

**STATE OF ILLINOIS  
SECRETARY OF STATE  
SECURITIES DEPARTMENT**

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<b>IN THE MATTER OF:</b>	)	
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<b>CHARLES SCHWAB &amp; CO., INC.;</b>	)	<b>FILE NO. 0800574</b>
	)	
<b>CHARLES SCHWAB INVESTMENT MANAGEMENT, INC.;</b>	)	
	)	

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**NOTICE OF HEARING**

**TO THE RESPONDENTS:** Charles Schwab & Co., Inc.  
(CRD #5393)  
c/o its attorney Neal Sullivan  
Bingham McCutchen LLP  
2020 K Street NW  
Washington, DC 20006-1806

Charles Schwab Investment Management, Inc.  
(CRD #106753)  
c/o its attorney Neal Sullivan  
Bingham McCutchen LLP  
2020 K Street NW  
Washington, DC 20006-1806

You are hereby notified in accordance with Sections 11.E and F of the Illinois Securities Law of 1953 [815 ILCS 5/11.E and F] (“the Act”) and 14 Ill. Adm. Code 130, subpart K, that a public hearing will be held at the Secretary of State’s office at the office of the Illinois Securities Department, 69 W. Washington Street, Suite 1220, in Chicago, Illinois 60602, on March 11, 2011 or as soon thereafter as possible before James Kopecky, or such other hearing officer who shall be presiding at that time.

Said hearing will be held to determine whether an Order shall be entered pursuant to Section 11.E of the Act sanctioning the Respondents and/or granting such other relief as may be authorized under the Act including, but not limited to, the imposition of a monetary fine in the maximum amount pursuant to Section 11.E of the Act, payable within ten (10) business days of the entry of the Order.

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The grounds for this proposed action are as follows:

### **BACKGROUND**

1. Respondent Charles Schwab & Co., Inc. ("CSCO") is a securities broker-dealer with a current address of 211 Main St., San Francisco, CA 94105.
2. Respondent Charles Schwab Investment Management, Inc. ("CSIM") is a federally registered investment adviser with a current address of 211 Main Street, San Francisco, CA 94105.
3. Schwab Investments is an open-end management investment company organized as a Massachusetts business trust and is registered under the Investment Company Act ("ICA"). Schwab Funds are managed by CSIM.
4. The Schwab YieldPlus Fund (the "fund") is a bond mutual fund that was created in October of 1999 and offered as one of the mutual funds of Schwab Funds. CSCO was responsible for sales and marketing of the fund, and CSIM managed the fund's investments.
5. During the relevant time period, over 13,000 brokerage accounts in the State of Illinois purchased shares of the fund. Since the second half of 2007, some Illinois residents made complaints to CSCO about the fund alleging, among things, inaccuracies about the risk, volatility and suitability of the investment and the marketing of the fund.

### **CSCO IMPROPERLY MARKETED THE FUND TO INVESTORS**

6. In the course of selling and marketing the fund, CSCO failed to conduct business in accordance with the provisions of the Illinois Securities Law of 1953 [815 ILCS 5/1 *et. seq*] (the "Act").
7. CSIM also failed to act in accordance with the provisions of the Act in the course of managing the fund's investments.
8. In advertisements for the fund, CSCO described YieldPlus as a cash alternative investment, and compared the fund to money market funds, saying it had a "slightly higher risk" than a money market fund. Schwab's registered representatives similarly informed customers that YieldPlus was an alternative to money market funds and certificates of deposit. However, CSCO did not sufficiently differentiate the risk characteristics of a money market investment versus an investment in the fund.
9. One Illinois resident who filed a complaint with the Illinois Securities Department (Investor A) alleged that the Illinois resident opened an account with CSCO in 2005. In opening the account, Investor A stated that the investment objective was low risk with modest income due to the investor's planned retirement. The CSCO registered representative recommended the fund to Investor A stating the fund was a low risk

investment with higher yields than similar funds. Investor A purchased shares in the Fund on three separate occasions.

10. A money market fund is commonly defined as follows:

A money market fund is a type of mutual fund that is required by law to invest in low-risk securities. These funds have relatively low risks compared to other mutual funds and pay dividends that generally reflect short-term interest rates. Money market funds typically invest in government securities, certificates of deposit, commercial paper of companies, or other highly liquid and low-risk securities.

11. In its marketing materials, CSCO compared the fund to money market funds. For example, in a September 2006 mailing to customers, CSCO claims that the fund:

...offers higher potential returns than money market funds with only marginally higher risk

12. Additionally CSCO stated in a January 2006 marketing brochure:

If you're comfortable accepting a slightly higher amount of risk in exchange for a return that's generally better than other cash - equivalent investments, consider this ultra short bond fund.

13. CSCO also stated in an August 2006 web page that "The Schwab YieldPlus fund... can be a smarter alternative to investing in money market [funds]."

14. CSCO marketed the fund as an ultra-short bond fund. An ultra-short bond fund is commonly defined as a mutual fund that generally invests in fixed income securities with extremely short maturities, or time periods in which those securities become due for payment. In 2000, the fund's prospectus was revised to remove the maturity limitations of the fund. Despite this change in the prospectus, CSCO continued to market and sell the fund as an ultra-short bond fund even though the fund invested heavily in longer maturity securities in a manner inconsistent with that of an ultra-short bond fund.

15. While ultra-short bond funds are permitted to invest in a wide variety of instruments including asset and mortgage-backed securities, the fund invested heavily in residential non-agency mortgage backed securities. Residential mortgage-backed securities generally are not short term securities.

16. The fund's prospectus was revised in November of 2000 to remove the maturity limitations of the fund:

To help maintain a very high degree of share price stability and preserve investors' capital, the fund seeks to keep the average effective duration of its overall portfolio at one year or less...

Duration is a measure of a bond's interest rate risk. Specifically, duration measures a bond's sensitivity to a one percent change in market interest rates. Duration does not however, measure other types of risks that are associated with fixed income securities.

17. In short, CSCO should have known that an investment in the fund carried higher potential risk than an investment in a money market fund and an ultra-short bond fund.
18. Due to CSCO's improper marketing of the fund as an alternative to money market funds and as a low risk bond fund, many individuals invested in the fund and experienced losses in the fund.
19. CSCO improperly used as a benchmark the Lehman Brothers US Treasury Short 9 - 12 Month Index. The benchmark held treasury securities with average maturities of 9 - 12 months. The fund held securities with longer periods. Further the benchmark held securities that were on average more liquid. CSCO inadequately disclosed these differences. The fund was less liquid and was a higher risk investment than its benchmark.

**CSIM CONCENTRATED THE FUND IN NON-AGENCY MORTGAGE  
BACKED SECURITIES WITHOUT A SHAREHOLDER VOTE**

20. CSIM concentrated the fund's assets in non-agency MBS. This concentration violated the fund's policy in regard to the concentration of investments in the fund. The concentration contributed to the substantial drop in the fund's NAV once the financial crisis of 2007-08 affected the value of those securities.
21. In regard to its concentration policy, CSIM:
  - a. Initially defined non-agency mortgage backed securities as a single industry; and
  - b. Subsequently changed that definition on September 1, 2006, to define mortgage backed securities as not part of any single industry.
22. CSIM laid out the guidelines regarding the concentration of investments in the fund's Statement of Additional Information ("SAI"). The SAI for November 15, 2004, which the Fund's prospectus incorporates by reference, states that:

The Schwab YieldPlus fund... may not... concentrate investments in a particular industry or group of industries, as concentration is defined under the 1940 Act, or the rules and regulations thereunder, as such statute, rules and regulations may be amended from time to time.
23. This same SAI defines concentration as "investing 25% or more of an investment company's net assets in an industry or group of industries..."

24. In regard to what constitutes an industry, the SAI made it clear that non-agency mortgage backed securities were to be considered a single industry. The November 15, 2004, SAI stated:

Based on the characteristics of mortgage backed securities, each fund has identified mortgaged-backed securities issued by private lenders and not guaranteed by U.S. government agencies or instrumentalities as a separate industry for the purposes of a fund's concentration policy.

25. In other words, CSIM informed investors that it would not invest more than 25% of the Fund's assets in non-agency mortgage backed securities.

26. This policy remained in effect until September 1, 2006, when CSIM amended its November 15, 2005 SAI in order to re-define non-agency mortgage backed securities as investments that do not belong to any one industry:

The funds have determined that mortgage backed securities issued by private lenders do not have risk characteristics that are correlated to any industry and, therefore, the funds have determined that mortgage-backed securities issued by private lenders are not a part of any industry for purposes of the funds' concentration policy.

27. This revision to the fund's SAI meant that the fund was able to invest more than 25% of its total assets in privately-issued mortgage backed securities. By mid-2007, approximately 50% of the fund's assets were in non-agency MBS.

28. CSIM changed the fund's concentration policy for non-agency mortgage backed securities without approval from existing shareholders of the fund. On March 30, 2010, a federal district court Judge found that Schwab's change of its policy regarding the fund's concentration in non-agency mortgage-backed securities was in violation of federal securities laws.

29. In 2006, CSIM modified the fund's registration statement to allow the fund to invest more than 25% of its assets in non-agency MBS. Prior to this change, the fund was not permitted to exceed this 25% threshold. As a result, the fund invested more of its assets in securities with longer maturities, making the fund more vulnerable to significant changes in market conditions such as the credit crisis that began in the summer of 2007.

30. Despite the increased risk involved in investing in the fund, CSCO failed to change its marketing materials to reflect the increased risk. Rather, they continued marketing the fund as they had prior to the change in the fund's MBS classification policy.

31. The fund also failed to disclose that pricing of MBS was becoming more unreliable in light of the significant changes in market conditions. Established procedures for determining the value of securities held by the fund ("Valuation Procedures") required an

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- independent pricing service, FT Interactive Data (“IDC”), to provide pricing for the securities. The procedures authorized a Pricing Committee to determine the “fair value” of certain securities when (i) the valuation furnished by the IDC appeared to be “manifestly incorrect” or (ii) events materially affecting such valuation occurred between the valuation determined by the IDC and the time the funds’ NAV is calculated.
32. During certain times in 2008, in a limited number of transactions, market conditions and partial sales of certain less liquid securities resulted in a difference in the sale price of those securities and the price provided by IDC, which the fund did not disclose.
  33. The activities described above constitute an offer and sale of a security, as those terms are defined in Sections 2.1, 2.5, and 2.5a of the Act.
  34. Section 12.A of the Act provides that it shall be a violation for any person to offer or sell any security except in accordance with the provisions of the Act.
  35. Section 8.E(1)(e)(i) of the Act provides, *inter alia*, that a dealer may be subject to sanctions if the dealer has failed reasonably to supervise the securities activities of any of its salespersons or other employees and the failure has permitted or facilitated a violation of Section 12 of this Act.
  36. Section 8.E(1)(e)(iv) of the Act provides, *inter alia*, that a dealer may be subject to sanctions if the dealer has failed to maintain and enforce written procedures that are reasonably designed to achieve compliance with applicable securities laws and regulations.
  37. Section 8.E(1)(f) of the Act provides that an investment adviser may be subject to sanctions if the investment adviser has failed reasonably to supervise the advisory activities of any of its employees and the failure has permitted or facilitated a violation of Section 12 of this Act.

NOTICE: You are further notified that you are required pursuant to Section 130.1104 of the Rules and Regulations (14 Ill. Adm. Code 130)(the “Rules”), to file an answer to the allegations outlined above within thirty (30) days of the receipt of this Notice. A failure to file an answer within the prescribed time shall be construed as an admission of the allegations contained in the Notice of Hearing.

Furthermore, you may be represented by legal counsel; may present evidence; may cross-examine witnesses and otherwise participate. A failure to so appear shall constitute default, unless any Respondent has upon due notice moved for and obtained a continuance.


A copy of the Rules and Regulations promulgated under the Illinois Securities Law and pertaining to hearings held by the Office of the Secretary of State, Illinois Securities Department, are available at the Department’s website at:  
<http://www.cyberdriveillinois.com/departments/securities/lawrules.html>, or on request.

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Delivery of Notice to the designated representative of any Respondent constitutes service upon such Respondent.

Dated: This 10th day of January 2011.

A handwritten signature in black ink, appearing to read "Jesse White", with a stylized flourish at the end.

JESSE WHITE  
Secretary of State  
State of Illinois

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