Charles Schwab
America's Largest Discount Broker
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<u>Via Federal Express</u>

Investment Company Act of 1940,
Section 22(d)

Act	ICA-40
Section	22(d)
Rule	
Public Availability	8/6/92

May 28, 1992

Thomas Harman, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Harman:

This letter requests that the Staff of the Securities and Exchange Commission advise Charles Schwab & Co., Inc. ("Schwab") that it would not recommend any enforcement action based on Section 22(d) of the Investment Company Act of 1940 if Schwab charges certain of its customers fees for executing transactions in shares of certain mutual funds and, at the same time, receives fees from those mutual funds, based on the value of other shares, for services rendered to those mutual funds, all as described below.

Schwab proposes to enter into contracts with certain mutual funds, shares of which are currently available through Schwab's Mutual Fund Marketplace® ("MFMP"), pursuant to which Schwab will offer certain services to the funds in return for fees ("Service Fees"). These Service Fees will differ depending on the level and kind of services offered to the funds, and will be calculated as a percentage of the assets of the funds held by some Schwab customers in the MFMP and/or per account. For those funds which enter into such contracts (the "Participating Funds"), Schwab will make shares of the funds available through the MFMP without transaction fees to the vast majority of Schwab's customers (the "Fee-Free Arrangement"). For certain very active traders (the "Active Traders", as defined further below) Schwab's standard transaction fees will continue to apply to purchases and redemptions in all funds, including the Participating Funds. However, the assets and/or accounts held by the Active Traders will not be counted in the calculation of assets and/or accounts in determining the fees charged to the Participating Funds. It is Schwab's opinion that Schwab's receipt from Active Traders of transaction fees for transactions in Participating Funds will not constitute sales of shares of the Participating Funds at a price other than "a public offering price described in the prospectus" as prohibited by section 22(d) of the Investment Company Act of 1940. In addition, it is Schwab's view that the proposed Fee-Free Arrangement will not violate the spirit of the no-action relief granted to Schwab in the past.

FACTS

Schwab

Schwab is a broker registered under the Securities Exchange Act of 1934 and is a member of the National Association of Securities Dealers, Inc., the New York Stock Exchange, and other national securities exchanges. Schwab is the largest discount securities broker in the United States, with over 150 offices nationwide. Schwab is affiliated with Charles Schwab Investment Management, Inc., an investment advisor registered under the Investment Adviser's Act of 1940, which is the investment manager for the Charles Schwab Family of Funds and Schwab Investments, both of which are registered open-end investment companies. Schwab has entered into Distribution Agreements with both such mutual funds. In addition, Schwab has entered into Distribution Agreements with some fully-loaded funds whose shares are available for sale through the MFMP. Schwab does not charge transaction fees to its customers for transactions in the shares of Schwab-sponsored mutual funds or for transactions in such fully-loaded funds with which Schwab has Distribution Agreements.

The Mutual Fund Marketplace

Schwab offers its customers a service it calls the Mutual Fund Marketplace ("MFMP"), which has been described in previous no-action requests to the Commission.[1] Through the MFMP, Schwab acts for its customers as an agent through which they may purchase or redeem shares of over 500 mutual funds. Customers may place both purchase and redemption orders with one telephone call, purchase mutual fund shares with margin credit, receive a single consolidated statement, and have checks for the proceeds of redemptions sent to their local Schwab branch within one business day. Such conveniences are not typically available when dealing directly with the funds. The program effectively enhances the liquidity of mutual fund investments by offering easy access to a

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[1] See, for example, Charles Schwab & Co., Inc., available January 8, 1982; Charles Schwab & Co., Inc., available June 29, 1983; Charles Schwab & Co., Inc., available January 2, 1987; and Charles Schwab & Co., Inc., available November 30, 1987.

wide variety of funds and by providing rapid and convenient execution of transactions in fund securities.

Currently, for most transactions, Schwab is compensated for its services by customers through a transaction fee based on the dollar size of each transaction. Schwab's transaction fee schedule is identical for all funds. As mentioned above, Schwab also takes a portion of the load in fully loaded funds; Schwab does not charge transaction fees for transactions in those funds or for transactions in Schwab-sponsored funds.

In order to be included in the MFMP, funds must (i) include in their prospectuses disclosure that a broker may charge a fee if shares are purchased or redeemed through that broker; (ii) be able to effect daily transfers of shares and funds at Schwab's volume levels; (iii) have a prospectus that provides that they are able to redeem shares upon telephonic instructions; and (iv) be able to perform certain other transfer-related functions in a manner compatible with MFMP operations.

<u>The Proposed Fee-Free Arrangement</u>

(a) Contracts with Participating Funds

Schwab would offer certain services to funds whose shares are available for sale through the MFMP. These services would include shareholder servicing, sub-accounting and transfer agency services. In addition, the Participating Funds would have the opportunity to benefit from any increase in assets in such funds as a result of Schwab's planned promotion of the Fee-Free Arrangement in the MFMP. Schwab currently plans to circulate or publish promotional materials for the MFMP identifying or "highlighting" all funds that are available with no transaction fees. Those promotional materials will not include materials designed to promote any particular Participating Fund to the exclusion of any other Participating Fund.

The Service Fee as to each Participating Fund would be calculated as a percentage of the assets and/or number of accounts held by Schwab customers in that Participating Fund, with certain exclusions. It would be up to the Participating Funds to determine whether payments for the various elements of the arrangement be made by the fund, its manager or distributor.[2] The arrangement would be set out in a formal written agreement between Schwab and the Participating Fund.

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[2] The Participating Funds would also choose whether to pay all or a portion of Service Fees through 12b-1 plans, if they have such plans.

(b) The effect on non-Active Trader customers

Once Schwab has entered into the above-described agreements with the Participating Funds, Schwab's customers would be able to purchase or redeem shares of Participating Funds free of the transaction charges currently imposed by Schwab on such trades. Customers would still be able to purchase and redeem shares in all funds offered through the MFMP, although only shares of Participating Funds would be offered fee-free to customers. Customers would continue to receive consolidated statements showing all transactions, the efficiency of being able to trade in all MFMP funds with a single phone call, liquidity, and all other features of their Schwab accounts. Shares of Participating Funds would not be immediately marginable, but would be marginable beginning 30 days after purchase as permitted by SEC Rule 240.11d1-2.

(c) The effect on Active Traders

Notwithstanding the treatment of non-Active Traders, certain customers identified by Schwab as "Active Traders" based on their trading activity in Participating Funds would, upon such identification, be charged transaction fees for purchases and redemptions of shares in all funds, including Participating Funds. These fees are charges for services which are requested by the Active Traders, namely, additional transactions in fund shares. No customers would be pre-defined as Active Traders based on historical trading activity. Instead, all customers would receive the benefit of fee-free transactions up to the time that they executed more than a certain "trigger" number of short term redemptions in fee-free funds during any twelve month period.[3] Once the "trigger" number of short term redemptions was made during any twelve month period by any customer, that customer's account would be coded as an Active Trader account, and the customer would be charged Schwab's normal transaction fees on all purchases and on most redemptions of mutual funds from that date forward. (Schwab would not charge transaction fees for any redemptions by Active Traders of shares they initially purchased fee-free.) Once a customer has been identified as an Active Trader, Schwab will track shares purchased by the Active Trader in any account that has been identified as an Active Trading Account and will charge Service Fees on shares only when Schwab does not charge a transaction fee.

Active Traders would pay transaction fees to Schwab only on accounts in which they do active trading. Trades in other, non-actively traded accounts belonging to the same individual would not incur transaction fees. For example, if a person had two accounts

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[3] The exact number of short term redemptions that would "trigger" Active Trader status is still to be decided. A short term redemption is defined for these purposes as a redemption of shares held less than six months from date of purchase.

at Schwab, one a personal brokerage account and one an IRA, both accounts would begin as non-Active Trader accounts. If that person effected more than the "trigger" number of short-term redemptions in the personal account, only the personal account would be deemed an Active Trader account and would be charged transaction fees. The IRA would not automatically be charged transaction fees as a result of the activity in the personal account of the same individual.

Schwab would put some controls in place to prevent abuses of this system. An individual attempting to avoid the imposition of transaction fees would not be permitted to open multiple accounts solely for this purpose. The means of controlling this abuse have not been finalized, but it is not Schwab's intention to charge transaction fees to all accounts held by an Active Trader unless active trading were occurring in all of the accounts.

Active Traders would have their accounts reclassified as non-Active Traders on an exception-only basis. Schwab would reserve the right to reverse the Active Trader classification at its discretion, but would only do so upon application by the customer and the submission of information satisfactory to Schwab that the customer did not intend to continue past active trading activity. Schwab would not automatically reverse Active Trader status based on periods of reduced trading activity. Of course, all customers would be notified of these conditions of the Fee-Free Arrangement in advance. In addition, Schwab would advise customers in writing both when they approach and when they reach Active Trader status.

(d) The effect on the MFMP

The Fee-Free Arrangement would effectively divide the MFMP into two parts. One part would consist of shares purchased by Active Traders ("Active Part") and would preserve the status quo in the MFMP, as discussed in previous no-action letters.

The Active Traders would pay reasonable transaction fees to Schwab for transactions made after they were identified as Active Traders. In addition, in the Active Part of the MFMP, Schwab would continue to abide by the conditions imposed on it by the Staff in previous no-action letters, namely, that (1) Schwab would not charge a transaction fee if it also received any portion of a sales load (including a contingent deferred sales load) charged on the shares; (2) the transaction fees charged by Schwab for transactions in fund shares would not be unreasonable, as that term has been defined by the Staff; (3) in no event would the total of a transaction fee charged by Schwab and the sales loads charged in connection with the sale or redemption of fund shares exceed the maximum sales charge that would be allowed under Article III, Section 26 of the NASD Rules of Fair Practice; (4) Schwab would charge a transaction fee only for transactions in fund shares that can also be purchased by the customer directly from the fund, its principal underwriter or its distributor without the intervention of a broker and without the imposition of the transaction fee; (5) Schwab would inform each of its customers, in writing, that fund shares may be purchased directly from the fund without incurring the Schwab transaction fee; (6) Schwab would not charge a transaction fee for transactions in the shares of a fund unless the fund's prospectus discloses both that a transaction fee may be imposed by broker-dealers, and that, if fund shares are purchased directly from the fund, its principal underwriter or its distributor without the intervention of such a broker-dealer, there will be no such charge; and (7) Schwab will not charge a transaction fee if Schwab is affiliated with the fund, its investment advisor, or its principal underwriter or distributor.

The second part of the MFMP (the "Investor Part") would consist of the vast majority of Schwab's customers, who will not pay transaction fees to purchase or redeem shares of Participating Funds. Participating Funds will pay the Service Fees based only on the assets and/or accounts in the Investor Part of the MFMP.

Schwab intends to design an elaborate tracking system for shares of Participating Funds purchased by its customers. Each share will fall into one or the other parts of the MFMP, depending on whether the customer is an Active Trader or not. For example, an individual could purchase or redeem shares of Participating Funds a number of times before being identified as an Active Trader; the shares purchased prior to such identification would be part of the Investor Part, while shares purchased after such identification would be part of the Active Part. An individual could have accounts in each part of the MFMP, or even different shares of the same Participating Fund in separate parts of the MFMP.

DISCUSSION

Schwab believes that the imposition of transaction fees on purchases and redemptions of mutual funds by Active Traders would comply with the terms of section 22(d) of the Investment Company Act. Schwab also believes that the Fee-Free Arrangement is in accord with the spirit of the conditions set forth in past no-action letters.

Background

Section 22(d) of the Investment Company Act of 1940 (the "Act") generally prohibits mutual funds, underwriters and dealers from selling fund shares to the public "except at a current public offering price described in the prospectus." For many years, the Securities and Exchange Commission viewed the imposition of any charge for transactions in shares of no-load fund shares as a violation of section 22(d), as well as a violation of anti-fraud provisions because of prospectus representations concerning no-load status. In 1974, however, the SEC authorized the Staff to permit brokers acting independently of funds and their underwriters to charge reasonable fees for services rendered in connection with transactions in shares of no-load funds. In taking this position, the SEC's stated purposes were: (1) to provide brokers with an incentive to recommend no-load fund shares that would be somewhat comparable to that existing with respect to other securities; and (2) to compensate brokers for services rendered in connection with no-load fund transactions.[4]

The Staff has granted Schwab three no-action letters with respect to section 22(d) and charging transaction fees. In the first, the Staff advised Schwab that it would not recommend enforcement action if Schwab charged transaction fees for services in connection with the purchase and redemption of no-load fund shares. In the second letter, the Staff extended this no-action position to include charging transaction fees in connection with transactions in low-load fund shares. The Staff recognized in this letter that the services rendered by Schwab were sufficiently separately identifiable to permit Schwab to charge such fees. In the third letter, the Staff stated that it would not recommend enforcement action if Schwab revised the fee schedule set forth in the previous two letters.

In each of these no-action letters, Schwab made certain representations, and the Staff made its response based on certain conditions. The Staff stated that these conditions are designed to ensure, first, that the broker acts independently of the fund and its regular distribution network; and second, that both the existence of the transaction fee and the possibility of avoiding the fee by dealing directly with the fund are adequately disclosed to investors.[5] (The second of these concerns is not an issue for the MFMP and the Fee-Free Arrangement because Schwab discloses in writing that all funds may be obtained without transaction fees by going directly to the fund. Schwab intends to continue this practice after introduction of the Fee-Free Arrangement.)

When the SEC first permitted brokers to impose transaction fees, it viewed independence as important because it wanted to be sure that the transaction fee would be viewed as separate from the price of the fund shares, a fee that the customer would understand as being paid voluntarily to a broker in order to compensate the broker for services not provided by the fund. There is a difference between this charge for services and a sales load or distribution charge

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[4] Report of the Division of Investment Management Regulation, "Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940" (August, 1974) (hereafter referred to as the "1974 Report") at p. 114.

[5] Kidder, Peabody & Co., available March 30, 1987 at Note 2.

imposed by the fund or a member of its distribution network.[6] The transaction fee is not part of the price of the shares, and therefore its imposition does not violate section 22(d) of the Act. Independence of the broker from the mutual fund appears to be important only because it is a test by which the Staff (and mutual fund customers) can determine whether a transaction fee charged by the broker is in fact a separate charge for the broker's services to the customer rather than part of payment for fund shares. In effect, independence is a proxy that makes it possible to test easily whether the terms of Section 22(d) are being met. Schwab believes that charging service fees to Participating Funds in the Investor Part will not alter the nature or method of delivery of services to Active Traders in the Active Part so as to make transaction fees charged to Active Traders a part of the price of the Participating Funds paid by Active Traders. As to Active Traders, Schwab remains adequately independent of the Participating Funds for section 22(d) purposes.

Analysis

(a) Overview

There are a number of reasons for Schwab's view that imposing transaction fees on Active Traders comports with the law and applicable interpretations.

The only variation from the conditions imposed by the Staff in past no-action letters is that Schwab would have arrangements with Participating Funds for Service Fees. However, these arrangements would relate only to the Investor Part of the MFMP, where no transaction fees would be paid by customers for transactions in Participating Fund shares. Service Fees would be calculated only on the assets and/or accounts in the Investor Part of the MFMP.

(b) Independence of Schwab

Schwab does not believe that the fact that transaction fees are charged to Active Traders in the Active Part of the MFMP would violate the condition imposed by the Staff in the past that the broker charging transaction fees must not have any formal or informal agreement with the fund, its investment advisor, or principal underwriter to distribute fund shares. This is because the two parts of the MFMP, the Active Part and the Investor Part, would be wholly independent of each other.

The proposed arrangements with Participating Funds would not change Schwab's independent status with respect to transactions by Active Traders in the Active Part of the MFMP. First, Schwab would continue to execute Active Traders' unsolicited transactions in

[6] 1974 Report at pp. 112-113.

funds in the same fashion as it does currently for all customers. The Active Traders would have no incentive to purchase any particular fund available through the MFMP, because all transactions in any of the funds would be made at equal cost to them.

Second, there would be no financial incentive to Schwab to promote either any particular Participating Fund or the Participating Funds as a group to Active Traders because the amount of the Service Fees paid by Participating Funds would be unaffected by the number of shares of the Participating Funds sold to Active Traders. Although Schwab currently plans to circulate or publish promotional materials for the MFMP identifying or "highlighting" all funds that are available with no transaction fees, those promotional materials will not include materials designed to promote any particular Participating Fund to the exclusion of any other Participating Fund. Those promotions would be aimed at the Investor Part of the MFMP. Therefore, Active Traders would not be encouraged by Schwab's marketing materials to purchase Participating Funds over non-Participating Funds.[7] In addition, Schwab believes that a large proportion of Active Traders are likely to be those with professionally managed accounts, or customers who follow market-timing or market switching newsletters and services. Neither these customers nor their professional financial advisors are likely to be affected by any advertising or promotional activities of Schwab, because they make purchase and redemption decisions based on independent analysis and information.

Schwab is charging fees to customers that are clearly for the services it renders rather than a part of the sales price of the mutual fund shares. In the case of the Active Traders, they would clearly see that only when they demanded additional services from Schwab (i.e., numerous short term redemptions) would they be charged fees by Schwab. These fees are unmistakably for services rendered by Schwab rather than part of the price of the shares, so the concerns underlying section 22(d) are met by this arrangement.

(c) Schwab will not be "double dipping"

The SEC has stated that a broker should not charge a transaction fee "if it also receives any portion of a sales load charged on the

[7] Schwab may, in the future, begin providing new services to some of its customers, possibly including information about or recommendations as to particular mutual funds, including Participating Funds. However, Schwab expects that most of such services would be of types that would be more useful to non-Active Traders than Active Traders and that it will remain clear to any Active Traders who may use them that they must pay transaction fees for transactions in Participating Fund shares.

shares or any payments under a distribution plan adopted by the fund in question in accordance with Rule 12b-1."[8]

In Olde, a broker wished to charge transaction fees to customers and accept a portion of the load imposed by the funds. This would not occur in the Fee-Free Arrangement, since Schwab would not be accepting any portion of a sales load from Participating Funds on shares as to which a transaction fee is charged. The Staff's position in Olde was that a broker could not charge transaction fees and accept payments from a fund's 12b-1 plan. Schwab believes that the prohibition was intended to apply to accepting 12b-1 fees for distribution of specific shares. Schwab will not receive compensation that would constitute double payment for the same services in violation of this provision of the Olde no-action letter. Schwab will receive transaction fees from the Active Traders, but the assets and/or accounts held by such Active Traders will not be counted in the determination of the Service Fees from Participating Funds. The Service Fees received by Schwab will be paid to Schwab in connection with the sales of shares to customers who are not Active Traders. The proposal outlined by Schwab herein can be distinguished from that presented by Olde, in which the broker planned to charge a transaction fee to its customers and to charge a fee to the mutual funds for sales of the same shares. The share tracking system described above would ensure that at no time would the Participating Funds pay Service Fees on shares as to which transaction fees would be charged by Schwab.

(d) Active Traders should pay for the services they use

Although the Active Traders would be paying for transactions in Participating Fund shares while most Schwab customers would not, this payment does not constitute unfair price discrimination between the Active Traders and the rest of Schwab's customers.

Even if the Fee-Free Arrangement resulted in discrimination between investors it would not be unjust within the terms of section 22(d). The fact that Schwab would charge Service Fees to Participating Funds should not preclude it from also charging fees to Active Traders for additional services rendered to the Active Traders in the MFMP. Indeed, one of the two reasons articulated by the SEC for allowing brokers to charge transaction fees was to enable brokers to receive reasonable compensation for services rendered in

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[8] Olde & Co., Inc. (available August 31, 1984). A footnote in the 1974 Report on section 22(d) at p. 113, note 1, also indicates that the Commission is concerned with preventing double payments for the same services.

connection with no-load fund purchases, thereby removing any disincentive for making such fund shares available for sale.[9]

Active Traders will receive special services not available to customers in the Investor Part, including the ability to make any number of trades in Participating Funds. Active Traders will also be permitted an extra hour beyond Schwab's normal cut-off time in which to place orders for all funds in the MFMP and receive that day's net asset value. These services are not only benefits received by Active Traders, but place a cost burden on Schwab for which Schwab should be compensated. Without the ability to charge for those services, Schwab would be in the position of not being permitted to charge for services rendered.

(e) Policy Arguments

(1) Effect on Cost Structure

Permitting fee-free transactions by Active Traders would escalate Schwab's costs too far to make implementing the Fee-Free Arrangement possible. Each transaction involves both direct costs in taking the order, as well as indirect costs such as mailing trade confirmations and prospectuses; sub-accounting costs for tracking dividend payments; and reconciliation of the customer's accounts with the funds. Heavy transaction activities also mean greater (and more expensive) reporting requirements for and to the funds. If Schwab were not permitted to charge Active Traders for transactions in Participating Funds, Schwab would not have transaction fee revenue to offset its costs.

Moreover, without the imposition of transaction fees, Active Traders would be likely to change their trading behavior upon the introduction of the Fee-Free Arrangement, conducting more transactions in Participating Funds. This would further erode Schwab's cost structure to the point that the Fee-Free Arrangement would not be feasible from Schwab's point of view. In addition, Participating Funds would experience much higher costs related to the repeated redemption activities of the Active Traders, costs borne by all fund shareholders. If such funds withdraw from the MFMP as a result of Active Traders, all of Schwab's customers would suffer, and the advantages of liquidity and convenience offered by the MFMP would be reduced accordingly. Alternatively, if the funds make their own determination that Active Traders are likely to trade heavily in Participating Funds, the funds may simply refuse to enter into contracts with Schwab for the Fee-Free Arrangement.

[9] 1974 Report.

(2) Equitable considerations

A customer currently faces a situation in which s/he may (i) buy shares of a fund directly from the fund and pay no transaction fee; (ii) buy shares of the same fund through Schwab's MFMP and pay transaction fees; or (iii) go to a hypothetical broker which could have arrangements with the fund to receive fees for services and would not charge transaction fees to the customer. In this situation, the fund and each broker act independently of each other. What Schwab proposes with the Fee-Free Arrangement is to divide the MFMP into two parts which would resemble situations (ii) and (iii) above. This is no different than making shares of a fund available through two separate brokers. What is now permitted to two separate brokers, or to a broker and the funds, ought not to be prohibited just because the activity is taking place in one broker, Schwab. As discussed above, the existence of the fee-free trading in the Investor Part of the MFMP and the Service Fees which are part of that arrangement, would not affect Schwab's independence with respect to the Active Traders. The Active Part of the MFMP would constitute a different base of assets as to which transaction fees would apply. The remaining customer assets in the Investor Part of the MFMP would be used to calculate the Service Fees charged to Participating Funds. Since Schwab would not be engaged in unfair price discrimination between customers, nor would it be receiving double payment for the same services, principles of equity require that Schwab be permitted to institute these arrangements.

<u>CONCLUSION</u>

As the volume of trading through the MFMP attests, the services offered by Schwab have proved valuable to customers. The current program has been made economically feasible because Schwab is able, pursuant to Staff no-action letter authority, to charge transaction fees to its customers. Schwab believes that for most customers, it can offer an even lower cost service by eliminating the transaction fees charged for transactions in Participating Funds. Thus, for the vast majority of Schwab customers, the benefits of trading through the MFMP would be made available at no cost. Mutual fund investing will be made more convenient for a large number of investors who will receive Schwab's services for free. For Active Traders, Schwab would still permit as many purchases and redemptions as they wanted to make, providing Active Traders with one of the few places where they can pursue their investment strategies. (Many funds do not permit frequent transactions.) The Fee-Free Arrangement would also provide advantages to Participating Funds in that they would still be able to offer their shares to MFMP customers, without the disincentive of transaction fees normally charged by Schwab. Hence, both Schwab customers and the Participating Funds would derive benefits from the Fee-Free Arrangement.

These benefits will not be available, however, if Schwab cannot charge transaction fees to Active Traders. As described above, the effect on both Schwab's cost structure and its relationships with funds would be severely strained if Schwab cannot charge Active Traders for the services they require. Based on current customer trading patterns, Schwab estimates that the Investor Part of the MFMP would constitute about 97% of Schwab's current MFMP customers, accounting for 78% of the assets currently in the MFMP. The Active Part would constitute 3% and 22%, respectively. Therefore, a small minority of 3% of Schwab's total customers would need services that would prevent the Fee-Free Arrangement from benefitting the remaining 97% of the MFMP customers.

The Staff has the authority "to view favorably interpretive requests with respect to proposals that brokers which act independently of funds and their underwriters be permitted, under certain circumstances, to charge reasonable fees for services rendered" in connection with customer transactions in mutual funds.[10] Schwab hereby respectfully requests that the Staff advise that it will not recommend to the Commission that any action be taken if Schwab undertakes the Fee-Free Arrangement as described above.[11] If you have any questions, require further clarification, or are disinclined to issue the requested no-action letter, please call the undersigned. Thank you for your attention to this matter.

Sincerely,

Christina Polischuk

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[10] SEC Investment Company Act Release No. 8570, November 4, 1974, p. 5

[11] Schwab recognizes that any response to this letter by the Staff will not in any way vary any obligations Schwab may have to comply, in its role as a service provider, with terms of any Commission orders exempting any Participating Funds from Sections 18(f), (g), and (i) of the Investment Company Act.

PUBLIC

AUG 6 1992

Our Ref. No. 92-303-CC
Charles Schwab & Co., Inc.
File No. 8-16514

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

By letter dated May 28, 1992, you request our assurance that we would not recommend any enforcement action to the Commission under Section 22(d) of the Investment Company Act of 1940 (the "1940 Act") if Charles Schwab & Co., Inc. ("Schwab"), a registered broker-dealer, charges certain of its customers transaction fees on purchases and redemptions of investment company shares while also receiving service fees from those investment companies.

Schwab offers customers various services in connection with purchases and redemptions of shares in over 500 investment companies through its Mutual Fund Marketplace ("MFMP"). Schwab permits MFMP customers to place purchase and redemption orders in a single telephone call, purchase investment company shares with margin credit, receive a single consolidated account statement, and obtain redemption proceeds through the local Schwab branch within one business day. These services are typically not available when dealing directly with investment companies. Customers pay Schwab for these services through a fee levied on each purchase and redemption of investment company shares based on the dollar size of the transaction. 1/

Schwab provides shareholder, sub-accounting, and transfer agency services to certain investment companies ("Participating Funds") whose shares are available through MFMP. The Participating Funds (or their manager or distributor) pay Schwab a service fee calculated as a percentage of Schwab customer assets and/or number of accounts. 2/ Once Schwab enters into a service agreement with a Participating Fund, Schwab customers no longer pay a transaction fee on trades in shares of that investment company, but still receive Schwab's MFMP services.

1/ The amount of the transaction fees and the MFMP services are further described in three previous no-action requests. Charles Schwab & Co., Inc. (pub. avail Jan. 8, 1982); Charles Schwab & Co., Inc. (pub. avail. Jan. 2, 1987) (Schwab II"); Charles Schwab & Co., Inc. (pub. avail. Nov. 30, 1987). Schwab customers pay no transaction fee when trading in shares of investment companies for whom Schwab acts as a dealer or underwriter, including two Schwab-sponsored investment companies (The Charles Schwab Family of Funds and Schwab Investments). In those instances, Schwab receives a portion of the sales load.

2/ A Participating Fund may pay the service fees under a distribution plan adopted under Rule 12b-1 of the 1940 Act.

Certain customers, identified as "active traders," eventually will pay the same transaction fees as before. Schwab will identify active traders as those persons who have executed more than a specified number (as yet undetermined) of short term redemptions in Participating Funds. 3/ Schwab will notify customers in writing as they approach and when they become active traders. 4/ In calculating its service fee, Schwab will not include active traders' Participating Fund shares or their accounts. Active traders will, as stated above, incur a transaction fee on all trades of MFMP investment company shares. 5/ You state that the transaction fees are justified because active traders place additional costs on Schwab. 6/

Section 22(d) prohibits an investment company from selling its securities except at "a current public offering price described in the prospectus" to any person other than to or through a principal underwriter for distribution. It further states that "if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus." Section 22(d)'s restrictions do not apply to a broker, as that term is defined in the 1940 Act. 7/ Because Schwab purchases and redeems MFMP investment

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3/ Schwab considers a short term redemption to be a redemption of shares held less than six months. Schwab estimates, based on present customer trading patterns, that approximately 3% of MFMP customers will be "active traders," and they will account for about 22% of MFMP customer assets.

4/ Active traders would pay transaction fees only on transactions in an actively-traded account. These customers may have other accounts that are infrequently traded that would not be subject to the fee.

5/ Schwab will not charge a transaction fee on the redemption of shares acquired prior to becoming an active trader.

6/ Active traders receive special services not available to other MFMP customers, including an additional hour each day to place orders at that day's net asset value.

7/ Under Section 2(a)(6) of the 1940 Act, broker means "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank or any person solely by reason of the fact that such person is an underwriter for one or more investment

(continued...)

company shares on behalf of its customers solely as broker, Section 22(d)'s restrictions do not apply to Schwab's involvement in these transactions. 8/ We do not view the shareholder, subaccounting, and transfer agency services as being incompatible with Schwab acting solely as a broker. Our position is based, in particular, on your representation that Schwab acts as agent for its customers in the purchase or redemption of MFMP investment company shares. Because this response is based on the representations made to the Division, you should note that any different facts or circumstances might require a different conclusion.

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7/ (...continued)
companies" [emphasis added]. The 1940 Act defines dealer in Section 2(a)(11).

8/ United States v. National Ass'n of Sec. Dealers, 422 U.S. 694 (1975).