope of its entire financial relationship with that offeror. This disclosure would not provide investors with the information they need to make an informed decision because such disclosure provides investors with no context by which to identify potential conflicts of interest or the extent of such conflicts, if any.

The proposed disclosures also would confuse and potentially mislead investors because firms presenting similar conflicts might appear at both the top and bottom of the list of offerors, depending on assets held at the member firm and the source of the compensation. For example, an offeror paying 25 basis points annually for shareholder servicing on \$5 million in assets would appear lower in the disclosed list than a firm paying 25 basis points annually on \$40 million in assets. Under the Proposed Rule the client might infer that the lower-listed offeror poses less of a conflict of interest when in fact both offerors are paying the same asset-based fee for the same services and therefore present similar conflicts.

We further note that the Supplemental Material accompanying the Proposed Rule expands the definition of "cash compensation" to include "revenue sharing payments" made to a member firm. "Revenue sharing" typically describes those payments made by a mutual fund's advisor or other affiliate out of its reasonable profits to a brokerage firm or bank platform 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 other arrangements pursuant to which the advisor compensates a firm for an array of services provided, such as shareholder servicing, administrative and recordkeeping services, that would otherwise be borne by the fund or other service provider to the fund, such as a transfer agent.¹²

We question whether "revenue sharing" disclosure will provide useful information to investors regarding potential conflicts, absent additional information about the purpose for which

¹¹ Commission Release No. 33-8544, at Section II, A, 1. ("Also, many investors wanted point of sale disclosure to provide comprehensive information about all the costs of owning covered securities, not just distribution-related costs. They sought comprehensive information about ownership costs, in percentage terms and in dollar terms, to better inform them about the total costs associated with purchasing and owning these securities.") See also "Mutual Fund Point of Sale Disclosure Investor Research Findings", dated March 23, 2005 (prepared by Applied Research and Consulting LLC), pp. 10 and 17.

¹² We are concerned that the Supplementary Material would require prospectus disclosure of any revenue sharing payments being paid to a member firm to compensate the member firm for shareholder services, although the introductory discussion in the Proposed Rule indicates that prospectus disclosure of revenue sharing would not be required. Such disclosure not required by Form N-1A and may be a departure by FINRA from the principles underlying the Form's disclosure requirements.

such payments are being made.¹³ Such payments are not made by the fund, and therefore, do not factor into an investor's overall costs of investing in a particular fund, which investors have indicated is one of their primary concerns.¹⁴ And while payments made to member firms for promotional activity should be disclosed as a potential conflict, revenue sharing may be paid for member firm activities that are not promotional or sales related. These payments represent a far lesser conflict of interest, if any, than payments for promotional activities, such as preferred placement or similar marketing efforts.

Schwab supports member firm disclosure of its financial relationship with offerors to aid investors in identifying and understanding the potential conflicts of interest these relationships create. However, as discussed in further detail below, Schwab believes this is best achieved through narrative disclosure made available via the Internet or otherwise in writing describing the nature of a member firm's financial relationships with offerors—including the types of services it provides and nature of compensation it receives—so that investors can most easily identify and understand the full extent of potential conflicts of interest. In addition, we encourage FINRA to conduct investor surveys or testing to determine if these disclosures will be useful and meaningful to investors in identifying the existence and extent of any conflicts of interest.

2. Compliance with the Proposed Rules Would Be Challenging and Costly to Member Firms and Fund Companies

a. Member Firm Challenges and Costs

The Proposed Rule also presents compliance challenges for member firms and offerors, and imposes potentially substantial costs, which we believe outweigh the limited, if any, benefit the Proposed Rule may confer on investors.

As an initial matter, it may be challenging to determine the sources from which the payments received by a member firm are derived. Many member firms maintain a platform through which investors can purchase and custody unaffiliated third party funds (often referred to as a "mutual fund supermarket"). Mutual fund supermarkets typically invoice and receive a single payment for the administrative, sub-accounting and recordkeeping services the member firm provides. A member firm typically has no knowledge of, and would find it difficult to determine, what portion of the payments it receives are based on fees disclosed in a fund's prospectus fee table and what portion is paid by the advisor or other service provider to the fund.

Even if a member firm were to look to a prospectus fee table for validation of the source of the fees, the member firm may not be able to readily discern whether the payment is being made from fees disclosed in the fee table. For example, fees paid pursuant to a fund's Rule 12b-1

¹³ The NASD has recognized that not all payments made to member firms create the same types of conflicts for member firms. See NASD Regulation Request for Comment 97-50, August 1997, at p. 410 ("Investors may find that information on cash compensation arrangements would be important in determining whether a [registered representative's] particular product recommendation was influenced by such arrangements. Yet some of the cash compensation arrangements described above may be of so little interest to investors or so far removed from any effective point-of-sale influence that disclosure of such information would not serve a significant customer protection or other regulatory purpose.").

¹⁴ See *supra*, fn. 10 and fn. 11.

Plan are expressly set out in the prospectus fee table. However, it is also possible that other fees, if paid by a fund, would be reflected in the fee table, potentially as a separate line item, but more likely aggregated with other fund expenses within the "other expenses" line item of the fund's fee table.¹⁵ A member firm will in most cases be unable to discern based solely on a review of the fund's prospectus what portion of the fee is being paid by the fund and what portion is being paid by the advisor.

Even more problematic is the definition of "special sales charges or service fees" and the assumptions set forth in the Supplemental Material. A "special sales charge or service fee arrangement" is defined to include any compensation arrangement under which a member receives greater sales charges or service fees than other members, even if the fund would have made the arrangement available to other member firms if requested. As a practical matter, a member firm could not know what sales charge or service fee arrangements the offeror has made with other member firms, and thus would be unable to determine whether it is receiving fees greater than any other member with whom the fund may have an arrangement. Therefore, absent a contractual obligation of the fund to inform the member firm of any special arrangements the fund might have in place, the assumptions set forth in the Supplementary Material would almost always apply. That is, a member firm would have to assume that it has entered into a special sales charge or service fee arrangement if it receives a sales charge or service fee in addition to the standard dealer reallowance or commission disclosed in the fund's prospectus fee table.¹⁶

From a member firm's perspective, the only reasonable solution is to impose a contractual obligation on the mutual fund to require the fund to disclose to the member firm exactly what payments are (i) disclosed within a prospectus fee table; (ii) disclosed elsewhere in the prospectus; (iii) paid for by a fund affiliate or service provider; and (iv) "special sales charges or service fee" arrangements, as defined under the Proposed Rule. In addition to the costs associated with amending current fund agreements to reflect these obligations, member firms would also incur costs in connection with the ongoing monitoring of fund prospectus disclosures in an attempt to ensure that those contractual obligations have been met (which may nevertheless be difficult to ascertain).

b. Fund Company Challenges and Costs

Fund companies would also have difficulties in complying with the Proposed Rule, particularly in light of the contractual obligations they would most likely have to undertake, as

¹⁵ We assume, for purposes of this letter, that a fee included in the "other expenses" line item of a fee table would sufficiently meet the requirement under the Proposed Rule that a payment accepted by the member firm be disclosed in the prospectus fee table if paid by the fund. FINRA has previously provided guidance regarding the types of fees that fall outside the definition of "service fees" for purposes of NASD Rule 2830, such as sub-accounting, sub-transfer agency and custodial fees, among others. *See, e.g.*, NASD Notice to Members 93-12 (Questions #17 and #18) and NASD Notice to Members 92-41. Such fees are borne by the fund, and therefore must be disclosed in the prospectus fee table, however, the Commission's Form N-1A does not require separate disclosure of these fees in a prospectus fee table.

¹⁶ As discussed earlier, fees received by mutual fund supermarkets are typically characterized as payments for the shareholder, administrative and recordkeeping services provided by the member firms. These payments are likely fees "in addition to" the standard dealer reallowance or commission, and therefore, under these assumptions would always be required to be disclosed in a fund's prospectus as "special" fee arrangements.

described above. Under the Proposed Rule, any sales charge or service fee arrangement under which a member firm receives greater fees than other members would be considered a "special" arrangement that must be disclosed in the fund prospectus, even if such fee would have been available to the other member firm had they requested such an arrangement.

This poses challenges for a fund company, at least partially due to ambiguity in the Proposed Rule's use of terms. For example, the proposed definition of "special sales charges or service fees" does not clearly define what is "special," other than by exclusion. Therefore, the definition fails to consider differential service fees paid for legitimate differences in the services being provided by the member firm. A fund company (and member firm) would find it difficult to determine whether a fee is truly "greater" than fees paid for similar but not necessarily the same services. Further, a fund may have difficulty distinguishing true "service fees" paid to member firms as defined under the Proposed Rule, from payments they make to member firms for other types of services, such as sub-accounting and recordkeeping.¹⁷ These considerations only add to the challenge of determining whether a "special arrangement" exists, particularly in the context of shareholder servicing.

Fund companies would also incur costs under the Proposed Rules in connection with amending agreements with member firms, meeting their contractual disclosure obligations to member firms, and modifying fund prospectus disclosures as necessary. We note that the Proposed Rule does not include a cost-benefit analysis, and in light of the above concerns, strongly urge FINRA to review the costs of complying with the disclosure requirements of the Proposed Rule, both for member firms as well as for mutual funds.

3. Schwab's Recommendation For Compensation Disclosure Practices

As an alternative to the Proposed Rule, Schwab requests FINRA consider instead requiring a member firm to describe the nature of services it provides to offerors, and the nature of compensation received by the member firm and its associated persons from offerors, regardless of whether from revenue sharing or other sources (including payments made by the fund as disclosed in the fund's prospectus fee table).¹⁸

A narrative approach to disclosure is particularly appropriate in describing a member firm's financial relationship with offerors because these relationships can be complex; appropriate context and concise explanation of these relationships is often necessary to ensure that the disclosure is meaningful and helpful to investors. Schwab does not believe a single formulaic or quantitative approach to compensation disclosure can effectively communicate to investors the potential conflicts of interest such payments can represent. Schwab's recommended approach would provide to member firms the flexibility necessary to provide a complete view of

¹⁷ See fn. 15. We note that the definition of "service fee" in NASD Rule 2830(b)(9) means "payments made by an investment company for personal service and/or the maintenance of shareholder accounts" and does not encompass all payments made by an offeror, as that term is defined in NASD Rule 2830(b)(1)(E).

¹⁸ As stated in previous communications with the Commission and with FINRA, Schwab supports specific disclosure of payment received by a member firm for preferred placement and other sales-related activities. See, e.g., Letter to NASD dated October 17, 2003 commenting on proposed amendments to NASD Rule 2830 and Letters to the Commission dated, April 12, 2004 and April 4, 2005, related to proposed rules 15c2-2 and 15c2-3 ("point of sale" rules).

the potential conflicts that may be presented by financial arrangements between a mutual fund and a member firm. Such disclosures should be presented in plain English, and take advantage of layered disclosure practices, including use of the Internet and other mediums, as recently endorsed by the Commission in its adoption of the summary prospectus rule.¹⁹

C. Extension of Compliance Date and Request for Additional Rule Clarification

Finally, for practical reasons, if FINRA moves forward with the Proposed Rule as currently written we request FINRA consider allowing member firms at least 180 days following adoption of the Proposed Rule to comply with the requirements for accounts already established with member firms on the effective date of the rule. It will take a significant amount of time to gather the required information to prepare the disclosure and determine the appropriate presentation, particularly given that member firms do not presently have the information necessary to make these disclosures and member firms will need time to amend contracts with fund companies to require funds to provide the necessary information. For example, Schwab estimates that the adoption of the Proposed Rule would necessitate amendments to at least 1,200 contracts Schwab has in place with mutual funds. Ninety days is simply not enough time to accomplish such a daunting task.

We also seek clarification of certain ambiguities in the terminology used in the Proposed Rule. For example, there are slight differences in terminology between sub-sections (D) and (B) of the Proposed Rule that could significantly change the scope of the Proposed Rule, depending on interpretation. Sub-section (D) describes the same method of disclosures as set forth in sub-section (B), but seems to indicate that such disclosures would be triggered by receipt of “any cash payments from investment companies or their affiliates, other than sales charges or service fees disclosed in the prospectus fee table”, regardless of when such payment was received (i.e., prior to the previous 12 months). By contrast, sub-section (B) requires that “any member that has within the previous 12 months received from an offeror any form of cash compensation, other than sales charges or service fees disclosed in the prospectus fee table.” (Differences between the two sub-sections are underlined in the above.) We seek clarification that the intention of sub-section D is simply to outline the methods of disclosure, and not to restate the triggers for such disclosure.

II. Conclusion

Again, we applaud FINRA’s endeavors to provide investors with clear and useful information to assist in determining the existence and extent of conflicts of interest that may be present when a member firm recommends a mutual fund. However, we recognize that regulatory reforms are under active consideration by the Commission and that investor protection is at the forefront of both the Commission’s agenda as well as the current Administration’s efforts. In

¹⁹ See Commission Release No. 8998, at p. 60-61 (“The rule provides for a layered approach to disclosure in which key information is sent or given to the investor and more detailed information is provided online and, upon request, is sent in paper or by e-mail. This is intended to provide investors with better ability to choose the amount and type of information to review, as well as the format in which to review it (online or paper).”).

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light of these impending regulatory developments and the additional concerns we have outlined above, Schwab strongly urges FINRA to reconsider the provisions set forth in the Proposed Rule.

We appreciate the opportunity to provide comments and thank FINRA for its consideration of the points we have raised in this letter. Please feel free to contact me at (415) 667-0866 to discuss further.

Sincerely,

A handwritten signature in cursive script, appearing to read "Bari Havlik".

Bari Havlik
SVP and Chief Compliance Officer
Charles Schwab & Co., Inc.