

SEC v. CHARLES SCHWAB INVESTMENT MANAGEMENT, et al

U.S. SECURITIES AND EXCHANGE COMMISSION

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SEC v. CHARLES SCHWAB INVESTMENT MANAGEMENT, CHARLES SCHWAB & CO., INC., and SCHWAB INVESTMENTS, Civil Action No. CV-11-0136 EMC (N.D. Cal. Jan. 11, 2011)

SEC CHARGES SCHWAB ENTITIES WITH MAKING MISLEADING STATEMENTS

The Securities and Exchange Commission today charged Charles Schwab Investment Management (CSIM) and Charles Schwab & Co., Inc. (CS&Co.) with making misleading statements regarding the Schwab YieldPlus Fund and failing to establish, maintain and enforce policies and procedures to prevent the misuse of material, nonpublic information. The SEC also charged CSIM and Schwab Investments with deviating from the YieldPlus fund's concentration policy without obtaining the required shareholder approval.

CSIM and CS&Co. agreed to pay more than \$118 million to settle the SEC's charges.

The YieldPlus Fund is an ultra-short bond fund that, at its peak in 2007, had \$13.5 billion in assets and over 200,000 accounts, making it the largest ultra-short bond fund in the category. The fund suffered a significant decline during the credit crisis of 2007-2008 and saw its assets fall from \$13.5 billion to \$1.8 billion during an eight-month period due to redemptions and declining asset values.

According to the complaint filed in federal court in San Francisco and a related order issued by the Commission, CSIM and CS&Co. failed to inform investors adequately about the risks of investing in the YieldPlus Fund. For example, they described the fund as a cash alternative that had only slightly higher risk than a money market fund. The statements were misleading because the fund was more than slightly riskier than money market funds, and the Schwab entities did not adequately inform investors about the differences between YieldPlus and money market funds. In particular, the maturity and credit quality of the YieldPlus Fund's securities were significantly different than those of a money market fund.

The SEC also found that the YieldPlus Fund deviated from its concentration policy when it invested more than 25 percent of fund assets in private-issuer mortgage-backed securities (MBS). Mutual funds and other registered investment companies are required to state certain investment policies in their SEC filings, including a policy regarding concentration of investments. Once established, a fund may not deviate from its concentration policy without shareholder approval. Schwab's bond funds, including the YieldPlus Fund and the Total Bond Market Fund, had a policy of not concentrating more than 25% of assets in any one industry, including private-issuer MBS. The funds violated this policy, and the Investment Company Act, by investing approximately 50% of the assets of the YieldPlus Fund and more than 25% of the Total Bond Fund's assets in private-issuer MBS without obtaining shareholder approval.

According to the complaint and the related order, the YieldPlus Fund's NAV began to decline and many investors redeemed their holdings as the credit crisis unfolded in mid-2007. Unlike a money market fund, few of the fund's assets were scheduled to mature within the next several months. As a result, the fund had to sell assets in a depressed market to raise cash. While the YieldPlus Fund's NAV declined, CSIM and CS&Co. held conference calls, issued written materials, and had other communications with investors that contained a number of material misstatements and omissions concerning the fund.

The Commission also found that CSIM and CS&Co. did not have policies and procedures reasonably designed, given the nature of their businesses, to prevent the misuse of material, nonpublic information about the fund. For example, they did not have specific policies and procedures governing redemptions by portfolio managers who advised Schwab funds of funds, and did not have appropriate information barriers concerning nonpublic and potentially material information about the fund. As a result, several Schwab-related funds and individuals were free to redeem their own investments in YieldPlus during the fund's decline.

Without admitting or denying the allegations in the Commission's complaints, CSIM and CS&Co. agreed to pay a total of \$118,944,996, including \$52,327,149 in disgorgement of fees by CSIM, a \$52,327,149 penalty against CSIM, a \$5,000,000 penalty against CS&Co., and pre-judgment interest of \$9,290,698. CSIM's disgorgement may be deemed satisfied, up to a maximum of \$26,944,996, for payments made within the next 60 days to settle related investigations by FINRA or state securities regulators. The Commission seeks to have payments placed in a Fair Fund for distribution to harmed investors, and the related recoveries by other regulators, such as FINRA, may be contributed to the Fair Fund. The payments and any Fair Fund are subject to approval by the United States District Court for the Northern District of California.

The Commission today also instituted related cease-and-desist proceedings against CSIM, CS&Co. and Schwab Investments for the same conduct. In connection with these proceedings, CSIM, CS&Co. and Schwab Investments consented to a Commission order requiring them to cease and desist from committing or causing future violations of the federal securities laws. The Commission order also requires them to comply with certain undertakings, including correction of all disclosures regarding the funds' concentration policy. In addition, the Commission censured CSIM and CS&Co., and required them to retain an independent consultant to review and make recommendations about their policies and procedures to prevent the misuse of material, nonpublic information.

In its complaint, the Commission alleges and, in its related order, found that:

- CSIM and CS&Co. willfully violated anti-fraud provisions of the Securities Act of 1933, Sections 17(a)(2) and (3).
- CSIM willfully violated anti-fraud provisions of the Investment Advisers Act of 1940, Section 206(4) and Rule 206(4)-8.
- Schwab Investments willfully violated Section 13(a) of the Investment Company Act of 1940 by deviating from its concentration policy, and CSIM willfully aided and abetted and caused the violation.
- CSIM and CS&Co. willfully aided and abetted and caused violations of the false filings provision of the Investment Company Act, Section 34(b).
- CS&Co. violated Section 15(g) (formerly Section 15(f)) of the Securities Exchange Act of 1934, and CSIM violated Section 204A of the Advisers Act, both of which require policies and procedures that are reasonably designed, taking into consideration the nature of the entities' businesses, to prevent the misuse of material, nonpublic information.

The Commission acknowledges the assistance of FINRA.