UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

October 25, 1999

Mr. Steven L. Scheid
Executive Vice President
Chief Financial Officer
Charles Schwab & Co., Inc.
101 Montgomery Street
San Francisco, CA 94104

Re: Net Capital Treatment of Deferred Tax Liabilities Directly Related to Capitalized Costs Associated with Internal Software Development

Dear Mr. Scheid:

This responds to your letter dated December 8, 1998, on behalf of Charles Schwab & Co., Inc. (the "Firm"), regarding the net capital treatment under Rule 15c3-1[1] under the Securities Exchange Act of 1934 ("Exchange Act") of its deferred tax liability directly related to certain capitalized costs associated with internal software development.

Based on your letter and conversations with the staff of the Division of Market Regulation ("Division"), I understand the following facts to be pertinent to your request. Paragraph (c)(2)(iv) of Rule 15c3-1 requires a broker-dealer when computing net capital to deduct from its net worth certain illiquid or nonallowable assets. In addition, paragraph (c)(2)(i)(C) of Rule 15c3-1 provides that a broker-dealer may add back to its net worth when computing net capital certain deferred tax liabilities which directly relate to: (1) income derived from nonallowable assets; (2) unrealized gains on assets subject to haircuts under paragraph (c)(2)(vi) and Appendices A and B of Rule 15c3-1 at the applicable tax rates; or (3) unrealized gains on assets otherwise deducted from net worth.

1 17 C.F.R. § 240.15c3-1 (1999).

You request that the Firm be allowed to add back to its net worth the amount of its deferred tax liability which relates to capitalized costs associated with internal software development, as determined under Generally Accepted Accounting Principles ("GAAP") under AICPA Statement of Position 98-1 ("SOP 98-1").[2] You state that SOP 98-1 requires the Firm to capitalize portions of its employee compensation and professional service costs incurred in the application development stage of internal use software projects. These capitalized costs must be amortized over the estimated useful life of the software. You further state that the Internal Revenue Code permits the deduction of these costs in the period in which they are paid. The Firm accounts for the resulting tax-to-book discrepancy by recognizing a deferred tax liability and a related nonallowable asset entitled "software assets."

You contend that the net capital treatment of the deferred tax liability should be similar to the treatment under paragraph (c)(2)(i)(C) of Rule 15c3-1 because it is directly related to a nonallowable asset. You further contend that the deferred tax liability does not affect the Firm's cash flows, income tax liability or overall operating risk profile and that the journal entry "merely alters the timing under which software development costs are recognized in book net income." However, you assert that the accounting treatment for the software development costs result in an inappropriate double charge to net capital because software assets are nonallowable and the deferred tax liability also reduces the Firm's net worth.[3]

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2 ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE, Statement of Position 98-1 (American Inst. of Certified Pub. Accountants, April 1998).

3 Exchange Act Release No. 18737 (May 13, 1982), 47 FR 23919 (June 2, 1982) specifically requires a broker-dealer to adopt the accrual method of accounting under GAAP for its financial reporting.

Based on the foregoing, the Division will not recommend enforcement action if, when computing net capital, the Firm adds back to its net worth the amount of its deferred tax liability which directly relates to the nonallowable asset entitled software assets capitalizing certain costs associated with internal software development under SOP 98-1. You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. This position is based solely on the foregoing description. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely,

Michael A. Macchiaroli
Associate Director

cc: Raymond J. Hennessy, NYSE
Thomas R. Cassella, NASD

The Charles Schwab Corporation

Steven L. Scheid
Executive Vice President and
Chief Financial Officer

December 8, 1998

Mr. Michael A. Macchiaroli, Esq.
Associate Director
Office of Risk Management and Control
Securities and Exchange Commission
450 5th Street, N. W. Stop 5-1
Washington, D. C. 20549

Re: Net Capital Implications of New Accounting Standard for Computer Software

Dear Mike,

This letter requests that the staff of the Division of Market Regulation grant Charles Schwab & Co., Inc. ("Schwab") a "no-action" position allowing it to net certain internal-use capitalized software assets with related deferred tax liabilities for purposes of computing net capital under Securities Exchange Act Rule 15c3-1.

Under the newly-issued AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use ("SOP 98-1")[1], a significant portion of the costs incurred to develop software for internal use is required to be capitalized and amortized into earnings over the estimated useful life of the software. These capitalizable costs will not include preliminary research and development costs, but will primarily include certain costs incurred in the application development stage of internal use software projects. Since Schwab currently expenses such costs as incurred, SOP 98-1 will result in Schwab recording portions of its employee compensation and professional services costs as "software assets", which are considered deductions from net worth in computing net capital under paragraph (c)(2)(iv) of Rule 15c3-1.

SOP 98-1 will have the effect of increasing current earnings, and thus Schwab's capital base. However, due to the accounting treatment for deferred taxes, absent a change in regulatory application, Schwab's net capital for regulatory purposes actually declines. This is due to the fact that the resultant increase in earnings is reduced by the effect of income taxes, while the resultant nonallowable assets charge relating to the newly-created software assets is not reflected on a tax-adjusted basis in the net capital computation. For example, for each $1,000 of software development expense capitalized, equity capital would be increased by $600 (the $1,000 deferred expense reduced by the $400 in income tax expense generated by the additional reported income). The same $1,000 will be included at 100% as a nonallowable asset in calculating net capital, creating a $400 net reduction in net capital for regulatory purposes.

[1] The new pronouncement will become effective for financial statements for fiscal years beginning after December 15, 1998.

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Mr. Michael A. Macchiaroli, Esq.
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This negative impact on net capital will be eliminated over the useful life of the software asset as the software asset and related deferred tax liability are amortized through earnings. This negative impact occurs even though there has been no change in the firm's cash flows, income tax liability or overall operating risk profile. The SOP merely alters the timing under which software development costs are recognized in book net income, and in doing so creates an unintended negative net capital consequence through our balance sheet.

Given current trends in technology usage within the financial services industry, technology expenses are likely to continue to represent ever-higher proportions of operating expenses for member firms. We do not believe that the required January 1, 1999 adoption of SOP 98-1, which is intended to bring about comparable accounting practice across all industries, should negatively impact net capital. As a straightforward means of neutralizing the negative impact to net capital, we propose that Schwab be allowed to net deferred tax liabilities relating to internal use software assets against such software assets for net capital purposes.

We appreciate your prompt consideration of our proposal. Should you have any questions or comments, please do not hesitate to contact me at (415) 636-5822.

Sincerely,

Steven L. Scheid

Steven L. Scheid
Executive Vice President
Chief Financial Officer

Cc: Raymond J. Hennessey
New York Stock Exchange, Inc.

Patricia James
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