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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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

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