Deborah Doyle McWhinney, President
101 Montgomery Street, San Francisco, California 94104
Tel (415) 636-5160 fax (415) 636-5772

November 25, 2005

Via Electronic Filing

Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: File No. S7-09-05 – *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934* (Release No. 34-52635)

Charles Schwab & Co., Inc. ("Schwab")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's ("Commission" or "SEC") recently proposed interpretive Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934 (the "Proposed Guidance"). The Proposed Guidance seeks to clarify the application and scope of the safe harbor under Section 28(e) of the Securities Exchange Act of 1934 for money managers' use of client commissions as payment for "research" and "brokerage" services. Schwab supports the Commission's efforts and our comments below reflect our concern that the Commission's guidance with regard to bundled products and services may cause significant disruption to the custodial relationships between independent investment advisors and their broker-dealers.

Schwab Institutional's Services to Independent Investment Advisers

Through our Charles Schwab Institutional division ("Schwab Institutional"), we are one of the largest providers of brokerage, custody and related services to independent investment advisory firms ("IAs") and their clients. Schwab Institutional serves approximately 5,000 independent IAs, and we maintain approximately 1.4 million accounts for IAs' clients. Client assets associated with Schwab Institutional total approximately $388 billion. A significant portion of the IAs that Schwab Institutional serves are registered with the Commission under the Investment Advisers Act of 1940 ("Advisers Act"). Others are registered with state securities regulators. IAs' clients establish accounts with Schwab and appoint their IAs through limited powers of attorney to exercise trading and certain other authorities over their accounts. IAs' clients pay for Schwab's services through commissions and some account service fees. There is no separate fee for custody. Even though the account is maintained in Schwab's custody, the

[1] The Charles Schwab Corporation, parent of Schwab, through its operating subsidiaries, serves approximately 7.1 million active accounts and is one of the nation's largest financial services firms.

IA may select broker-dealers other than Schwab to execute trades for settlement in the IA's client accounts through our prime brokerage and related services.

Schwab Institutional has traditional soft dollar arrangements with a number of IAs under which it provides third party research and brokerage services to the IA based on commissions from the IA's clients' accounts. Separately, we make Schwab's own and some third parties' research available to IAs through SchwabInstitutional.com, our password protected web-site for IAs. This research is made available on an unsolicited basis and without regard to the rates or amounts of commissions paid by the IAs' clients' accounts.

On the same unsolicited basis, without charge, and without any tie to the commissions paid by IAs' clients' accounts, Schwab Institutional also makes available to IAs various other products and services that are not research or brokerage within the meaning of the Section 28(e) safe harbor. We are aware that a number of other broker-dealers have business models substantially similar to Schwab Institutional's and provide IAs with products and services in the same manner described here. These items include, among others, online tools that facilitate IAs' management of their clients' accounts (such as account transfer alerts, account opening and cashiering tools, etc.), educational materials (on topics such as IAs' regulatory compliance obligations, practice management and business development), and discounts from third party providers of products and services such as regulatory compliance consulting, errors and omissions insurance and fidelity bonds. As these products and services are merely made available as part of a bundled business package to our IAs, who may or may not use them, Schwab Institutional has never set discrete prices or established systems to separate out products and services from our offering. Schwab Institutional's commission rates, which are certainly competitive with other providers of similar services, are the same or lower than Schwab retail rates and yet Schwab Institutional account holders (IAs' clients) receive substantially all the same services as Schwab retail customers.

Comments

While we believe that the Proposed Guidance will assist IAs in determining eligibility of research and brokerage services and other conditions to the availability of the Section 28(e) safe harbor, we believe the modifications recommended below are needed to achieve the clarity sought and to avoid imposing unwarranted (and perhaps unintended) and clearly impractical burdens on IAs and the broker-dealers that serve them.

I. The Guidance Should Confirm the Availability of the Safe Harbor Where Bundled Services Are Made Available on an Unsolicited Basis and Not Tied to Client Commissions.

Our concern with the Proposed Guidance is primarily drawn from a single footnote. In a statement that seems to greatly expand upon previous Commission interpretations, footnote 108 to the Proposed Guidance states that:

> "[I]f the money manager seeks the protection of the safe harbor and receives both Section 28(e) eligible and ineligible products and services for a bundled commission rate, the manager must use his own funds to pay for the allocable portion of the cost of products and services that are not within the safe harbor."[2]

Use of the word "receives" and not including a phrase such as "purchased with client commissions"[3] appears to require an IA to pay hard dollars for non-research and non-brokerage services that are merely made available to an IA:

- on an unsolicited basis;
- without charge or even any stated price;
- without regard to commission volume and rates or, indeed, whether the IA's client accounts generate any commissions; and
- regardless of whether the IA even uses the services.

Requiring the IA to pay hard dollars for these services as footnote 108 suggests, would, in turn, require the broker-dealer making them available to unbundle the services from the rest of its platform, set discrete prices for them, and possibly introduce additional billing mechanisms, all for services unrelated to client commissions. If actually intended by the Commission, this entirely new condition to the availability of the safe harbor (set forth in a footnote) is unnecessary and inconsistent with both the Commission's previous interpretations of 28(e) as well as established market practices. It would impose a new and undue burden on IAs and broker-dealers and significantly disrupt industry practices. Compliance with this new requirement would be extremely difficult. The costs would be significant and any conflict of interest concerns can be addressed through much less draconian means.

A. The Commission's Interpretations of Section 28(e) and Established Industry Practice Are Predicated on the Existence of an Exchange.

The Section 28(e) safe harbor is predicated on the existence of the conflict of interest that arises from an exchange, specifically an IA's expenditure of client commission dollars (commonly called "soft dollars" by market participants and by the Commission) in order to receive services beyond trade execution. Such an exchange is not present with broker-dealers' integrated trading and custody platforms that make available non-research and brokerage services on an unsolicited basis and without any requirement that the IA's clients' accounts generate any commissions. The availability of those services should not be viewed as a "client commission practice" within the scope of the Proposed Guidance.[4]

---

[2] Proposed Guidance, III.E., p.37.

[3] *See* Proposed Guidance, I. Introduction and Summary, p.2 ("Section 28(e) of the Exchange Act establishes a safe harbor that allows money managers to *use client funds to purchase* 'brokerage and research services' for their managed accounts under certain circumstances without breaching their fiduciary duties to clients." [Emphasis supplied.]).

[4] *See* Proposed Guidance footnote 2, p.3 ("To avoid confusion that may arise over the usage of the phrase "soft dollars," in this release, the Commission uses the term "client commission" practices or arrangements

The Commission has long recognized that the safe harbor is premised upon an exchange of client commissions for research, and the language of the Proposed Guidance recognizes it as well:

> "Use of client commissions *to pay for* research and brokerage services presents money managers with significant conflicts of interest…"[5]

Unsolicited bundled services do not involve the exchange of client commissions by the IA in order to obtain the services, and the mere availability of the services does not create the conflict for which the safe harbor was designed. An IA seeking the protection of the safe harbor for its use of client commissions to obtain eligible research and brokerage services should not, as footnote 108 would require, have to determine the value of the broker's unsolicited bundled services not tied to commissions and pay that value to the broker in hard dollars.

To be clear, we are not suggesting that the safe harbor should protect an IA's actual use of client commissions to purchase services that are neither research nor brokerage as defined by the Proposed Guidance. Were the broker providing the services to condition their availability on the generation of commissions, then the conflict of an exchange would exist, and the safe harbor should not apply. In contrast, where ineligible bundled services are available without the expenditure of client commissions, the potential conflict of interest is attenuated, and precisely the type for which disclosure (as discussed below) has long been recognized as the appropriate and effective solution.

B. The Mixed Use Concept Should Not Apply to Bundled Services Made Available on an Unsolicited Basis.

We hope that the effect of footnote 108 described above is not what the Commission intends. We note that footnote 108 appears in the section of the Proposed

---

to refer to practices under Section 28(e).") We respectfully submit that, notwithstanding the intent to clarify and avoid confusion, footnote 108 leads to the opposite result, and changing the label from soft dollars to client commission practices does not clarify the confusion.

[5] Proposed Guidance, I., p.3. *See also* Proposed Guidance, I., p.2 ("…use client funds *to purchase* 'brokerage and research services'"); *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Securities Exchange Act Release No. 34-23170 (April 23, 1986) ("1986 Release") at IV.A.1., p.17 ("…when an adviser receives research *as a result of* allocating brokerage on behalf of clients' accounts…"); NASD Report of the Mutual Fund Task Force, *Soft Dollars and Portfolio Transaction Costs* ("NASD Task Force Report"), p.1, *citing* SEC Release No. 34-35375, IA-1469 *Disclosure by Investment Advisers Regarding Soft Dollar Practices* (February 14, 1995) ("1995 Release") ("the SEC has defined the term [soft dollars] to mean products and services, other than execution of securities transactions, that an investment manager receives from or through a broker-dealer *in exchange for* the adviser's direction of client brokerage transactions to the broker-dealer."); T. Lemke and G. Lins, Soft Dollars and Other Brokerage Arrangements, (2004 ed.) §1.01. p.1 (…a soft dollar arrangement involves an agreement or understanding where a discretionary money manager receives research or execution services from a broker-dealer in addition to transaction execution, and does so *in exchange for* the brokerage commissions…) [All emphasis supplied.]

Guidance that reiterates the allocation approach for "mixed use items"[6] first articulated by the Commission in its 1986 Release on Section 28(e).[7] As the Proposed Guidance and the 1986 Release reflect, mixed use allocation applies to *individual* products and services, not to entire integrated platforms.[8] Accordingly, we believe footnote 108 unnecessarily confuses the otherwise clear standards for mixed-use product allocations articulated by the Proposed Guidance and reflects a departure from previous Commission guidance and industry practice. We urge the Commission to delete footnote 108 from its final interpretive guidance.

C. Client Commissions Must be Reasonable in Relation to Eligible Services Used.

An IA can make a good faith determination that the commissions it causes its clients to pay are reasonable in relation to the value of just the *eligible* services (research and brokerage as interpreted in the Proposed Guidance) provided by the broker and for which the IA directs commissions. IAs able to make this determination (and standing ready to demonstrate it through documentation[9]) should be deemed to have satisfied the conditions of the Section 28(e) safe harbor without valuing and paying hard dollars for unsolicited bundled services. The IA should not be open to a claim that it breached its fiduciary duties merely because the IA receives services other than research and brokerage that (1) it did not request, (2) it did not expend client commissions to obtain, and (3) it disclosed to its client were made available to it and, if applicable, used by it. We request that the Commission clarify this in its final guidance.

D. IAs Cannot Practically Value and Pay for Unsolicited Bundled Services.

Bundled services are not priced by broker-dealers and are not conducive to valuation by IAs in any practical or uniform manner. Consequently, IAs would not be able to satisfy the new prerequisite to the safe harbor imposed by footnote 108. As thoroughly discussed in the NASD Task Force Report, there is no accepted uniform method for determining the value of bundled services, and there is no industry or regulatory consensus that such an exercise would be beneficial. That kept the NASD Task Force from reaching consensus on unbundling.[10] Given this to be true for proprietary research obtained with mutual fund brokerage commissions as was the issue before the Task Force, it is certainly the case for unsolicited ineligible services available without expenditure of client commissions, as discussed here. Furthermore, with individually managed accounts (as opposed to mutual fund investing), commission charges are more transparent to investors, and they can easily assess the reasonableness of commissions their IAs cause them to pay.

---

[6] Proposed Guidance, III.E. Mixed Use *Items* [Emphasis supplied.], p. 36.
[7] *See* 1986 Release.
[8] *See* Proposed Guidance, III.E. p.36 ("Where *a product obtained with client commissions* has a mixed use…). *See also* 1986 Release, II.B., p. 10 ("Where *a product obtained with soft dollars* has a mixed use…). [All emphasis supplied.]
[9] *See* Proposed Guidance, III.F., p.38 ("The burden of proof in demonstrating [the good faith] determination [of reasonableness] rests on the money manager."), and III. E., p. 37 ("Lack of documentation makes it difficult for the manager to make the required good faith showing…").
[10] *See* NASD Task Force Report footnotes 26-29 and accompanying text, pp. 9-10.

At minimum, if the Commission decides to pursue the unbundling concept embedded in footnote 108 despite the compelling reasons not to, that action should be delayed and taken up as part of the Commission's expected action on IAs' disclosure of their soft dollar and brokerage allocation practices.[11] That would give affected industry participants a better opportunity to fully address the important issues arising from the concept, including uniformity, clarity, practicability, costs and benefits. We believe that a requirement to unbundle the products and services on our platform, either for purposes of valuation or restricting IAs' access, would involve significant systems and other costs.

E. Mandatory Valuation and Payment for Unsolicited Bundled Services Would Disrupt Industry Practices Without a Compelling Policy Justification.

If the language of footnote 108 is included in the Commission's final guidance, IAs would have the following choices:

- Cease using broker-dealers they otherwise deem appropriate from an overall best execution perspective because they make available certain bundled ineligible services, even if the IA doesn't use the ineligible services;
- Forego the availability of the safe harbor, which many IAs are loathe to do and which may not be an option if the IA has clients that are retirement accounts or registered investment companies; or
- Spend considerable time and resources ascribing a value, probably little better than a guess, to services that the IA may not even use and for which it does not spend client commissions.

Given the untenable nature of the first two choices, in effect, the Commission would require broker-dealers to unbundle their offerings and dictate new pricing structures. An action that is so intrusive on the market and competition is entirely unjustified in light of the lack of a conflict of interest driven by an "exchange" and the availability of much less restrictive means to protect investors.

F. Disclosure Effectively Manages Potential Conflicts Related to Bundled Services.

We acknowledge that the availability of bundled products and services may pose a potential conflict of interest for IAs. As noted above, where ineligible services are available to an IA from a broker-dealer not based on client commissions but as a result of the IA's client choosing to maintain its assets in the broker-dealer's custody, any advice the IA provides its clients about the choice of custodian could be influenced. This is the type of potential conflict of interest not uncommon to an IA's practices and for which full and fair disclosure is a well established requirement. Section 28(e)(2) and Form ADV require that IAs make extensive disclosure about their client commission practices, and the Commission has often considered further expanding these requirements, and may soon do so again.[12] While, as discussed above, an IA should not, as footnote 108 would require,

[11] *See* Proposed Guidance, footnotes 7 and 72, pp. 4 and 24, respectively.
[12] *See* Advisers Act Form ADV *Uniform Application for Investment Adviser Registration*; 1986 Release, IV. Disclosure and Other Obligations Under the Investment Advisers Act of 1940 and the Investment

have to value and pay hard dollars for unsolicited bundled services not tied to commissions, the IA is required to disclose those services to its clients.[13]

Schwab Institutional strongly supports full disclosure by IAs to their clients of all potential conflicts, including those relating to access to bundled products and services. We publish a compliance newsletter and host webcasts authored and presented by independent third party experts on IA regulatory compliance obligations, including many on IA disclosure requirements and best practices.[14] Schwab Institutional has also provided our IA clients with a template of disclosure language describing our services to IAs and the basis of the availability of those services to help facilitate their proper disclosure of our services. Finally, while we are not under any duty to do so, we have included disclosure about the services we make available to IAs in our account agreements with IAs' clients.

The well-established disclosure requirements for IAs assures that their clients are well informed of the nature and scope of services available to them and how those services could affect the IA's selection of or advice about a broker or custodian. This disclosure obviates any need for IAs to value and pay for unsolicited bundled services as provided in footnote 108.

II. The Final Guidance Should Clarify That Custody is a Brokerage Service Eligible for the Safe Harbor.

Custody is included in the definition of "brokerage… services" in the statutory language of Section 28(e)(3)(C) as a function, along with clearance and settlement, incidental to effecting securities transactions. The Proposed Guidance recites this definition.[15] Nevertheless, the Proposed Guidance fails to mention custody when it specifically names clearance and settlement as "explicitly identified as eligible incidental brokerage services."[16] Presumably this was a drafting oversight. The Proposed Guidance then goes on to articulate a new temporal standard for eligible brokerage services that begins when an order is transmitted to a broker-dealer and ends at the conclusion of clearance and settlement. Custody continues on after settlement and is outside the temporal standard for eligible brokerage. But since it, like clearance and settlement, is explicitly identified in Section 28(e) as an eligible incidental brokerage service, we

---

Company Act of 1940 Applicable to Money Managers Engaging in Soft Dollar Arrangements, pp.16-31; 1995 Release; SEC Release No. IA-1862 *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV* (April 5, 2000), II.D.2.a. Part 2A: The Firm Brochure, Item 11. Brokerage Practices.

[13] *See* Form ADV, Part II, Items 12.B (factors IA considers when selecting or recommending brokers and determining the reasonableness of their commissions) and 13.A (arrangements under which IA receives economic benefits (including non-research services) from someone other than a client in connection with giving advice).

[14] Ironically, footnote 108 would discourage these educational services promoting disclosure (services that benefits IAs' clients) by requiring Schwab Institutional to unbundle so IAs can pay us hard dollars for them, even though IAs don't solicit these services or spend client commissions to receive them.

[15] *See* Proposed Guidance, III.D. Eligibility Criteria for "Brokerage" under Section 28(e); Lawful and Appropriate Assistance, p.32.

[16] Proposed Guidance, III.D., p.32.

suggest that the Commission's final guidance confirm that and foreclose any question that might otherwise arise in light of the Proposed Guidance.

III. The Final Guidance Should Provide an Adequate Transition Period.

The Commission's proposed narrowing of the products and services eligible for the Section 28(e) safe harbor would, if adopted as final, require IAs and broker-dealers to alter some arrangements in place today. The arrangements are often implemented for one year terms and renewed or modified annually, and this annual cycle often is the calendar year. Hence, while the Proposed Guidance is pending, many IAs and broker-dealers are in the middle of renewals and modifications of 2005 arrangements for 2006. That process involves legal documents between IAs and brokers and between brokers and third party vendors. It also involves operational processes for tracking and reporting. Changes required by the Commission's guidance will drive substantial changes to this documentation and these processes.

We strongly recommend that in its final Guidance the Commission delay the effective date of the guidance as applicable to new arrangements for at least 90 days after adoption and provide a transition period of one year to bring existing arrangements into alignment with the final guidance.

Conclusion

Schwab greatly appreciates the opportunity to comment on the Proposed Guidance and strongly supports the Commission's efforts to clarify the application and scope of the Section 28(e) safe harbor. Our comments above are intended to help achieve clarity in the most beneficial and least costly way. If the Commission or any members of the staff would like to discuss these issues with us, we would be pleased to make ourselves available for that purpose.

Sincerely,

/s/

Deborah Doyle McWhinney
President, Charles Schwab Institutional