

1 David J. Gottesman (Trial Counsel) (Illinois Bar No. 6182719)
(gottesmand@sec.gov)
2 Frederick L. Block
Antonia Chion
Robert A. Cohen
3 Melissa R. Hodgman
David S. Mendel

4 Attorneys for Plaintiff
5 SECURITIES AND EXCHANGE COMMISSION
100 F Street, N.E.
Washington, DC 20549-4030
6 Telephone: (202) 551-4470 (Gottesman)
Facsimile: (202) 772-9245 (Gottesman)
7

8 UNITED STATES DISTRICT COURT
9 NORTHERN DISTRICT OF CALIFORNIA
10 SAN FRANCISCO DIVISION

11 SECURITIES AND EXCHANGE COMMISSION,

12 Plaintiff,

13 vs.

14 KIMON P. DAIFOTIS and RANDALL MERK,

15 Defendants.
16
17

Case No. _____

COMPLAINT

DEMAND FOR JURY TRIAL

18 Plaintiff Securities and Exchange Commission (the "Commission") alleges:

19 **SUMMARY OF THE ACTION**

20 1. Between 2005 and mid-2008, defendants Kimon Daifotis ("Daifotis") and
21 Randall Merk ("Merk") were senior officials of Charles Schwab Investment Management,
22 Inc. ("CSIM"), and employees or officers of Charles Schwab & Co., Inc. ("CS&Co."), both of
23 which provided investment advisory and other services to Schwab Investments. Daifotis and
24 Merk engaged in fraudulent and deceptive conduct in violation of the antifraud provisions of

1 the federal securities laws, and also violated and aided and abetted violations of various other
2 provisions of the securities laws involving shareholder voting rights, disclosure and reporting
3 requirements.

4 2. Defendants' unlawful conduct primarily relates to the Schwab YieldPlus Fund
5 ("YieldPlus" or the "Fund"), the former flagship fixed-income mutual fund advised by CSIM
6 and CS&Co. At its peak in 2007, YieldPlus had \$13.5 billion in assets and 200,000 accounts,
7 and was the largest ultra-short bond fund in its category.

8 **A. Fraudulent Offer and Sale of YieldPlus**

9 3. By 2006, Merk, acting knowingly or recklessly, substantially participated in
10 directing a campaign to offer, sell, and market YieldPlus to the investing public as a cash
11 alternative or cash equivalent investment, with only "slightly" or "marginally" more risk than
12 cash products, such as certificates of deposit ("CDs") or money market funds.

13 4. Merk and Daifotis knowingly or recklessly made or substantially participated
14 in making misrepresentations and omissions of material fact about YieldPlus, such as its
15 supposedly being comparable to cash investments or money market funds.

16 5. The descriptions of YieldPlus were materially false and misleading because,
17 for example, YieldPlus was substantially riskier than cash products such as CDs and money
18 market funds, but defendants failed to disclose the material facts regarding such risks.

19 **B. Unlawful Deviations From Fund Concentration Policy**

20 6. Daifotis, as lead portfolio manager, along with CSIM and CS&Co., as the
21 Fund's advisers, directed the investments of the Fund. Daifotis approved the Fund's
22 investment in assets that violated the Fund's "concentration policy." The Fund's long-
23 standing concentration policy provided that the Fund would not invest more than 25 percent
24 of assets in non-agency, mortgage-backed securities ("MBS"), i.e., MBS issued by private

1 entities and not backed by federal agencies or government-sponsored enterprises. Pursuant to
2 Section 13(a) of the Investment Company Act [15 U.S.C. § 80a-13(a)], YieldPlus could not
3 deviate from that policy without first obtaining authorization by a vote of the majority of
4 YieldPlus's outstanding shareholders.

5 7. Through the knowing or reckless actions of Daifotis, the Fund deviated from
6 its concentration policy by at least early 2006, and violated the Investment Company Act, by
7 investing more than 25 percent of its assets in non-agency MBS without shareholder approval.

8 8. As a trustee, Merk voted to change the treatment of non-agency MBS and to
9 allow the Fund's investment advisers to concentrate the Fund's assets in those investments,
10 even though the concentration was a deviation from the Fund's concentration policy and was
11 not authorized by a shareholder vote.

12 9. Daifotis knew, or was reckless in not knowing, that reports and other filings
13 with the Commission effectively masked the Fund's violation of its concentration policy.
14 Although Daifotis reviewed and was able to edit various of such filings, he failed to make
15 those materials adequately or appropriately disclose the deviation.

16 10. Daifotis also substantially assisted other funds, including but not limited to the
17 Schwab Total Bond Market Fund ("Total Bond Fund"), in violating the Investment Company
18 Act [15 U.S.C. § 80a-13(a)] by deviating from their concentration policy without shareholder
19 approval.

20 11. Daifotis and Merk knew, or were reckless in not knowing, that they had
21 submitted, or caused to be submitted, false and misleading reports and certifications to the
22 Commission that failed to properly, fully, and accurately disclose the material fact that the
23 funds described above had deviated from their concentration policy without shareholder
24 approval.

1 **C. False and Misleading Statements and Other**
2 **Fraudulent Conduct During the Fund's Decline**

3 12. In the summer of 2007, YieldPlus's net asset value ("NAV") began to decline
4 as its assets lost value. Many investors expected YieldPlus's NAV to fluctuate only
5 minimally, at least in part because of the way the Fund had been marketed. A significant
6 number of investors redeemed their investments when the NAV fell by more than a few
7 pennies. Because YieldPlus did not have cash holdings, the redemptions forced YieldPlus's
8 portfolio managers to sell assets in a depressed market to raise cash.

9 13. In a series of communications, including written materials and conference calls
10 between at least August 2007 through at least March 2008, defendants knowingly or
11 recklessly made a series of materially false and misleading statements and omissions of
12 material fact about YieldPlus, and knowingly provided substantial assistance to others'
13 misrepresentations, in an effort to dissuade YieldPlus investors from redeeming their
14 investments. For example, in August 2007, Daifotis assured independent investment advisers
15 and Schwab's registered representatives who were to communicate with Schwab's investors
16 that "we've got very, very, very slight negative flows" from the Fund, or that the Fund had
17 "minimal" outflows, when he knew that the Fund actually was suffering massive outflows.

18 **D. Redemptions By Other Schwab-Related Funds**

19 14. During the effort to discourage most investors from redeeming their YieldPlus
20 investments, Merk approved a series of redemptions of YieldPlus investments by a group of
21 other Schwab-related mutual funds. Merk did so even though he knew material, nonpublic
22 information about YieldPlus and knew that a portfolio manager involved in the redemptions
23 had material, nonpublic information about the Fund.
24

1 **E. Impact**

2 15. During an eight-month period from 2007 to 2008, YieldPlus’s NAV dropped
3 28 percent and its assets plummeted from \$13.5 billion to \$1.8 billion. To date, YieldPlus’s
4 NAV has declined by 50 percent and its assets are below \$200 million. As a result of
5 defendants’ false and misleading statements and other misconduct, YieldPlus’s investors lost
6 hundreds of millions of dollars.

7 16. Unless enjoined, defendants are likely to engage in future violations of the
8 securities laws. Accordingly, as to each defendant, the Commission seeks an injunction
9 against future violations of the particular securities laws identified in the prayer for relief,
10 disgorgement of ill-gotten gains with prejudgment interest, and civil money penalties.

11 **JURISDICTION AND VENUE**

12 17. This Court has jurisdiction over this action under Sections 20(b), 20(d) and
13 22(a) of the Securities Act of 1933 (“Securities Act”) [15 U.S.C. §§ 77t(b), 77t(d) and
14 77v(a)]; Sections 21(d), 21(e) and 27 of the Securities Exchange Act of 1934 (“Exchange
15 Act”) [15 U.S.C. §§ 78u(d) and (e), and 78aa]; Sections 42(d), 42(e) and 44 of the Investment
16 Company Act of 1940 (“Investment Company Act”) [15 U.S.C. §§ 80a-41(d), (e) and 80a-
17 43]; and Sections 209(d), 209(e) and 214 of the Investment Advisers Act of 1940 (“Advisers
18 Act”) [15 U.S.C. §§ 80b-9(d), (e) and 80b-14]. Defendants have made use, directly or
19 indirectly, of the means or instrumentalities of interstate commerce, of the means or
20 instruments of transportation or communication in interstate commerce, of the mails, or of the
21 facilities of a national securities exchange, in connection with the transactions, acts, practices,
22 and courses of business alleged in this Complaint.

23 18. Venue is appropriate in this Court under Section 22(a) of the Securities Act [15
24 U.S.C. § 77v(a)]; Section 27 of the Exchange Act [15 U.S.C. § 78aa], Section 44 of the

1 Investment Company Act [15 U.S.C. § 80a-43]; and Section 214 of the Advisers Act of [15
2 U.S.C. § 80b-14], because certain of the acts or transactions constituting the violations alleged
3 herein occurred in this judicial district.

4 INTRADISTRICT ASSIGNMENT

5 19. Assignment to the San Francisco Division is appropriate pursuant to Civil
6 Local Rule 3-2(d) because a substantial part of the events or omissions that give rise to the
7 Commission's claims occurred in San Francisco County and one or more related class actions
8 are pending in the San Francisco Division.

9 DEFENDANTS

10 20. **Kimon Daifotis**, 51, resides in Corte Madera, California. Daifotis was
11 employed by CS&Co. and was a Senior Vice-President and Chief Investment Officer – Fixed-
12 income at CSIM until his position was eliminated in July 2008. At all relevant times until his
13 position was eliminated, Daifotis was lead portfolio manager for YieldPlus, the Total Bond
14 Fund, and the Schwab Short-Term Bond Fund (“Short-Term Bond Fund”). Daifotis was
15 actively involved in the day-to-day operations of YieldPlus, the Total Bond Fund, and the
16 Short-Term Bond Fund. Among other things, Daifotis was responsible for directing the
17 funds' investments and was actively involved in the offer, sale, and marketing of YieldPlus.
18 From at least July 2007 until his departure, Daifotis reported to Randall Merk. At all relevant
19 times, Daifotis has had Series 3, 7 and 63 licenses. Daifotis continues to serve as a paid
20 consultant to Schwab-related entities.

21 21. **Randall Merk**, 56, resides in Menlo Park, California. Merk is and at all
22 relevant times was an Executive Vice President at Charles Schwab Corporation and was an
23 Executive Vice President at CS&Co. From July 2007 until December 2010, Merk served as
24 President of CSIM, and, at all relevant times until 2007, was a trustee of YieldPlus and the

1 other funds identified herein. At all relevant times, Merk has had a Series 24 license. Merk
2 was actively involved in the offer, sale, and marketing of YieldPlus.

3 RELEVANT ENTITIES

4 22. **Charles Schwab Investment Management, Inc. ("CSIM")** is a San
5 Francisco-based, wholly-owned subsidiary of the Charles Schwab Corporation. CSIM was
6 incorporated in Delaware in October 1989 and has been a registered investment adviser since
7 January 25, 1990. CSIM manages the assets of registered and unregistered investment
8 companies, including YieldPlus, the Total Bond Fund, the Short-Term Bond Fund, and other
9 Schwab Funds. CSIM is the primary investment adviser of those funds.

10 23. **Charles Schwab & Co., Inc. ("CS&Co.")** is a wholly-owned subsidiary of
11 Schwab Holdings, Inc., which is a wholly-owned subsidiary of the Charles Schwab
12 Corporation. CS&Co. was incorporated in California in 1971. CS&Co. is a registered
13 broker-dealer, transfer agent, and investment adviser. CS&Co. provided advisory,
14 shareholder, and distribution services to the funds described herein, and at all relevant times,
15 served as the distributor and transfer agent for funds, including YieldPlus, the Total Bond
16 Fund, the Short-Term Bond Fund, and other Schwab Funds. CS&Co. also provided personnel
17 who performed advisory, marketing, legal, and compliance services to those funds.

18 24. **Schwab Investments** is a no-load, open-end management investment company
19 organized as a Massachusetts business trust and is registered under the Investment Company
20 Act as of October 26, 1990. YieldPlus, the Total Bond Fund, and the Short-Term Bond Fund
21 are series of mutual funds issued by Schwab Investments.

1 **FACTUAL ALLEGATIONS**

2 **A. False and Misleading Statements and Omissions, and**
3 **Other Fraudulent Conduct In the Offer and Sale of YieldPlus**

4 25. From at least 2005 through at least mid-2008, as discussed below, Daifotis and
5 Merk made, substantially participated in making, or knowingly provided substantial
6 assistance in the making of misrepresentations and omissions of material material fact with
7 regard to the offer and sale of YieldPlus, including but not necessarily limited to those set
8 forth in this Section A.

9 26. As shown below, in statements disseminated to the public, CSIM and CS&Co.
10 described YieldPlus as a cash “alternative” or “equivalent” that generated a premium yield
11 and was only minimally riskier than a money market fund, compared YieldPlus to insured
12 CDs, and emphasized that YieldPlus’s NAV was stable because, although it “may fluctuate
13 minimally” and/or would fluctuate, it had fluctuated by only pennies in recent years.

14 27. Daifotis and Merk knew, or were reckless in not knowing, about these
15 descriptions and they directly and substantially participated in the making of such statements
16 to the public. Daifotis and Merk reviewed and approved the general approach of describing
17 the Fund in this manner, and they reviewed and approved various specific advertisements
18 containing these mistatements. Various of the false and misleading statements therein were
19 directly attributed to Daifotis, as shown more fully below.

20 28. Daifotis and Merk knew, or were reckless in not knowing, that these
21 communications were materially false and misleading because, in the various ways described
22 below, YieldPlus was significantly riskier than money market funds, CDs, and other cash or
23 cash-equivalent products, and its NAV had fluctuated significantly more than the three cents
24 or pennies advertised. For example, at various times between 1999 (when the Fund was

1 established) and 2003, the Fund's NAV sometimes fluctuated by six cents or more in just one
2 day, by more than 15 cents in a month, and by 34 cents over a ten-month period. It was
3 misleading and deceptive to characterize YieldPlus as a cash alternative or cash equivalent
4 without fully disclosing the ways in which YieldPlus was fundamentally and substantially
5 riskier than such products.

6 29. Daifotis and Merk also knew, or were reckless in not knowing, that these
7 statements grew even more misleading over time because the Fund grew riskier as it
8 concentrated in non-agency MBS. Daifotis directed the investments that caused this increased
9 risk, and at least by late August 2006, Merk approved such investments.

10 1. **YieldPlus Was Substantially Riskier Than Cash**
11 **Products, Such as CDs and Money Market Funds**

12 30. Daifotis and Merk knew, or were reckless in not knowing, that in the ways
13 described below, YieldPlus materially differed from CDs and money market funds in ways
14 which made the Fund fundamentally and significantly riskier than those and other cash or
15 cash-equivalent products to which it was compared.

16 31. Lack of Insurance. Investments in YieldPlus were not insured, as are CDs.

17 32. Maturity. From at least 2005 through at least mid-2008, the average maturity
18 of YieldPlus's portfolio was significantly longer than the average maturities of money market
19 funds. During the relevant period, under rules promulgated by the Commission under the
20 Investment Company Act, a money market fund was required to have an average portfolio
21 maturity of no more than 90 days and could not acquire any security with a remaining
22 maturity of more than 397 days. In contrast, YieldPlus's average maturity was at least one-
23 and-one-half to two years and, by one measure, reached four years in mid-2007, and a
24 substantial portion of the Fund's assets were invested in securities with remaining stated

1 maturities of more than 20 years. Ninety percent or more of YieldPlus's holdings could not
2 have been held by a money market fund.

3 33. The Fund's concentration in non-agency MBS, beginning at least by 2006
4 (described more fully below), which Daifotis directed and Merk ultimately approved in late
5 August 2006, caused the Fund's average maturity to increase.

6 34. In mid-2007, at the beginning of the period when the Fund's NAV declined
7 dramatically, only 6 percent of YieldPlus's assets—\$675 million of \$11 billion in assets—
8 were scheduled to mature within the next six months. This was drastically different from a
9 money market fund's average portfolio maturity of 90 days.

10 35. The longer maturities of the securities owned by YieldPlus exposed the Fund
11 to increased risk, including liquidity and default risk. Such liquidity risk contributed to the
12 Fund's decline during the credit crisis of 2007-2008. For example, when faced with
13 redemptions, a money market fund largely is able to rely on frequently maturing securities to
14 raise cash at par. In contrast, YieldPlus was forced to sell securities in a depressed market
15 because its securities did not mature frequently.

16 36. Daifotis and Merk knew, or were reckless in not knowing, the facts above.
17 Despite the Fund's longer average maturity, Merk, Daifotis, CSIM, and CS&Co. classified
18 YieldPlus as an ultra-short bond fund because of its short "duration" (which is a measure of
19 interest rate sensitivity, as explained more fully below).

20 37. Lower Credit Quality Bonds. As Daifotis and Merk knew, or were reckless in
21 not knowing, YieldPlus also was significantly riskier than a money market fund because it
22 invested in lower credit quality bonds. Pursuant to rules under the Investment Company Act,
23 a money market fund may invest in a security only if the fund's board has determined that the
24 security presents minimal credit risks. In contrast, YieldPlus did not make such

1 determinations and was permitted to invest up to 25 percent of assets in below-investment-
2 grade bonds, and actually invested 15 to 25 percent of YieldPlus in bonds rated BBB (the
3 lowest investment grade) or lower.

4 38. Lack of Risk Management. Daifotis and Merk knew or were reckless in not
5 knowing that they did not adequately monitor and analyze the risks posed by YieldPlus's
6 substantial investment in non-agency MBS and lower quality bonds. Just before YieldPlus's
7 decline began in the summer of 2007, internal auditors warned CSIM and CS&Co. officials,
8 including Daifotis and Merk, that YieldPlus's portfolio managers were not conducting
9 sufficient portfolio-wide risk management and scenario-analysis testing regarding the possible
10 performance of YieldPlus's portfolio during adverse market events. The auditors warned that
11 this risk was heightened for YieldPlus, due to its "concentration in mortgage securities and
12 lower credit rated corporate bonds."

13 **2. Defendants' Roles**

14 **a. Merk**

15 39. Two key departments responsible for YieldPlus reported to Merk. First, the
16 Senior Vice President for Product Development who was in charge of the CS&Co. product
17 development and management group responsible for YieldPlus reported to him. This group
18 was largely responsible for creating and reviewing the statements about YieldPlus that are the
19 subject of this Complaint. As Merk knew or was reckless in not knowing, the department
20 relied on him as a fixed-income expert and relied upon him to ensure that that the overall
21 public message – including characterizations of the Fund that are described herein – were
22 accurate, complete, and not misleading. Second, the President of CSIM, who supervised the
23 Fund's portfolio managers, also reported to Merk. Later, shortly before the Fund began its
24

1 decline, Merk assumed the position of CSIM President and Daifotis began to report directly to
2 him.

3 40. In 2006, senior Schwab executives were concerned that a competitor was
4 selling its cash products more successfully than Schwab. Schwab then established, in mid-
5 2006, the "Cash Council." The Cash Council was a committee of high-level executives who
6 met to coordinate, increase, and improve marketing of Schwab's cash products company-
7 wide. Merk was a member of the Cash Council.

8 41. Merk was very knowledgeable about fixed-income products and, as part of his
9 work on the Cash Council, in 2006, was asked to identify fixed-income products to highlight
10 on Schwab's website to draw attention to cash products at Schwab.

11 42. In May 2006, Merk identified YieldPlus as such a product. Merk directly and
12 substantially participated in the decision to include YieldPlus on the cash page of the Schwab
13 website. For example, in an email exchange on May 17 and 18, 2006, members of the Cash
14 Council twice requested that Merk identify appropriate products to include in the cash
15 campaign, specifically tasking him with identifying fixed-income products to highlight on the
16 cash page of the Schwab website.

17 43. In a response on May 18, 2006, Merk endorsed the selection of YieldPlus as a
18 cash product for inclusion on the cash page, sometimes referred to as "cHome." Merk
19 personally informed the Cash Council that he and his team had identified YieldPlus for
20 inclusion in the "[i]ncreased cash promotion." Merk then received a summary of the
21 "[p]roposed cHome cash promotion" that was "[b]ased on the exchanges [above]," and
22 involved "text boxes to enable a cash emphasis," including one text box on the Schwab
23 website for CDs, another for Schwab's money market fund, and a third for YieldPlus.

24 44. From at least mid-2006, the Cash Council, including Merk, then directed an

1 effort to highlight YieldPlus on portions of the Schwab website that discussed cash products,
2 such as by adding links to take investors to pages with YieldPlus information. Merk directly
3 and substantially participated in that effort to highlight YieldPlus. For example, in at least
4 June and August 2006, Merk reviewed and agreed to the marketing plans and the proposed
5 website changes that positioned YieldPlus with CDs and money market funds on the cash
6 page of Schwab's website.

7 45. In causing YieldPlus to be placed and emphasized on the cash page of the
8 website without substantial disclosures about the difference between YieldPlus and genuine
9 "cash" investments, Merk knowingly or recklessly caused the misrepresentations or omissions
10 of material fact about YieldPlus and the fact that it was significantly riskier than the other
11 products listed, as described above.

12 46. The Cash Council, including Merk, also directed that sales materials
13 emphasize claims that YieldPlus had a stable NAV. Merk directly and substantially
14 participated in the marketing that resulted from the efforts of the Cash Council. In at least
15 June and August 2006, as a member of the Cash Council and as a Trustee, Merk reviewed and
16 agreed to the content of websites and communications that represented YieldPlus as being a
17 cash-equivalent or cash-alternative investment. Examples are included in Section A.3. below.
18 This was misleading because, especially when compared to cash products identified in the
19 marketing materials, YieldPlus was more prone to substantial NAV fluctuations, as described
20 above.

21 47. Merk knew, or was reckless in not knowing, that the statements about the
22 Fund's stable NAV were misleading, in part because of the Fund's prior NAV fluctuation. In
23 particular, from 1999 through 2003, the Fund's NAV fluctuated by \$0.34, ranging from
24 \$10.03 to \$9.69, with particular volatility in 2002 and 2003. The NAV also fluctuated

1 significantly within short periods, as described above. The Fund's fluctuations in NAV were
2 material and significant, particularly because the Fund was characterized as a supposed "cash"
3 product, was positioned with CDs and money market funds, which typically have no
4 fluctuation in principal or NAV, respectively, and was characterized as having an NAV that
5 had fluctuated in recent times by only a few cents.

6 48. The Cash Council, including Merk, also directed an effort in mid-2006 to re-
7 design the Fund's own web-page to highlight the yield that it generated and its supposed
8 narrow NAV fluctuation as described below. Merk was aware of this effort and reviewed the
9 revised web page. Merk knew, or was reckless in not knowing, that the marketing materials
10 that he reviewed were materially false and misleading and contained material omissions, such
11 as those concerning the risks associated with investing in the Fund.

12 49. Merk (along with Daifotis) directly and substantially participated in the
13 issuance of a "cash/CD/YieldPlus related press release" on August 1, 2006. Merk was the
14 source of the idea to issue the August 1, 2006, press release, and Merk saw the draft and the
15 final language of the press release, but did not correct the misrepresentations and omissions of
16 material fact described below, despite his obligation to do so in light of his knowledge,
17 positions, and responsibilities.

18 50. Specifically, consistent with the Cash Council's re-focused marketing
19 approach for the Fund, the August 1, 2006, press release misleadingly called the Fund a "cash
20 alternative." Although the press release mentioned a recommended one-year holding period,
21 it also stated that: "Unlike money market funds, ultra-short bond funds are subject to minimal
22 price fluctuations." As Merk knew or was reckless in not knowing, this statement was
23 misleading because it suggested that the Fund's price fluctuations would be limited to
24 "minimal" changes. In stating that, in comparison to a money market fund, YieldPlus's NAV

1 would have “minimal” fluctuations, the press release substantially understated the riskiness of
2 the fund and its prior fluctuations, and thus was misleading and omitted material facts.

3 51. At the August 29, 2006, meeting of the Fund’s board of trustees, which Merk
4 attended as a trustee, Merk and the other trustees received documents and presentations
5 concerning the plans to market YieldPlus to retail investors as a cash alternative. As a trustee,
6 Merk was responsible for reviewing the materials and determining, based on his own
7 knowledge and expertise, whether the marketing was truthful and appropriate. This
8 marketing was to take the form of direct mail, email, and statements on the Schwab website.

9 52. For example, among the board materials that Merk received was a document
10 entitled “Board Marketing Update, Schwab Funds” that was the subject of a presentation at
11 the August 29, 2006, meeting and included summaries of the current and future marketing of
12 YieldPlus. The materials discussed the growth of the YieldPlus Fund and provided a
13 “Marketing Summary” for the second quarter. Among other things, the Marketing Summary
14 listed four planned advertisements. One of those communications was for YieldPlus and
15 read: “Are you sitting on cash? Do you need additional income? Here’s a smart solution.
16 The Schwab YieldPlus Fund™.” The presentation also included the marketing plans for
17 YieldPlus for the third and fourth quarter of 2006, including marketing YieldPlus as a cash
18 alternative.

19 53. These marketing plans were carried out through, for example, the publication
20 of the sales and marketing materials described in Section A.3. below, which were materially
21 false and misleading in the ways described below.

22 54. YieldPlus experienced exceptional growth in the year following the Cash
23 Council’s effort to highlight YieldPlus as a cash alternative with a stable NAV. From mid-
24 2006 to mid-2007, YieldPlus assets grew from under \$7.5 billion to over \$13 billion.

1 55. Also included in the materials given to Merk and the other trustees at the
2 August 29, 2006 meeting was a piece published by Dow Jones on July 19, 2006, based in part
3 upon an interview with Daifotis. The piece was circulated to Merk and others and was
4 characterized as, “Dow Jones feature story on YieldPlus.” The Dow Jones piece stated, “[t]he
5 Schwab YieldPlus Fund (SPYSX) is aimed at investors seeking better returns than on money
6 market products, but without significantly more market volatility or risk.”

7 56. Also at the August 29, 2006, meeting of the board of trustees, Merk voted to
8 change the Fund’s concentration policy (unlawfully, as described below) to allow the Fund’s
9 portfolio managers to concentrate the Fund’s investments in non-agency MBS. Most of the
10 Fund’s non-agency MBS investments were securities that a money market fund could not own
11 because of the length of their maturities. As a result, the concentration in non-agency MBS
12 made the Fund even less like a money market fund. As a fixed-income expert who
13 participated in the decision to concentrate the Fund’s investments in non-agency MBS, Merk
14 knew or was reckless in not knowing that this was a material change that made the Fund even
15 riskier than cash investments and less like the cash investments to which it was being
16 compared. Merk knew or was reckless in not knowing that this change was not revealed in
17 the sales and marketing materials described in Section A.3. below.

18 57. Merk was obliged to correct any misrepresentations or omissions of material
19 fact in any marketing materials, including those described herein, because of: (1) his senior
20 executive positions as Executive Vice President at Charles Schwab Corporation, Executive
21 Vice President at CS&Co., and trustee of YieldPlus; (2) his responsibilities as an executive
22 overseeing other executives at CSIM; (3) the fact that he knew or was reckless in not knowing
23 that he was relied upon within CSIM, CS&Co., and the Cash Council as a fixed-income
24 expert; and (4) the fact that he knew or was reckless in not knowing that he was relied upon

1 by those within CSIM and CS&Co. who prepared offer, sales, and marketing materials for the
2 Fund to make sure that the overall offer, sale, and marketing message for the Fund, as well as
3 any descriptions of the overall characteristics of the Fund, and its comparison to cash products
4 as described herein, were accurate, complete, and not misleading.

5 58. In addition to the foregoing, because of Merk's experience managing fixed-
6 income products, Merk was in a unique position to correct the misleading statements in the
7 YieldPlus sales materials, the website, and press releases that he reviewed or of which he was
8 aware, as described above, and to make sure that they contained sufficient disclosures about
9 the riskiness of the Fund, its significant NAV fluctuations, and the differences between the
10 Fund and cash investments.

11 59. Merk knew, or was reckless in not knowing, that, among other things, CSIM
12 and CS&Co. were issuing sales and marketing materials, displaying a website, and issuing
13 press releases, including those described above and in Section A.3. below, that included
14 materially false and misleading statements and omissions of material fact and would mislead
15 investors regarding the riskiness of the Fund. Yet Merk failed to correct the misleading
16 statements or to make sure that those materials included sufficient disclosures to make them
17 not misleading.

18 60. As shown above, Merk directly and substantially participated in the
19 preparation of misrepresentations and omissions of material fact about YieldPlus that were
20 disseminated to the public.

21 61. Merk's actions and failures to act as described herein had the principal purpose
22 and effect of creating a false appearance of fact in furtherance of the scheme to mislead the
23 public about YieldPlus.

24

1 **b. Daifotis**

2 62. Daifotis was actively involved in the day-to-day operations of YieldPlus.

3 63. Because of Daifotis's knowledge of the Fund, which he helped develop; his
4 day-to-day involvement in, knowledge of and responsibility for the Fund's portfolio,
5 management, and characteristics; and his expertise in fixed-income products (including
6 money market funds), Daifotis was relied on by marketing, compliance and other personnel
7 within CS&Co. and CSIM to substantially participate in determining whether statements in
8 marketing and sales materials, and in other materials describing the Fund's characteristics and
9 performance, were accurate and complete, and Daifotis knew or was reckless in not knowing
10 that he was relied upon in that regard. For example, Daifotis was relied upon to make sure
11 that marketing materials and communications were consistent with the facts concerning the
12 Fund's portfolio, management, and characteristics.

13 64. In the normal course of business, Daifotis regularly received, reviewed, and
14 contributed to sales and marketing materials regarding YieldPlus and made suggestions and
15 edits to some of them, many of which contained misrepresentations and omissions of material
16 fact, as discussed below.

17 65. As shown in Section A.3. below, a number of sales and marketing materials
18 disseminated to the public from at least 2005 through at least March 2008 contained
19 statements regarding the nature of YieldPlus that quoted Daifotis or that were directly
20 attributed to Daifotis, some of which included his picture. Daifotis was aware of, or was
21 reckless in not knowing, the content of these statements and that they included materially
22 false and misleading statements and omissions of material fact in, for example, characterizing
23 the Fund as a cash alternative or cash equivalent without disclosing the fundamental and
24 significant differences and risks associated with the Fund. Although Daifotis was in a

1 position to change the content of those materials, he failed to make them accurate, complete,
2 and not misleading.

3 66. Daifotis (along with Merk) directly and substantially participated in the
4 issuance of the August 1, 2006 “cash/CD/YieldPlus related press release.” He participated in
5 the discussions about and drafting of the press release, which, as discussed above, was
6 misleading in calling the Fund a “cash alternative” and stating that it was “subject to minimal
7 price fluctuations,” without disclosing the material facts involving the substantially greater
8 riskiness and price fluctuations associated with the Fund.

9 67. Daifotis saw one or more drafts and the final language of the August 1, 2006
10 Press Release. Daifotis knew or was reckless in not knowing that it was misleading and
11 omitted material facts, in the ways described above, but he did not correct the false and
12 misleading statements and omissions, despite his obligation to do so in light of his knowledge,
13 positions, and responsibilities.

14 68. In an August 2007 conference call with registered investment advisers,
15 Daifotis admitted that marketing YieldPlus as a money market alternative was misleading but
16 he falsely denied marketing YieldPlus in that manner. He stated: “[W]e do not and have
17 never said this should be marketed as a money market fund alternative. So if anybody ever
18 positioned it that way with [registered representatives], that is certainly not the right way to
19 position this fund.” Daifotis knew or was reckless in not knowing that YieldPlus had been
20 marketed as a cash or money market alternative – and indeed as a “cash equivalent” – and that
21 his denial was false and misleading.

22 69. By no later than the summer of 2007, CSIM, CS&Co. and Daifotis knew that
23 investors were using YieldPlus as an alternative investment to money market funds and CDs.
24 Nonetheless, Daifotis continued to compare YieldPlus to money market funds, as did CSIM

1 and CS&Co. Examples include, but are not limited to, Daifotis's comparing YieldPlus to
2 money market funds in August 2007 conference calls primarily with CS&Co. registered
3 representatives and independent advisers, CS&Co.'s and CSIM's including such comparisons
4 in sales materials placed on Schwab.com (including the YieldPlus landing page), the Schwab
5 Mutual Fund Center, and the cash hub of the Schwab Marketplace webpage, and their
6 continuing to market the Fund on the cash page of the public website, as discussed above.
7 Daifotis knew or was reckless in not knowing of these statements and that they were
8 materially misleading and failed to disclose that YieldPlus was significantly riskier than the
9 cash products to which it was being compared, for the reasons discussed above.

10 70. Daifotis was obliged to make sure that such materials were accurate, complete,
11 and did not contain any misrepresentations or omissions of material fact because of: (1) his
12 senior executive position as Senior Vice-President and Chief Investment Officer – Fixed-
13 income at CSIM; (2) his position as lead portfolio manager for YieldPlus; (3) his active
14 involvement in the day-to-day operations of YieldPlus, including its offer, marketing, and
15 sale; and (4) his knowledge that others within CS&Co. and CSIM relied on him as described
16 above.

17 71. Daifotis knew, or was reckless in not knowing, that sales materials, the
18 website, press releases, and other communications with investors that he made, reviewed, or
19 of which he was aware, including those described above and in Section A.3. below, included
20 materially false and misleading statements and omissions of material fact and would mislead
21 investors regarding characteristics such as the riskiness of the Fund and other material facts
22 described above, yet he failed to correct the misleading statements or to make sure that those
23 materials included sufficient disclosures to make them not misleading.

24 72. By reason of the foregoing, and the matters alleged in Section A.3. below,

1 Daifotis directly and substantially participated in the preparation of misrepresentations and
2 omissions of material fact about YieldPlus that were disseminated to the public.

3 73. Daifotis's actions and failures to act as described herein had the principal
4 purpose and effect of creating a false appearance of fact in furtherance of the scheme to
5 mislead the public about YieldPlus.

6 **3. Misrepresentations and Omissions In Sales**
7 **and Marketing Materials For YieldPlus**

8 74. The following are examples of false and misleading written and electronic
9 communications to which the foregoing paragraphs refer. Daifotis and Merk knew about
10 these communications or were reckless in not knowing about them. In particular, CS&Co.,
11 with the assistance of CSIM, issued the following on behalf of Schwab Investments (*italics*
12 and bold added):

13 (a) From at least late 2006, following the Cash Council's directives,
14 Schwab's Cash Investments and Strategies page on its public website, which was
15 reached by selecting the "Cash" tab, included sweep accounts, CDs, a money market
16 fund and YieldPlus as investment options and read:

17 (i) "Want to make your cash work hard? This section highlights the
18 different options Schwab offers to get more out of your cash."

19 (ii) The webpage then offered a description of each product,
20 including: "**Schwab YieldPlus Fund**® If you're comfortable accepting a
21 *slightly higher amount of risk* in exchange for a return that is generally better
22 than the other *cash equivalent investments*, consider this ultra-short bond
23 fund. This fund consisting of hundreds of bonds that offer enhanced
24 diversification is best suited for those with investment horizons of one year or

1 more. Note that the Schwab YieldPlus Fund's net asset value will fluctuate."

2 (b) A brochure mailed to Schwab investors in or about Spring 2006 with the
3 heading, "***STASH YOUR CASH—ULTRA-SHORT BOND FUNDS***" and in which
4 YieldPlus is the only ultra-short bond fund mentioned read:

5 (i) "In the current uncertain interest rate and investing environment,
6 cash has become an increasingly attractive defensive holding for many
7 investors. ***Kimon Daifotis***, chief investment officer and fixed-income portfolio
8 manager of Charles Schwab Investment Management, says investors can
9 receive better returns by using ultra-short bond funds as ***an alternative to***
10 ***traditional cash holdings, like money market funds and CDs***, though with a
11 ***slightly increased risk*** to principal."

12 (c) A brochure mailed to Schwab clients in or about September 2006,
13 entitled "Schwab ***YieldPlus Fund*** read: Your cash could be in a much more
14 rewarding position" stated:

15 (i) "If you're looking for a smart ***alternative for your cash***, investing
16 in the Schwab YieldPlus Fund ® could be your answer."

17 (ii) "YieldPlus can be a great choice for clients with a 12-month or
18 longer investment horizon. With historically strong performance, it offers
19 higher potential returns than money market funds ***with only marginally more***
20 ***risk***."

21 (iii) "YieldPlus is an actively managed mutual fund consisting primarily
22 of ***ultrashort duration bonds that mature frequently*** to limit interest rate
23 exposure. Its net asset value (NAV) has fluctuated by no more than \$0.03
24 (between \$9.65 and \$9.68) over the last year ending 06/30/2006, giving it the

1 performance potential and *relative stability* necessary in today's market."

2 (d) In June 2006, the YieldPlus page on Schwab's public website read:

3 (i) "Schwab YieldPlus Fund. Discover a smart alternative for
4 long-term cash holdings."

5 (ii) "Looking for a way to earn better yields on your long-term cash
6 *without taking on significantly higher risk?* The Schwab YieldPlus Fund™
7 seeks to benefit from the current rising-rate environment and can be a smarter
8 *alternative to investing in money market* and long-term bond funds."

9 (iii) "The fund offers: *Increased yield potential*—Ultrashort bond
10 funds like YieldPlus Fund have historically provided higher sustained yield
11 versus money market funds, as their short duration helps minimize exposure to
12 falling bond prices as rate rise. Even though the share *price may fluctuate*
13 *minimally*, these funds offer lower risk than longer-term bonds funds and *only*
14 *marginally higher risk than money market funds.*"

15 (e) In or about September 2006, an email was sent to investors from Charles
16 Schwab with the subject line "Put your *cash in a stronger position with YieldPlus.*"

17 The body of the text included the following claims:

18 (i) "Higher income potential, *minimal risk.*"

19 (ii) "It offers higher potential returns than many money market funds,
20 with *only marginally higher risk.*"

21 (iii) "YieldPlus primarily consists of ultra-short duration bonds *that*
22 *mature frequently* to limit interest rate risk exposure. Its net asset value
23 (NAV) has fluctuated by no more than \$0.03 (between \$9.65 and \$9.68) over
24 the past year ending 6/30/2006, giving it the performance potential and *relative*

1 *stability necessary* in today's market.”

2 (iv) “What are the advantages of the Schwab YieldPlus Fund? High
3 Yield. . . . Strong Ratings. . . . *Minimal Risk.*”

4 (f) In or about September 2005, an advertisement ran with a *picture of*
5 *Daifotis and a quote attributed to him* reading: “With consistent exceptional
6 performance, The Schwab YieldPlus Fund™ is a smart *cash alternative* for your
7 clients in the current rising-rate market, providing enhanced yield potential *over*
8 *money market funds.*”

9 (g) A September 2005, advertisement included a *picture of Daifotis* and the
10 claim: “It’s an ultrashort bond fund, not a money market fund. It seeks to provide
11 higher yield with *slightly higher risk than a money market fund, but maintains*
12 *minimal fluctuation in share price* and lower risk than a longer-term bond fund.”

13 (h) A brochure mailed to investors in or about January 2006, entitled “Smart
14 cash strategies. Easy ways to keep your cash working.” stated: “Understanding the
15 different roles *that cash plays in* your portfolio can help you make smart decisions
16 about the type of investment that is best suited for your cash. Use this chart to review
17 some of your choices.” The chart listed YieldPlus with money market funds and CDs
18 as a type of investment cash, and included as suggested uses for such cash:
19 emergency reserves, upcoming tax bills, planned vacations, down payments, future
20 purchases and portfolio diversification. Next to these uses was a brief explanation of
21 each product. YieldPlus was described as follows:

22 (i) “If you’re comfortable with accepting a *slightly higher amount of*
23 *risk* in exchange for a return that’s generally better than *other cash-equivalent*
24 *investments*, consider this ultra-short bond fund. The net asset value of the

1 Schwab YieldPlus Fund will fluctuate.”

2 (i) From at least 2005 through at least March 2008, CSIM and CS&Co.
3 listed the Lehman Brothers U.S. Treasury 9-12 Month Index as the benchmark for
4 measurement of YieldPlus’s performance. The benchmark was listed on fact sheets
5 for the YieldPlus Fund on Schwab’s public website, Schwab.com. This was
6 misleading because it suggested that the Fund invested regularly and substantially in
7 bonds issued by the U.S. Treasury, and that YieldPlus’s performance and risk profile
8 would be similar to that of Treasury bonds, neither of which were true. Daifotis
9 participated in selecting the benchmark, and he and Merk knew, or were reckless in
10 not knowing, that use of a 9-12 month Treasury benchmark for the Fund would be
11 misleading for the reasons described above.

12 75. The sales and marketing materials described in the preceding paragraph were
13 misleading and contained misrepresentations or omissions of material fact in at least the
14 following respects: (a) identifying YieldPlus as a cash-alternative and cash-equivalent
15 investment and asserting that YieldPlus was only slightly or marginally riskier than other cash
16 or cash-like products, such as CDs or money market funds, was false and misleading because
17 YieldPlus in fact was substantially riskier than those products, and the greater risks were not
18 fully or accurately disclosed; (b) asserting that YieldPlus offered enhanced diversification was
19 false and misleading because it deviated from its own concentration policy and its investments
20 were heavily concentrated in residential mortgage-backed securities and financial institutions,
21 which was not adequately disclosed; (c) asserting that YieldPlus consisted primarily of
22 ultrashort duration bonds that matured frequently was false and misleading because it held a
23 large percentage of investments with longer actual maturities, especially in comparison to
24 investments held by money market funds, which was not disclosed; and (d) asserting that

1 YieldPlus's NAV fluctuated only minimally was false and misleading, and asserting that it
2 fluctuated by only \$0.03 in the year ending June 30, 2006 was at best misleading because it
3 had fluctuated much more during other recent periods and was subject to the risk of much
4 greater fluctuation, which was not adequately disclosed.

5 76. The foregoing sales and marketing materials were reviewed and/or prepared by
6 CS&Co.'s product development and management group. The personnel who prepared such
7 materials, along with others within Schwab who reviewed such materials, relied upon Daifotis
8 and Merk, as described above.

9 77. At or about the time periods of the sales and marketing materials identified
10 above, Daifotis and Merk knew or were reckless in not knowing that CS&Co. and CSIM were
11 disseminating either those particular marketing and advertising materials or materials
12 containing the substance thereof, and that materials were materially false and misleading in
13 the ways described above.

14 78. Because of their senior-executive positions and their responsibilities, their
15 knowledge of the Fund and fixed-income products generally, and the fact they knew or were
16 reckless in not knowing that they were relied upon within CSIM and CS&Co. as described
17 above, Daifotis and Merk were obligated to see to it that CSIM and CS&Co. did not make
18 false and misleading statements and omissions about YieldPlus such as those described above.
19 Daifotis and Merk nevertheless, as described above, made or substantially participated in
20 making various of these statements, and knew or were reckless in not knowing that CSIM and
21 CS&Co. were making these statements, but failed to prevent such materials from being
22 disseminated or stop them even after they knew, or were reckless in not knowing, that such
23 misleading statements or omissions of material fact were being disseminated to the public.

1 **4. Misleading Statements and Omissions Regarding**
2 **YieldPlus's Weighted Average Maturity**

3 79. With regard to mutual funds such as YieldPlus, facts pertaining to the term of
4 investments held by the Fund, i.e., the time until maturity of the investments, are material
5 facts.

6 80. Investors can use weighted average maturity ("WAM")—a measurement of
7 the average length of time until the underlying bonds in a portfolio mature—to evaluate the
8 riskiness of a product. Among similar funds, those with longer WAMs generally involve
9 more risk.

10 81. For eighteen months, from February 2006 to September 2007, CSIM and
11 CS&Co., with Daifotis's substantial participation, misstated YieldPlus's WAM in
12 communications designed for investors, including but not limited to marketing materials on
13 the public website (as explained more fully below) and one Commission filing, a Form N-
14 CSR Annual Report dated August 31, 2007.

15 82. In early 2006, the YieldPlus Fund's WAM tripled to over one to two years in
16 length because of a change in the calculation method used by Schwab Investment's new fund
17 accountant. Investors complained about the increase, some even telling CSIM and CS&Co.
18 that they might invest in CDs instead of YieldPlus as a result of the longer WAM.

19 83. Because of the response of investors and representatives to the longer WAM,
20 between at least November 2005 and February 2006, Daifotis suggested to others at CSIM
21 and CS&Co. that "duration" be included instead of or in addition to WAM.

22 84. "Duration" is a ratio that measures interest-rate sensitivity affected by hedging
23 techniques, but is not a measure of maturity or any other unit of time.

24 85. Despite owning many long-maturity bonds, YieldPlus was classified as an

1 ultra-short fund because of its low duration. To keep YieldPlus's duration low, YieldPlus
2 "shorted" Treasury futures. By selling Treasury futures short (which means selling the
3 futures contracts without owning them, and profiting if the value of the securities declines),
4 CSIM and CS&Co. hedged the interest rate risk of the securities in YieldPlus's portfolio.
5 This may have reduced YieldPlus's exposure to interest rate risk, but it did not mitigate the
6 liquidity risk and other risks posed by the bonds held by YieldPlus, especially those with
7 longer maturities.

8 86. The numerals reflecting YieldPlus's duration (which generally ranged from 0.4
9 to 0.6) were significantly lower than the numerals reflecting the Fund's WAM (i.e., 1.2 to
10 over 4.2 by some calculations).

11 87. Based on Daifotis's suggestion in or about January 2006, CSIM and CS&Co.
12 then began listing YieldPlus's "duration" in place of its WAM in various sales materials, such
13 as tables on its public website listing Schwab funds and their attributes. Daifotis also
14 discussed with CS&Co. and CSIM officials how to make that change.

15 88. CSIM and CS&Co. replaced WAM with duration only for YieldPlus, not for
16 any other fund. In some communications, CSIM and CS&Co. noted the replacement with a
17 footnote indicating that duration, not WAM, was listed, while in other communications,
18 CSIM and CS&Co. failed even to disclose that they had made such a substitution.

19 89. From at least February 2006 through September 2007, CSIM and CS&Co.
20 listed a duration figure of 0.5 in place of WAM, without any notation of the replacement, on
21 Schwab's external website available to the public, Schwab.com. The duration figure was
22 included in tables of multiple Schwab investments, allowing comparisons of the products and
23 quick review of their attributes (including WAM and performance data). The tables listed the
24 investment products by categories and included columns for yield or performance data as well

1 as the WAM for each product. But the website did not disclose that YieldPlus's duration had
2 replaced WAM figures.

3 90. Because duration figures had replaced WAM figures for YieldPlus but that
4 change was not disclosed, the website and tables deceptively appeared to still be listing WAM
5 figures for the Fund. The mere fact that CSIM and CS&Co. were listing a duration figure
6 instead of WAM for YieldPlus was a material fact. Their failure to disclose that fact, and to
7 explain the differences between "duration" and WAM, caused these communications with
8 investors to be deceptive and misleading.

9 91. Because the numerals reflecting duration (i.e., 0.4 to 0.6) were significantly
10 lower than the numerals that would have reflected WAM (i.e., 1.2 to 4.2 years), this made the
11 materials appear to indicate that YieldPlus held investments with maturities of a few months
12 to six months, when in fact the maturities were at least three times that.

13 92. Further, CSIM and CS&Co. also listed a duration figure of 0.5 in place of
14 WAM, without any notation of the replacement, in a Commission filing, a Form N-CSR
15 Annual Report dated August 31, 2007, and filed with the Commission on November 2, 2007.

16 93. CSIM and CS&Co. also listed a duration figure of 0.5 in place of WAM,
17 without any notation of the replacement in Schwab's publicly distributed magazine, entitled
18 "*On Investing*," including at least the issue dated March 21, 2007.

19 94. Also for the period of at least February 2006 to at least September 2007, on the
20 Schwab Mutual Fund Center website, CSIM and CS&Co. replaced WAM with duration in
21 tables listing data for Schwab products. Again, they made the replacement only for
22 YieldPlus, not other products. Although they included a footnote noting the change, they
23 failed to make the change obvious or to explain its import.

24 95. Thus, even when CSIM and CS&Co. included a footnote indicating that

1 duration was listed for YieldPlus instead of WAM, their failure to explain the difference
2 between the two measures was materially misleading.

3 96. The difference between duration and WAM greatly confused many investors
4 and even CS&Co. representatives, who erroneously believed that YieldPlus's short duration
5 meant that it held only short-maturity bonds.

6 97. The duration number that CSIM and CS&Co. listed was false and misleading
7 in another way because the figure itself was false. Although YieldPlus's duration fluctuated,
8 CSIM and CS&Co. hard-coded the number "0.5" into tables and documents discussed above.
9 This misleadingly suggested to investors that YieldPlus's duration (or WAM, when the
10 footnote was omitted) was absolutely constant, implying a stability that did not exist.

11 98. Having been a lead decision-maker in deciding to replace WAM with duration,
12 Daifotis knew or was reckless in not knowing that that the materials described above,
13 including the Schwab.com website, the November 2, 2007 Form N-CSR, and the issues of the
14 *On Investing* publication listed duration figures in place of WAM but did not disclose that
15 change. Indeed, the November 2, 2007 Form N-CSR even bore Daifotis's picture, thus
16 attributing the contents to him.

17 99. Daifotis also knew or was reckless in not knowing that replacement of a 0.5
18 WAM with duration figures without disclosing the change and fully explaining the duration
19 figures in the above-described materials was false and misleading because, as discussed
20 above, the Fund's WAM was substantially longer than that.

21 100. Daifotis knew or was reckless in not knowing that CSIM and CS&Co. listed a
22 hard-coded duration figure of 0.5 on the Schwab Mutual Fund Center website, without
23 explaining the nature of duration or how it differed from WAM figures, as described above,
24 and that it was misleading to fail to fully explain those things and to list a hard-coded figure

1 that actually fluctuated.

2 101. Daifotis failed to correct the misrepresentations or omissions regarding the
3 listing of duration figures, as described above, despite his obligation to do so as a result of his
4 senior executive position, his involvement in causing the change to be made, his
5 responsibilities and the fact that, as he knew or was reckless in not knowing, he was relied
6 upon within CSIM and CS&Co. to make sure that information about the Fund that was
7 disseminated to the public was accurate, complete, and not misleading.

8 102. As a result of the foregoing, CS&Co. employees, including, but not limited to
9 registered representatives and regional bond specialists, communicated incorrect information
10 to investors. For example, during one telephone call, on or about July 24, 2007, a CS&Co.
11 representative told a Schwab customer that the Fund invested in bonds with maturities of 180
12 days or less. This was false because many of the Fund's holdings had maturities much longer
13 than 180 days.

14 **B. Unlawful Deviation From Concentration Policy**

15 **1. Background**

16 103. Section 8 of the Investment Company Act [15 U.S.C. §80a-8] requires that a
17 fund's registration statement contain a recital of certain investment policies, including its
18 policy regarding concentration of investments in particular industries, fundamental investment
19 policies or any investment policy that is only changeable if authorized by a shareholder vote.
20 Section 13(a)(3) of the Investment Company Act [15 U.S.C. § 80a-13(a)(3)] states that a fund
21 may not "deviate from" these investment policies unless authorized by a shareholder vote.

22 104. To comply with Section 8, Schwab Investments recited a single concentration
23 policy for its taxable bond funds, including YieldPlus, the Total Bond Fund, and the Short-
24 Term Bond Fund, in a registration statement shared by all of the funds. The registration

1 statement was filed with the Commission when the funds were created, which was 1999 for
2 YieldPlus, 1997 for the Total Bond Fund, and 1991 for the Short-Term Bond Fund, and
3 updated registration statements were filed at least annually. They were available to the
4 public.

5 105. All registration statements filed for the above-mentioned funds from each of
6 their inception stated that the funds would not concentrate more than 25 percent of their
7 assets in any industry.

8 106. For five years prior to August 2006, the registration statements also stated that,
9 “for the purpose of its concentration policy,” each fund would treat non-agency MBS as an
10 industry. As a result, the bond funds, including YieldPlus, the Total Bond Fund, and the
11 Short-Term Bond Fund, could not invest more than 25 percent of portfolio assets in non-
12 agency MBS.

13 107. The concentration policy and treatment of non-agency MBS as an industry
14 were material facts that impacted the riskiness, desirability and performance potential of the
15 funds.

16 **2. YieldPlus Invested More Than**
17 **25 Percent of Assets in Non-Agency MBS**

18 108. Schwab Investments, in violation of Section 13(a)(3) of the Investment
19 Company Act [15 U.S.C. § 80a-13(a)(3)], deviated from YieldPlus’s concentration policy by
20 at least early 2006 when it invested more than 25 percent of its assets in non-agency MBS.
21 Contemporaneous documents, including quarterly review power point presentations for
22 YieldPlus dated March 31, 2006, and June 30, 2006, created by Fund portfolio managers, and
23 that Daifotis reviewed or was reckless if he did not review, reflected the deviation in charts
24 summarizing the Fund’s holdings, which conflicted with holding percentages reported in

1 documents that Schwab Investments filed with the Commission.

2 109. By at least March 2006, Daifotis directed YieldPlus's investments that caused
3 it to deviate from its concentration policy and violate Section 13(a)(3) of the Investment
4 Company Act [15 U.S.C. § 80a-13(a)(3)], and he knew or was reckless in not knowing that
5 this was the result of his actions.

6 110. Moreover, YieldPlus deviated from its concentration policy partly because
7 Daifotis and the portfolio managers that he supervised failed to classify some securities as
8 non-agency MBS for purposes of YieldPlus's concentration policy. For example, from at
9 least 2005 through mid-2008, Daifotis and the portfolio managers he supervised excluded two
10 entire categories of securities, commercial MBS and subprime MBS, when calculating the
11 percentage of assets invested in non-agency MBS, even though those categories should have
12 been included as non-agency MBS. If these categories of MBS were included in the
13 calculation of non-agency MBS, YieldPlus's total non-agency MBS holdings significantly
14 exceeded 25 percent by early 2006, as Daifotis knew or was reckless in not knowing.

15 111. In addition, some securities were moved among classifications in filings with
16 the Commission, thus masking the improper concentration, as Daifotis knew or was reckless
17 in not knowing. Consistently classifying the securities as MBS would have disclosed that
18 YieldPlus had exceeded its concentration limit.

19 112. As a result of the foregoing, CSIM and CS&Co. filed reports with the
20 Commission that substantially understated the actual percentage of YieldPlus's total non-
21 agency MBS holdings, making those reports materially false and misleading because they
22 falsely made it appear that non-agency MBS did not make up more than 25 percent of
23 YieldPlus's holdings.

24 113. In particular, from at least late 2005 through mid-2008, the annual registration

1 statement amendments filed each November on Form N-1A and supplemented as necessary,
2 the annual and semi-annual Certified Shareholder Reports filed on Form N-CSR as of
3 February 28 and August 31 of each year, and the annual and semi-annual Quarterly Schedule
4 of Portfolio Holdings filed on Form N-Q as of May 31 and November 31 of each year, were
5 false and misleading in indicating that YieldPlus's non-agency MBS holdings did not exceed
6 25 percent, when in fact YieldPlus's non-agency MBS holdings substantially exceeded 25
7 percent.

8 114. During the time period that the above-referenced reports were being filed with
9 the Commission, Daifotis knew or was reckless in not knowing that YieldPlus investments
10 that he directed, the improper classification of assets that he and his portfolio managers
11 directed, and the improper shifting of classification of assets, as described above, were
12 causing such false reports to be filed with the Commission. Daifotis thereby substantially
13 participated in the creation of the false reports described above.

14 115. From at least March 2006, CSIM, CS&Co. and Daifotis knew, or were reckless
15 in not knowing, that YieldPlus had deviated from its recited concentration policy without
16 shareholder approval. CSIM, CS&Co., and Daifotis knew or were reckless in not knowing,
17 that YieldPlus's filings with the Commission, including but not necessarily limited to those
18 discussed above, contained material misstatements and omissions about YieldPlus's
19 concentration in non-agency MBS.

20 **3. Schwab Investments' Invalid Change of the**
21 **Concentration Policy Without Shareholder Approval**

22 116. After exceeding the 25 percent limit, the board of trustees of Schwab
23 Investments, including Merk, voted in August 2006 to stop treating non-agency MBS as an
24 industry and allow the funds to invest more than 25 percent of assets in non-agency MBS for

1 funds including YieldPlus, the Total Bond Fund and the Short Term Bond Fund.

2 117. By at least August 2006, Daifotis and another CSIM portfolio manager
3 recommended the change and Daifotis presented the recommendation to the board. Daifotis
4 did not inform the board that, as Daifotis knew or was reckless in not knowing, YieldPlus
5 already had deviated from the concentration policy.

6 118. The board voted in August 2006 to approve the change, but did not seek
7 shareholder approval to allow the funds to invest over 25 percent of their assets in non-agency
8 MBS as required by Section 13(a) of the Investment Company Act.

9 119. This vote was improper and invalid because, under Section 13(a) of the
10 Investment Company Act [15 U.S.C. §80a-13(a)], any such change in concentration policy
11 had to be approved by a shareholder vote.

12 120. YieldPlus's investment in non-agency MBS ballooned after the purported
13 change, approaching 50 percent within a year.

14 121. By at least November 2006, the Total Bond Fund and the Short Term Bond
15 Fund, which were governed by the same prospectus, also exceeded 25 percent of assets
16 invested in non-agency MBS in violation of the concentration policy.

17 **4. Failure to Properly Disclose the Change of Concentration Policy**

18 122. Not only was Section 13(a) of the Investment Company Act violated as set
19 forth above, defendants also signed or substantially participated in the submission of one or
20 more false documents to the Commission regarding the deviation from the concentration
21 policy, including but not necessarily limited to those set forth below.

22 123. As a trustee, Merk, among others, authorized his signature on and the filing of
23 one or more documents that contained material misstatements or omissions concerning the
24 concentration policy, including filings on Form 485B on November 15, 2006. The filing was

1 misleading because it failed to properly and adequately disclose to the Commission or the
2 public the material facts that Merk and the other trustees had voted to materially change the
3 funds' concentration policies, and that the funds had not obtained the required shareholder
4 approval for the change and had taken on the additional risk, and that YieldPlus already had
5 deviated from the concentration policy.

6 124. Moreover, Merk knew, or was reckless in not knowing, that the Form 485B
7 filing contained a false certification that the filing did not contain any material changes.
8 Merk's signature appears on the same page as the certification that the document contained no
9 material changes. Merk allowed his signature to be affixed to the document even though he
10 knew that the trustees had voted to change the funds' concentration policy and knew, or was
11 reckless in not knowing, that it was a material change and that, therefore, the certification in
12 the Form 485B was false.

13 125. Daifotis reviewed the November 2006 Form 485B before it was filed and he
14 was specifically asked to review and comment on the language concerning the change to the
15 concentration policy and the related additional risk disclosure. Although Daifotis knew or
16 was reckless in not knowing that the document was false and misleading for the reasons stated
17 above, and that it was to be filed with the Commission, Daifotis failed to make the changes
18 that would have been necessary to prevent the document from being false and misleading,
19 such as disclosing that the Form 485B contained a material change to the funds' concentration
20 policy, and that YieldPlus already had deviated from the policy.

21 126. In light of Merk's and Daifotis's executive-level positions and responsibilities,
22 as described above, and the fact that they knew or were reckless in not knowing that others
23 within CSIM and CS&Co. who prepared such documents relied on them to make sure that
24 statements that they reviewed or that they were asked or able to review were factually

1 accurate, complete, and not misleading, Daifotis and Merk were obligated to see to it that the
2 filings described above did not contain misrepresentations or omissions of material fact.

3 **C. Fraudulent Statements and Conduct**
4 **Regarding YieldPlus During its Decline**

5 **1. The Decline**

6 127. Due, in part, to the misrepresentations and omissions described above, such as
7 the misleading comparisons of YieldPlus to cash investments, the false descriptions of
8 YieldPlus as only marginally riskier than a money market fund, the false statements that its
9 NAV was unlikely to fluctuate by more than a few pennies, the understatement of YieldPlus's
10 WAM, and the failure to seek shareholder approval for YieldPlus's concentration in non-
11 agency MBS, and YieldPlus's historical performance, many YieldPlus investors expected that
12 YieldPlus would experience minimal NAV fluctuations.

13 128. When YieldPlus's NAV began to decline in the summer of 2007, many
14 investors redeemed their holdings.

15 129. Daifotis and Merk believed that they needed investor redemptions to diminish.
16 For example, early in the crisis, a senior portfolio manager for YieldPlus sent an email to
17 Daifotis, Merk and others stating that, "we need flows to stabiliz[e]." Shortly after, Daifotis
18 sent an email to Merk stating that, "[i]f the Advisor community starts to bail out, who [sic]
19 has been stable to this point, we will be in trouble."

20 130. In response, as detailed below, CSIM and CS&Co. held a series of conference
21 calls, spoke with individual customers and advisers, issued written materials, and circulated
22 internal talking points regarding the Fund's decline.

23 131. As described more fully below, Daifotis and Merk played key roles in this
24 communication effort and knew or were reckless in not knowing that statements that they

1 made, or statements for which they knowingly provided substantial assistance, contained
2 misrepresentations and omissions of material fact.

3 132. Daifotis was the primary face of CSIM and CS&Co.'s statements. He led
4 conference calls discussing YieldPlus's status, personally made misrepresentations and
5 omissions of material fact, received daily updates about YieldPlus's level of redemptions and
6 cash status, and authored or reviewed most of the documents circulated to investors, advisers
7 and CS&Co. representatives.

8 133. Merk authored, reviewed, and/or approved a number of the public statements
9 and internal talking points that contained misrepresentations and omissions of material fact.
10 He received daily updates concerning the Fund, monitored the Fund's performance and
11 participated in crafting the public response. He also supervised Daifotis during the relevant
12 period.

13 134. The defendants made, substantially participated in making, or knowingly
14 provided substantial assistance in the making of misrepresentations or omissions of material
15 fact during the period of the Fund's decline, including but not necessarily limited to those set
16 forth in sections C.2. and C.3. below.

17 **2. False Statements and Omissions About the Level of Redemptions**

18 135. Prominent among the false statements early in the crisis were two false
19 statements by Daifotis about YieldPlus's level of redemptions in two prescheduled conference
20 calls on August 14 and 16, 2007, with large groups of registered representatives and
21 independent investment advisers. The calls were intended to respond to investors' questions
22 and concerns about YieldPlus.

23 136. From August 1 through 14, 2007, investors redeemed almost \$1.2 billion in
24 assets, or approximately 10 percent of Fund assets. Because YieldPlus had a negative cash

1 position as of July 31, 2007, it had to sell assets to meet the redemptions and prepare for more
2 redemptions. During that two-week period, YieldPlus sold over \$2.1 billion in portfolio
3 securities, representing 16 percent of assets. YieldPlus's portfolio managers had never before
4 sold a significant percentage of Fund assets.

5 137. Because redemptions were a growing concern, Daifotis monitored redemption
6 levels multiple times per day in August 2007, and thus was well aware of the high level of
7 redemptions.

8 138. Six days before the August 14, 2007 conference call, Daifotis and Merk
9 received the email from a portfolio manager stating that, "we need flows to stabiliz[e]."

10 139. Three days before the August 14, 2007 conference call, Daifotis sent an email
11 to Merk in which he said that, "[i]f the Advisor community starts to bail out, who has been
12 stable to this point, we will be in trouble."

13 140. On August 12, 2007, two days before the first conference call, Daifotis sent an
14 email editing a set of questions and answers ("Q&A") to be posted on the Schwab.com
15 website and thus available to the public. The edits removed redemption information from the
16 Q&A and, in the email, Daifotis explained, "*I don't want anyone to sense that we are having*
17 *outflows.*" (emphasis added).

18 141. On August 14, 2007, Daifotis held a prescheduled conference call with a large
19 number of independent registered investment advisers to discuss YieldPlus. During the call,
20 an adviser asked Daifotis, "how expensive have your redemptions been since the decline?"
21 During his answer, Daifotis responded that some advisers had purchased more shares, and that
22 "we've got *very, very, very slight* negative flows over the course of the last week or two."
23 (emphasis added).

24 142. Two days later, on August 16, 2007, Daifotis held a similar conference call

1 with a large number of CS&Co. registered representatives. In that call, a representative asked
2 “what are the net outflows of the Schwab Yield Plus fund to date?” During his answer,
3 Daifotis stated, “[i]t’s not that much. . . . So *outflows have been minimal*” (emphasis added).

4 143. Daifotis knew or was reckless in not knowing that his statements were
5 materially false and misleading because YieldPlus was experiencing tremendous,
6 unprecedented outflows, which required over \$2 billion in asset sales in only two weeks, and
7 therefore could not fairly be described as “very, very, very slight” or “minimal.”

8 144. Daifotis’s false statements were communicated to YieldPlus investors, and
9 Daifotis knew or was reckless in not knowing that this would occur. For example, in the
10 week after the conference calls, a CS&Co. representative told a YieldPlus investor during a
11 telephone call: “And what we really have to be concerned about, is what have the outflows
12 been on the fund. And surprisingly—and this—Kim Daifotis, who is the head of Schwab
13 Investment Management said that he was very surprised, and he said the redemptions were
14 negligible on the fund.”

15 3. Other Fraudulent Statements and Conduct During the Decline

16 145. August 2007 Q&A on the Website. In early August 2007, CS&Co. published
17 on the Schwab website a Q&A, which was available to the public, that listed Merk as the
18 author. Merk reviewed and edited the document before it was published. Among other false
19 and misleading statements and omissions, the Q&A stated that the “fund’s short maturity
20 structure has mitigated much of the price erosion that some other ultrashort bond funds have
21 experienced.” This remained on the Schwab website through at least March 2008.

22 146. When he made the statement described above, Merk knew or was reckless in
23 not knowing that his statement was false and misleading because YieldPlus did not have a
24 short maturity structure, especially compared to money market funds. Rather, as described

1 above, it held many long-term bonds with stated maturities of twenty years or more, and used
2 interest rate hedging strategies to limit YieldPlus's duration.

3 147. Merk's statement also was false and misleading because YieldPlus was
4 performing worse than most of its peers. For example, the day after the Q&A piece was
5 posted, Merk received statistics showing that YieldPlus was ranked in the bottom 15 percent
6 percentile of its peers. In light of Merk's statement about YieldPlus's performance in relation
7 to other funds, it was a material omission to not disclose the fact that the large majority of
8 peer funds had performed better, and this made Merk's statement on that point materially
9 misleading. Merk, however, did not remove his misleading statement from Schwab's
10 website, and the false statement remained on the website through at least March 2008.

11 148. In addition to being on the Schwab website, the false statements were
12 communicated to YieldPlus investors, as Merk knew or was reckless in not knowing would
13 result from his having posted the statements. For example, on August 21, 2007, a CS&Co.
14 representative told a YieldPlus investor during a telephone call: "And if we take a look at the
15 peer group of ultrashort term bond funds, this has actually performed much better than all the
16 other ultrashort term bond funds, because it does have a very quality portfolio."

17 149. November 2007 Talking Points. In late November 2007, CS&Co. and CSIM
18 circulated a set of internal talking points that were used by Schwab employees when
19 discussing YieldPlus with investors. Before circulation, both Daifotis and Merk reviewed the
20 talking points, which covered half of the one-page document, the rest of which mainly
21 contained standard disclosure language and a chart entitled "Average Annualized Total
22 Returns." Merk suggested an edit and then approved the talking points. The document stated
23 that:

- 24 • "The portfolio management team has confidence in the Fund's strategy given

1 our outlook for the fixed-income markets.”

- 2 • “Despite the recent spike in bond market volatility, history suggests this is a
3 temporary condition.”
- 4 • YieldPlus’s unrealized loss, which made up 75 percent of YieldPlus’s losses,
5 was a “paper loss.”
- 6 • “Since last summer, the Fund has maintained a higher than normal cash
7 position, in an effort to capitalize on investment opportunities and to
8 effectively manage potential redemption requests.”
- 9 • “The portfolio is highly diversified with approximately 400 securities across a
10 wide range of sectors and industries.”

11 150. The talking points contained a number of false and misleading statements and
12 omissions of material fact, including but not necessarily limited to the following:

13 (a) The statement that the portfolio management team had “confidence” in
14 YieldPlus was, at best, misleading because it omitted the material fact that the
15 portfolio management team’s contemporaneous internal discussions stated the
16 opposite. For example, in one email sent days before Merk approved the talking
17 points, the portfolio manager assigned to give daily updates on the Fund reported to
18 Daifotis, Merk, and other senior executives that raising cash “was like pulling teeth”
19 and that “[l]iquidity is AWFULperiod.” In a second email sent that week, the
20 same portfolio manager reported to Daifotis that “it[’]s not better today and likely
21 won’t be for some time.” In a third email that he sent shortly before the talking points
22 were finalized, he reported to Daifotis, Merk, and others that “we are hostage to the
23 market at this point and can’t improve the NAV.” The statement also was misleading
24

1 because it omitted material facts concerning the high level of redemptions and the fact
2 that many of the Fund's best assets were being sold at depressed prices in order to
3 meet redemptions.

4 (b) The statements that YieldPlus's losses to date were "paper loss[es]"
5 and were "unrealized" were at best misleading because they omitted the material fact
6 that, by that time, YieldPlus had sold its safest, most liquid assets, which made the
7 portfolio more vulnerable to further declines. YieldPlus had sold its safest assets
8 because it needed to raise cash to meet redemptions and the safest assets were easiest
9 to sell.

10 (c) The statement that YieldPlus was raising cash "since last summer" to
11 take advantage of buying opportunities was false, misleading, and omitted material
12 facts. During August 2007, Merk had instructed the portfolio management team to
13 focus on selling assets to raise cash, and to stop buying bonds. The false statement
14 was repeated in a November 2007 document labeled a "Manager's Discussion," which
15 stated that "[w]e continue to maintain higher-than-normal cash positions in an effort to
16 capitalize on purchasing opportunities in the current market environment and to
17 effectively manage the timing of any redemption requests." YieldPlus was not
18 looking for "current" buying opportunities.

19 (d) The statement that YieldPlus was "highly diversified" was misleading
20 and omitted material facts. Combining YieldPlus's MBS and its ownership of
21 corporate bonds issued by financial institutions, over 75 percent of YieldPlus's assets
22 were tied to the real estate and financial sectors.

23 151. As Daifotis and Merk knew or were reckless in not knowing would occur,
24 CS&Co.'s representatives repeated the substance of the talking points and other misleading

1 | communications in at least November 2007 when communicating with investors about
2 | YieldPlus in telephone calls regarding concern over YieldPlus's performance and general
3 | reviews of portfolios that held YieldPlus.

4 | 152. In light of their senior executive positions and responsibilities, and the fact that
5 | they knew or were reckless in not knowing that they were relied upon within CSIM and
6 | CS&Co. to convey accurate, complete, and not misleading information about the Fund, as
7 | described above, Daifotis and Merk were obligated to make sure that the November 2007
8 | talking points – which they reviewed and Merk approved – were accurate, complete, and not
9 | misleading in the ways described above. Daifotis and Merk failed to carry out that obligation
10 | because they allowed the talking points to be issued without correcting the above-described
11 | misrepresentations and omissions.

12 | 153. November 15, 2007 Email Regarding Sales at Distressed Prices. Also in
13 | November 2007, Daifotis and Merk knew or were reckless in not knowing that Fund
14 | representatives were misleading the public by understating the stress that YieldPlus was
15 | experiencing because, among other things, representatives were being told to inform investors
16 | that YieldPlus was not forced to sell assets at distressed prices to meet redemptions. One
17 | November 15, 2007, email, a copy of which was sent to Daifotis and Merk, was sent to
18 | CS&Co. representatives telling them that “[t]he portfolio managers have not been forced into
19 | selling securities at distressed prices to meet client redemptions.” Daifotis and Merk knew or
20 | were reckless in not knowing that the substance of this would be communicated to the public.

21 | 154. As Daifotis and Merk knew or were reckless in not knowing, the statement in
22 | the November 15, 2007 email was false, misleading, and omitted material facts. Only one day
23 | before that November 15, 2007 email was sent, the YieldPlus portfolio manager assigned to
24 | preparing a daily update told Daifotis, Merk and others that “we are selling securities that are

1 'money-good' high quality assets at depressed prices." The same portfolio manager told
2 Merk, two weeks prior, that "almost every sale in YP [YieldPlus] has been of a good bond at
3 depressed prices. We've had no choice but to sell or not provide daily liquidity to
4 shareholders."

5 155. Even though Daifotis and Merk knew or were reckless in not knowing that the
6 Fund was selling "good bond[s] at depressed prices," Daifotis and Merk did not correct the
7 statement that they saw going to the representatives in November 2007 that the Fund was not
8 being forced to sell securities at distressed prices to meet redemptions, and they failed to
9 ensure that that the statement included the material facts mentioned above. In light of their
10 senior executive positions and responsibilities, as described above, and the fact that they knew
11 or were reckless in not knowing that that they were relied upon within CSIM and CS&Co. to
12 convey accurate, complete, and not misleading information about the Fund, as described
13 above, Daifotis and Merk were obligated to make sure that the November 15, 2007 email was
14 accurate, complete, and not misleading, but they failed to do so.

15 156. This misstatement was communicated to Schwab investors. For example, in
16 March 2008, a Schwab representative told a YieldPlus investor in a telephone call that,
17 "Schwab hasn't been a forced seller into the lower prices, just selling those that have dropped
18 a lot in price. We haven't been forced to sell those to raise cash to meet redemptions, in that
19 manner."

20 157. Omission of Facts Regarding Alt-A MBS Investments. Also misleading was
21 frequent emphasis of YieldPlus's "minimal" subprime holdings, which constituted
22 approximately 6 percent of Fund assets, but omitting to state that, although YieldPlus
23 arguably had modest subprime holdings, approximately one-third of YieldPlus's assets were
24 invested in Alt-A securities, another type of security backed by lower quality residential

1 mortgages that were suffering price declines, which were similar to subprime mortgages and
2 which posed risks similar to those of subprime mortgages.

3 158. The early-August 2007 Q&A, discussed above, which identified Merk as the
4 author, included a discussion of YieldPlus's subprime holdings without references to the
5 related substantial Alt-A MBS investment. As Merk knew or was reckless in not knowing,
6 because this communication stressed the "minimal" exposure to "subprime" holdings, the
7 Q&A was misleading and deceptive because it omitted the material fact that the Fund had a
8 large percentage of Alt-A MBS securities, which exposed the Fund to risks similar to those of
9 subprime assets.

10 159. A November 2007 "Manager's Discussion" reviewed by Daifotis was issued to
11 the public under his title, "Manager," and Merk also received a copy. Thus, Daifotis and
12 Merk knew of or were reckless in not knowing the contents of the document. The Manager's
13 discussion, which was made available to the public and posted on Schwab's external website,
14 also emphasized the Fund's minimal subprime holdings, stating that they were approximately
15 5 percent of the Fund's holdings. This document also omitted the material fact that that the
16 Fund had a large percentage of Alt-A MBS securities, which exposed the Fund to risks similar
17 to those of subprime assets. It was misleading to state that the Fund held only 5 percent in
18 subprime assets without also disclosing the Fund's large holdings of Alt-A MBS securities.

19 160. Daifotis and Merk knew or were reckless in not knowing the contents of the
20 August and November documents described above, as well as other documents that contained
21 similar material omissions regarding the Fund's Alt-A holdings. In light of their senior-level
22 executive positions and responsibilities, as described above, and the fact that they knew or
23 were reckless in not knowing that they were relied upon within CSIM and CS&Co. to ensure
24 that such materials were accurate, complete, and not misleading, they were obligated to make

1 sure that the documents cited above did not contain false or misleading statements or
2 omissions, but they failed to do so. In particular, in connection with the documents'
3 statements about the Fund's minimal subprime holdings, they should have made sure that the
4 documents disclosed the Fund's substantial Alt-A holdings.

5 **D. Redemptions by Schwab-Related Funds**

6 161. While Daifotis and Merk were telling investors that they had confidence in
7 YieldPlus and to maintain a patient, long-term perspective on their investments, and while
8 Merk and Daifotis knew that CSIM and CS&Co. were making those statements to investors, a
9 number of Schwab-related Funds with material nonpublic information about the adverse
10 condition of YieldPlus redeemed their investments in YieldPlus.

11 162. For example, Schwab's five target date and retirement funds ("Target Date
12 Funds") redeemed investments in YieldPlus in March 2008, after its senior portfolio manager
13 received material, nonpublic information about YieldPlus. The Target Date Funds' senior
14 portfolio manager was the Chief Investment Officer for Equities ("CIO-Equities") at the time.

15 163. Both the CIO-Equities and Daifotis reported directly to Merk during
16 YieldPlus's decline, and the CIO-Equities learned material nonpublic information about
17 YieldPlus from Daifotis in regular meetings with Merk and his direct reports in at least
18 February and March 2008.

19 164. During these meetings, Daifotis discussed YieldPlus, its NAV decline, high
20 redemption levels, and plans to satisfy redemptions by selling assets.

21 165. While in possession of this information, the CIO-Equities approved the
22 recommendation of another portfolio manager to redeem the Target Date Funds' investments
23 in YieldPlus and personally arranged to expedite the redemptions. This material information
24 was not disclosed to the public at that time.

1 166. The CIO-Equities informed Merk of his intention to redeem.

2 167. CSIM and CS&Co. served as investment advisers to YieldPlus and thus owed
3 a fiduciary duty to YieldPlus, as did Merk because of his position as a trustee of YieldPlus
4 and as a senior officer of CSIM and CS&Co.

5 168. Despite Merk's awareness of the foregoing, and his knowledge that the CIO-
6 Equities learned material, nonpublic information about YieldPlus during the meetings of the
7 Merk reports, Merk approved the Target Date Funds' redemptions of investments in
8 YieldPlus.

9 169. Merk failed to disclose to YieldPlus's board of trustees and to the investors in
10 YieldPlus the material fact that the Target Date Funds were redeeming investments in
11 YieldPlus after their senior portfolio manager had learned material nonpublic information
12 about YieldPlus.

13 170. The material nonpublic information that was shared during the meetings with
14 Merk and Merk's direct reports belonged to YieldPlus and should not have been shared with
15 other investors — such as the CIO-Equities, who managed funds that invested in YieldPlus —
16 without the permission of YieldPlus's trustees. The trustees had not been informed of the
17 disclosure of the Fund's information and had not approved such disclosure.

18 171. This unauthorized disclosure harmed YieldPlus because it contributed to the
19 Target Date Funds' decision to redeem their YieldPlus investments. These redemptions
20 harmed YieldPlus because they came at a time when YieldPlus was struggling to raise cash to
21 meet redemptions by selling bonds in a declining market.

22 172. Through the actions of Merk, who was a senior officer of CSIM and CS&Co.,
23 in permitting the unauthorized disclosure of material nonpublic information and in approving
24 the Target Date Fund's redemptions in YieldPlus when he possessed material nonpublic

1 information and was aware of the unauthorized disclosures of material nonpublic information,
2 CSIM and CS&Co. breached the fiduciary duties that they owed to YieldPlus in their roles as
3 the Fund's investment advisers, and they violated Section 206(1) and (2) of the Investment
4 Advisers Act Act [15 U.S.C. § 80b-6(1) and (2)].

5 **FIRST CLAIM FOR RELIEF**
6 (Against Daifotis and Merk)

7 Violations of Section 10(b) of the Exchange Act
8 [15 U.S.C. §78j(b)] and Rule 10b-5 Thereunder [17 C.F.R. § 240.10b-5]

9 173. The Commission realleges and incorporates by reference paragraphs 1 through
10 172 above.

11 174. Daifotis and Merk, directly or indirectly, in connection with the purchase or
12 sale of securities, by the use of means or instrumentalities of interstate commerce, or the
13 mails, with scienter: (a) employed devices, schemes, or artifices to defraud; (b) made untrue
14 statements of material facts or omitted to state material facts necessary in order to make the
15 statements made, in the light of the circumstances under which they were made, not
16 misleading; or (c) engaged in acts, practices, or courses of business which operated or would
17 operate as a fraud or deceit upon other persons, including purchasers and sellers of securities.

18 175. By reason of the foregoing, Daifotis and Merk violated Section 10(b) of the
19 Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

20 **SECOND CLAIM FOR RELIEF**
21 (Against Daifotis and Merk)

22 Aiding and Abetting Violations of Section 10(b) of the Exchange Act
23 [15 U.S.C. §78j(b)] and Rule 10b-5 Thereunder [17 C.F.R. § 240.10b-5]

24 176. The Commission realleges and incorporates by reference paragraphs 1 through
175 above.

177. CSIM and CS&Co., directly or indirectly, in connection with the purchase or

1 sale of securities, by the use of means or instrumentalities of interstate commerce, or the
2 mails, with scienter: (a) employed devices, schemes, or artifices to defraud; (b) made untrue
3 statements of material facts or omitted to state material facts necessary in order to make the
4 statements made, in the light of the circumstances under which they were made, not
5 misleading; or (c) engaged in acts, practices, or courses of business which operated or would
6 operate as a fraud or deceit upon other persons, including purchasers and sellers of securities.

7 178. By reason of the conduct described above, Daifotis and Merk knowingly
8 provided substantial assistance to CSIM and CS&Co. in violation of Section 10(b) of the
9 Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5], and
10 thus aided and abetted such violations.

11 179. Accordingly, pursuant to Section 20(e) of the Exchange Act [15 U.S.C. §
12 78t(e)], Daifotis and Merk are liable for such violations.

13 **THIRD CLAIM FOR RELIEF**
14 (Against Daifotis and Merk)

15 Violations of Section 17(a) of the Securities Act [15 U.S.C. § 77q(a)]

16 180. The Commission realleges and incorporates by reference Paragraphs 1 through
17 179 above.

18 181. Daifotis and Merk, directly or indirectly, in the offer or sale of securities, by
19 use of the means or instruments of transportation or communication in interstate commerce or
20 by use of the mails, (a) employed devices, schemes, or artifices to defraud; (b) obtained
21 money or property by means of untrue statements of material fact or by omitting to state a
22 material fact necessary in order to make the statements made, in light of the circumstances
23 under which they were made, not misleading; or (c) engaged in transactions, practices, or
24 courses of business which operated or would operate as a fraud or deceit upon the purchasers.

1 182. By reason of the foregoing, Daifotis and Merk violated Section 17(a) of the
2 Securities Act [15 U.S.C. § 77q(a)].

3 **FOURTH CLAIM FOR RELIEF**
4 (Against Merk)

5 Aiding and Abetting Violations of
6 Sections 206(1) and (2) of the Advisers Act [15 U.S.C. § 80b-6(1) and (2)]

7 183. The Commission realleges and incorporates by reference Paragraphs 1 through
8 182 above.

9 184. CSIM and CS&Co., while acting as investment advisers, directly or indirectly,
10 by use of the mails or means or instrumentality of interstate commerce: (a) employed
11 devices, schemes, or artifices to defraud a client or clients or prospective clients; and/or (b)
12 engaged in transactions, practices or courses of business which operated as a fraud or deceit
13 upon a client or clients or prospective clients.

14 185. By reason of the foregoing, and in particular, Merk's conduct as described in
15 Section D, above, CSIM and CS&Co. violated Sections 206(1) and 206(2) of the Advisers
16 Act [15 U.S.C. § 80b-6(1) and (2)].

17 186. By reason of the conduct described above, Merk knowingly aided, abetted,
18 counseled, commanded, induced, or procured said violation by CSIM and CS&Co.

19 187. Accordingly, pursuant to Section 209 of the Advisers Act [15 U.S.C. 80b-9],
20 Merk is liable for such violations.

21 **FIFTH CLAIM FOR RELIEF**
22 (Against Daifotis and Merk)

23 Aiding and Abetting Violations of
24 Section 206(4) [15 U.S.C. § 80b-6(4)] of the Advisers Act
and Rule 206(4)-8 [17 C.F.R. § 275.206(4)-8] Thereunder

188. The Commission realleges and incorporates by reference Paragraphs 1 through
187 above.

1 189. CSIM and CS&Co., while acting as investment advisers, directly or indirectly,
2 by use of the mails or means or instrumentality of interstate commerce, engaged in acts,
3 practices, or courses of business that were fraudulent, deceptive or manipulative.

4 190. CSIM and CS&Co., while acting as investment advisers to pooled
5 investment vehicles: (a) made untrue statements of material facts or omitted to state material
6 facts necessary in order to make the statements made, in the light of the circumstances under
7 which they were made, not misleading, to investors or prospective investors in the pooled
8 investment vehicle; or (b) engaged in acts, practices, or courses of business that were
9 fraudulent, deceptive, or manipulative with respect to investors or prospective investors in the
10 pooled investment vehicle. CSIM and CS&Co. thereby violated Section 206(4) [15 U.S.C. §
11 80b-6(4)] of the Advisers Act and Rule 206(4)-8 [17 C.F.R. § 275.206(4)-8] thereunder.

12 191. By reason of the conduct described above, Daifotis and Merk knowingly
13 aided, abetted, counseled, commanded, induced, or procured said violations by CSIM and
14 CS&Co., and thus aided and abetted such violations.

15 192. Accordingly, pursuant to Section 209 of the Advisers Act [15 U.S.C. 80b-9],
16 Daifotis and Merk are liable for such violations.

17 **SIXTH CLAIM FOR RELIEF**
18 (Against Daifotis and Merk)

19 **Violations of Section 34(b) of the Investment Company Act [15 U.S.C. §80a-33(b)]**

20 193. The Commission realleges and incorporates by reference Paragraphs 1 through
21 192 above.

22 194. In registration statements, applications, reports, accounts, records, or other
23 documents filed or transmitted pursuant to the Investment Company Act, Daifotis and Merk
24 made untrue statements of material fact, and/or omitted facts necessary in order to prevent

1 statements made, in the light of the circumstances under which they were made, from being
2 materially misleading.

3 195. By reason of the foregoing, Daifotis and Merk violated Section 34(b) of the
4 Investment Company Act [15 U.S.C. §80a-33(b)].

5 **SEVENTH CLAIM FOR RELIEF**
6 (Against Daifotis and Merk)

7 Aiding and Abetting Violations of
8 Section 34(b) of the Investment Company Act [15 U.S.C. §§ 80a-33(b)]

9 196. The Commission realleges and incorporates by reference Paragraphs 1 through
10 195 above.

11 197. Schwab Investments, CSIM and CS&Co. made untrue statements of material
12 fact, and/or omitted facts necessary in order to prevent statements made, in the light of the
13 circumstances under which they were made, from being materially misleading, in registration
14 statements, applications, reports, accounts, records, or other documents filed or transmitted
15 pursuant to the Investment Company Act.

16 198. Schwab Investments, CSIM and CS&Co. thereby violated Section 34(b) of the
17 Investment Company Act [15 U.S.C. §80a-33(b)].

18 199. Daifotis and Merk knowingly provided substantial assistance to Schwab
19 Investments, CSIM and CS&Co., and thereby aided and abetted said violations of Section
20 34(b) of the Investment Company Act [15 U.S.C. §80a-33(b)].

21 200. Accordingly, pursuant to Section 48(b) of the Investment Company Act [15
22 U.S.C. §80a-47(b), as amended pursuant to Section 929M of the Dodd-Frank Wall Street
23 Reform and Consumer Protection Act (the "Dodd-Frank Act"), Public Law 111-203, 2010
24 HR 4173 (July 2010)], Daifotis and Merk are liable for such violations.

1 **PRAYER FOR RELIEF**

2 WHEREFORE, the Commission respectfully requests that this Court:

3 I.

4 Find that defendants Daifotis and Merk committed the violations alleged;

5 II.

6 Permanently enjoin Daifotis from directly or indirectly violating Section 17(a) of the
7 Securities Act [15 U.S.C. § 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. §§ 78j(b)],
8 and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5], Section 34(b) of the Investment
9 Company Act [15 U.S.C. § 80a-33(b)], Section 206(4) of the Advisers Act [15 U.S.C. §§ 80b-
10 6(4)], and Rule 206(4)-8 thereunder [17 C.F.R. § 275.206(4)-8], and from aiding and abetting
11 violations of Section 13(a) of the Investment Company Act [15 U.S.C. §§ 80a-13(a) and 80a-
12 33(b)].

13 III.

14 Permanently enjoin Merk from directly or indirectly violating Section 17(a) of the
15 Securities Act [15 U.S.C. § 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. §§ 78j(b)],
16 and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5], Sections 206(1), (2) and (4) of the
17 Advisers Act [15 U.S.C. §§ 80b-6(1), (2) and (4)], Rule 206(4)-8 thereunder [17 C.F.R. §
18 275.206(4)-8], and Section 34(b) of the Investment Company Act [15 U.S.C. § 80a-33(b)];

19 IV.

20 Order Daifotis and Merk to pay civil penalties pursuant to Section 20(d) of the
21 Securities Act [15 U.S.C. § 77t(d)], Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)],
22 Section 209(e) of the Advisers Act [15 U.S.C. § 80b-9(e)] and Section 42(e) of the Investment
23 Company Act [15 U.S.C. § 80a-41(e)];

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24

V.

Order Daifotis and Merk to disgorge any ill-gotten gains, including prejudgment interest;

VI.

Retain jurisdiction of this action in accordance with the principles of equity and the Federal Rules of Civil Procedure in order to implement and carry out the terms of all orders and decrees that may be entered, or to entertain any suitable application or motion for additional relief within the jurisdiction of this Court; and

VII.

Grant such other and further relief as this Court may determine to be just and necessary.

JURY DEMAND

Plaintiff respectfully demands trial by jury on all issues in this case triable by a jury.

DATED: January 11, 2011

Respectfully Submitted,



David J. Gottesman
Frederick L. Block
Antonia Chion
Robert A. Cohen
Melissa R. Hodgman
David S. Mendel

Attorneys for Plaintiff
SECURITIES AND EXCHANGE
COMMISSION
100 F Street, N.E.
Washington, DC 20549-4030
Telephone: (202) 551-4470 (Gottesman)
Facsimile: (202) 772-9245 (Gottesman)