

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
No. 2008012876902**

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Charles Schwab & Company, Inc., Respondent
CRD No. 5393

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent Charles Schwab & Company, Inc. submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Charles Schwab & Company, Inc. ("Schwab" or "firm"), with principal offices in San Francisco, California, is a nationwide broker-dealer that has been registered with FINRA since 1970. With over 6700 registered persons and approximately 330 branch offices nationwide, Schwab provides brokerage services to retail investors and independent investment advisory firms offering a wide array of investment products including stocks, bonds and mutual funds.

OVERVIEW

YieldPlus is an ultra-short term bond fund managed by Charles Schwab Investment Management ("CSIM"), an affiliate of the Firm. YieldPlus was intended to provide current income with minimal changes in share price, with an average duration of the portfolio holdings at one year or less. Schwab marketed YieldPlus as a relatively low-risk alternative to money market funds and other cash alternative investments.

After Schwab Investments' Board of Trustees approved the fund manager's proposal to no longer classify non-agency mortgage-backed securities obligations ("MBS") as an industry for purposes of the fund's concentration policies on August 29, 2006, CSIM began increasing the fund's holdings in MBS. As a result, the percentage of assets in mortgage-backed securities increased from less than 25% on August 31, 2006 to more than twice that amount by the end of February 2008. This increase caused YieldPlus to be disproportionately affected by the turmoil in the mortgage-backed securities market beginning in the summer of 2007 and through the credit crisis of 2007-08. The fund's NAV dropped significantly in 2007 and 2008, falling from the 2007 high of \$9.69 on February 26, 2007 to \$8.79 on February 29, 2008, a decline of 9.3%.

Schwab's investment management unit was aware of the changes in the fund's portfolio and failed to recognize the resulting increase in the risk and price volatility of the fund. But between September 1, 2006 and February 29, 2008 (the "relevant period"), Schwab continued to market YieldPlus as a relatively low-risk alternative to money market funds and certificates of deposit ("CDs") that had minimal fluctuations in NAV. In written materials and in certain conversations with customers, some representatives of the firm omitted or provided incomplete or inaccurate material information relating to the funds' characteristics, risk, and diversification.

Schwab failed to adequately supervise the sales and marketing of YieldPlus including failing to reasonably supervise how its representatives and sales materials were portraying the product.

By engaging in this conduct, Schwab violated NASD Rules 2110, 2210, and 3010.

FACTS AND VIOLATIVE CONDUCT

Schwab YieldPlus Fund Overview

YieldPlus was an ultra-short term bond fund whose objective was to provide current income with minimal changes in share price, with an average duration of the portfolio holdings at one year or less. The fund was advised by CSIM, the investment adviser affiliate of Schwab. The Fund's lead portfolio manager headed a team that selected the investments for the YieldPlus portfolio.

Prior to August 2006, pursuant to its fundamental investment policy and in accordance with Section 8(b)(1) of the Investment Company Act of 1940, YieldPlus was only permitted to invest a maximum of 25% of fund assets in the securities of any particular industry. Schwab's fixed income funds categorized non-agency MBS as an industry for this purpose. Accordingly, mortgage-backed securities constituted 19.0% of the fund's assets in August 2005, increasing to 23.2% by November 2005 and 23.5% by February 2006.

The Change in YieldPlus' Portfolio

On August 29, 2006, Schwab Investments' Board of Trustees approved the proposal of the fund managers of YieldPlus to no longer classify non-agency MBS as an industry for purposes of the fund's concentration policies. This change purportedly allowed the fund managers to increase the amount of non-agency mortgage-backed securities in the portfolio to greater than 25% of fund assets.

After the reclassification of non-agency MBS, the concentration of mortgage-backed securities in YieldPlus increased substantially. Three months later, by November 2006, YieldPlus had increased its percentage of assets in mortgage-backed securities to 34.2%. These holdings jumped to 42.4% by February 28, 2007, and further climbed to 46.5% by May 2007. By February 2008, YieldPlus held 50.1% of its assets in mortgage-backed securities. As of August 31, 2006, non-agency MBS composed 24.6% of the fund. This percentage increased to 40.4% by February 29, 2008.

The increased concentration in mortgage-backed securities caused YieldPlus to be disproportionately affected by the turmoil in the mortgage-backed securities market beginning in the summer of 2007. The fund's NAV dropped significantly in 2007 and 2008, falling from the 2007 high of \$9.69 on February 26, 2007 to \$8.79 on February 29, 2008, a decline of 9.3%.

The Marketing of YieldPlus

Because its business model relied primarily on unsolicited orders, Schwab largely sold the fund by distributing a variety of marketing materials to existing and potential customers. During the relevant period, Schwab promoted YieldPlus to customers through sales materials including print (magazine and direct mail), Internet advertisements, e-mails, brochures and posters in retail investor centers, informational pages on the firm's website, webcasts, news releases and periodic reviews and analyses.

Although the majority of Yield Plus orders were unsolicited internet orders, Schwab also sold YieldPlus through multiple sales channels, including its registered representatives in branch offices nationwide, telephone representatives located in call centers in Phoenix, Denver and Indianapolis, and "regional bond specialists" who supported branch representatives in various offices throughout the country. As with materials presented directly to investors, Schwab provided sales material to its registered representatives to promote YieldPlus to customers through means such as Frequently Asked Questions, Question & Answer materials, talking points and conference calls. Some of that information was then provided to customers or potential customers in conversations with the registered representatives.

Schwab's Sales of YieldPlus During the Relevant Period

Through 2006, Financial Consultants received the same compensation regardless of whether a client was invested in a money market fund, CD or YieldPlus. Beginning in 2007, however, the amount of compensation earned by Financial Consultants for CDs was reduced to be equal to what was received for individual stocks and bonds, but less than that was received for all mutual funds, including money market funds. This change may have created an incentive for Financial Consultants to recommend YieldPlus over CDs, although not over money market funds or other ultrashort term bond funds.

Schwab also had approximately 50 'regional bond specialists' who provided fixed income securities service and support to the firm's branch offices, registered representatives and customers. These representatives, who handled approximately 18% of the Yield Plus trades, received the same compensation for CDs and all mutual fund trades, regardless of whether they recommended a third party mutual fund or a Schwab proprietary fund. However, these representatives did not receive compensation for recommending money market funds, and this may have created an incentive for regional bond specialists not to recommend money market funds.

During the relevant period, Schwab sold over \$13.75 billion in shares of YieldPlus to customers. This accounted for approximately 98% of the amount Schwab customers invested in ultra short bond funds. The Fund's assets under management reached a high of \$13.5 billion on July 31, 2007. While the majority of sales were not solicited, Schwab's solicited sales of YieldPlus during the relevant period totaled approximately \$3.36 billion, approximately 40% of which were to customers 65 years of age and older.¹ Between September 1, 2006 and February 29, 2008, Schwab collected approximately \$17.5 million in fees from sales of the fund. In March 2008, YieldPlus was taken off of the Charles Schwab Select List.

Marketing YieldPlus During The Relevant Period

Although Schwab's investment management unit was aware of the changes in the fund's portfolio and the significant increase in the percentage of the fund's mortgage-backed securities holdings and failed to appreciate the concomitant increase in the risk of the fund and price volatility, the retail brokerage division did not change the way it marketed YieldPlus or the internal guidance it provided to its registered representatives. Schwab, while disclosing at times that Yield Plus was not a money market fund and that its NAV could fluctuate, continued to portray YieldPlus as a relatively low-risk alternative to cash alternatives such as money market funds and CDs.

In advertisements on its website, in brochures, in blast e-mails to Schwab customers and in other sales materials, Schwab described YieldPlus as a cash alternative investment. Schwab initiated marketing campaigns during the second half of 2006 and continued into 2007, one of which was internally called the "Cash" campaign, which compared the performance of YieldPlus to a money market fund and promoted YieldPlus as an

¹ Approximately 40% of Schwab's customers' assets are held in households that are over 65 years old.

alternative to money market funds. In the campaigns, Schwab did not disclose that the higher returns resulted from the greater risk in the portfolio.

Schwab's various promotional materials prominently and repeatedly emphasized YieldPlus as a cash alternative. For example, the firm told potential customers: "Your cash could be in a much more rewarding position . . . Put your cash to work for you today." The firm also told investors to "Put your cash in a stronger position with YieldPlus."

Similar to its use of the word "cash," Schwab used references to risk and stability in promotional materials distributed during the relevant period. For example, the firm described YieldPlus as having "Higher income potential, minimal risk." It also said, "Why Schwab YieldPlus Fund? . . . Limited exposure to interest rate risk with managed credit risk resulting in minimal principal fluctuation . . . Delivers a high degree of price stability by maintaining the fund's duration to one year or less." Similarly, the firm told potential customers "Looking for a way to earn better yields on your long-term cash without taking on significantly higher risk? . . . Even though the share price might fluctuate minimally, these funds offer lower risk than longer-term bond funds and only marginally higher risk than money market funds."

While comparing YieldPlus to money market funds, Schwab failed to disclose all of the material differences between these investments to its customers.

During the relevant period, Schwab was or should have been aware of the fund's significant exposure to mortgage-backed securities in light of the increasingly unfavorable financial markets. As the YieldPlus NAV declined in the latter part of 2007, Schwab acknowledged internally that YieldPlus was a higher risk investment than it had been in the past. Internally, some Schwab employees even began referring to YieldPlus as "Yield Minus." Schwab nevertheless continued to describe YieldPlus as being very low risk with minimal fluctuations in share price. Schwab also was aware that YieldPlus was being marketed improperly. The firm's product manager for YieldPlus advised others that the firm needed "to get a[]way from saying YieldPlus is equivalent to a money market fund," but the firm failed to stop this practice.

In the summer and fall of 2007, as the credit crisis began to unfold, Schwab provided talking points and FAQ's to its representatives and customers which discussed recent market volatility and the fund's performance. These talking points and FAQs contained inaccurate statements about YieldPlus similar to those contained in the advertisements and sales literature.

In certain telephone conversations discussing the fund during the relevant period, some of Schwab's registered representatives inaccurately informed customers that YieldPlus was "a money market equivalent," that the fund did not have exposure to mortgage-backed securities, and that the maturity dates of the bonds in the YieldPlus portfolio were as little as 30 days or six months or less.

Although the fund became less diversified in 2007 by increasing its exposure in two sectors, financial and mortgage-related, Schwab continued to represent that YieldPlus was widely or highly diversified. For example, Schwab advised its representatives in talking points that YieldPlus “. . . is a well diversified fund that invests in approximately 400 securities across a wide range of sectors and industries.” At that time, in November 2007, YieldPlus was only invested in approximately 330 securities, approximately 46.2% were MBS and another 35.6% were issued by banks or other entities with exposure to the mortgage market. Even though the majority of the fund’s MBS holdings were AA or AAA rated, and these securities had historically experienced very little volatility, Schwab’s representations regarding the fund’s diversification were not complete.

During the relevant period, as described above, Schwab made inaccurate statements and omitted material information in statements to customers or potential customers in the marketing or sale of YieldPlus. In written and oral communications, Schwab:

- portrayed YieldPlus as a stable, low-risk alternative to cash investments;
- claimed that YieldPlus was widely diversified when approximately 82% of its investments were in mortgage-related and financial services securities;
- discussed YieldPlus’ historical record of share price stability or safety when its holdings created risk and potential volatility; and
- omitted material information regarding the holdings of the fund and the risks involved in investing in the fund.

By virtue of these actions, Schwab violated NASD Rule 2110.

The claims and statements made in Schwab’s YieldPlus advertisements and sales materials were not fair and balanced and failed to provide the customers with a sound basis for evaluating the facts regarding YieldPlus. The firm also omitted material facts about the fund which caused these materials and statements to be misleading. In addition, the claims and statements made in communications with the public failed to provide essential information necessary to evaluate the claims made about the fund. As a result, Schwab violated NASD Rules 2210 and 2110.

Failure To Supervise

NASD Rule 3010(a) requires members to establish and maintain supervisory systems that are reasonably designed to achieve compliance with applicable securities laws and regulations. During the relevant period, Schwab failed to establish and maintain a supervisory system that was reasonably designed to achieve compliance with applicable securities laws and regulations regarding the promotion and sale of YieldPlus.

Since the second half of 2007, Schwab has received thousands of complaints from customers. The complaints alleged, among other things, inaccuracies about the risk, volatility and suitability of the investment.

Schwab provided its registered representatives with information and sales materials to provide to customers about YieldPlus that were not fair and balanced and failed to provide the customers with a sound basis for evaluating YieldPlus. Schwab knew or should have known that the firm's representatives were mischaracterizing YieldPlus as a stable, low-risk alternative to money markets and other cash instruments when the holdings of the fund in light of the volatility in the market indicated it did not fit that description. Schwab failed to take appropriate action to reasonably ensure that accurate information about the fund was provided to customers and potential customers.

By virtue of this conduct, Schwab violated NASD Rules 3010(a) and 2110.

B. Respondent also consents to the imposition of the following sanctions:

1. A censure; and
2. The payment by Schwab of \$18,000,000, which constitutes disgorgement of \$17,500,000 and a fine of \$500,000. The fine and disgorgement shall be paid into an account (the "Fair Fund") established in connection with the action filed by the United States Securities and Exchange Commission against Schwab (the "SEC action") arising from substantially the same facts and circumstances as this action. The \$18 million paid into the Fair Fund shall be used for the benefit of investors in YieldPlus or for costs and expenses associated with administering and distributing the fund and shall be administered in accordance with the order establishing the Fair Fund and all other orders in the SEC action. Schwab shall provide FINRA with proof of payment. Such proof shall be submitted to Carolyn Craig, Director, FINRA Department of Enforcement, 1801 K Street, NW, Suite 800, Washington, DC 20006, either by letter that identifies the Respondent and the case number or by e-mail from a work-related account of the registered principal of Respondent firm to EnforcementNotice@FINRA.org.

The imposition of a restitution order or any other monetary sanction and the timing of such ordered payments do not preclude customers from pursuing their own actions to obtain restitution or other remedies.

Respondent agrees to pay the monetary sanction(s) upon notice that this AWC has been accepted and that such payment(s) are due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a Complaint issued specifying the allegations against me;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs (“ODA”), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:
 - 1. this AWC will become part of Respondent’s permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against Respondent;
 - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about Respondent’s disciplinary record;
 - 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
 - 4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent’s right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

- D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Respondent has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

12-24-10
Date

C E My
Respondent Charles Schwab & Company, Inc.

By: _____

Date

Respondent Charles Schwab & Company, Inc.

By: _____

Reviewed by:

Neal E. Sullivan
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Bingham McCutchen LLP
2020 K Street, N.W.
Washington, DC 20006
(202) 373-6159

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(901) 983-6104

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The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Respondent has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

12/26/2010
Date

Respondent Charles Schwab & Company, Inc.

By: Joseph B. Vartan

Date _____

Respondent Charles Schwab & Company, Inc.

By: _____

Reviewed by:

Robert E. Skinner

Neal E. Sullivan
Bingham McCutchen LLP
2020 K Street, N.W.
Washington, DC 20006
(202) 373-6159

Accepted by FINRA:

1/11/11
Date

Signed on behalf of the
Director of ODA, by delegated authority

A handwritten signature in black ink, appearing to read 'Samuel L. Israel', written over a horizontal line.

Samuel L. Israel
Associate Vice President and Chief Counsel
FINRA Department of Enforcement
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