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Lessons Learned from the Fall of YieldPlus

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Introduction

At its pinnacle in early 2007, the Schwab YieldPlus Fund ("YieldPlus" or the "Fund") boasted $13.5 billion in assets, held over 200,000 accounts, and enjoyed a sterling reputation as one of the highest performing ultra-short bond funds in the market. One year later, it crumbled under the weight of the 2007-2008 credit crisis and faltering economy; and its assets tumbled to $1.8 billion. YieldPlus's investors lost billions of dollars, and the Securities and Exchange Commission (the "SEC"), in January 2011, brought a civil enforcement action against Charles Schwab & Co., Inc. ("Schwab"), Charles Schwab Investment Management, Inc. ("CSIM"), investment adviser to YieldPlus,[1] Schwab Investments ("Schwab Investments") and certain Schwab executives. Chairman Charles R. Schwab characterized YieldPlus's fall from grace as a "simple issue of liquidity and people all wanting out of the door at the same moment."[2] But, according to the SEC's allegations, there is more to the story. Deficient regulatory compliance in three areas paved the way for YieldPlus's collapse: (1) misleading representations in sales materials; (2) an unauthorized deviation from a stated concentration policy; and (3) a failure to prevent the misuse of material nonpublic information. This article will discuss these alleged deficiencies in the context of the events leading to YieldPlus's collapse and will suggest what we can learn from them.

What Happened: YieldPlus 2006-2008

YieldPlus is an ultra-short bond fund. An "ultra-short" bond fund typically invests in fixed income securities with extremely short durations of less than one year.[3] Duration, not to be confused with maturity, is a ratio expressing how quickly an investor will receive half of the total payment due over a fixed income security's remaining life.[4] Longer durations typically signify more interest rate risk exposure and inform investors that a security's price may fluctuate before maturity.[5] YieldPlus, however, owned many long-term bonds, including some with maturities of over 20 years. It relied on an interest rate hedging strategy

to shorten its portfolio's duration and preserve its ultra-short bond fund classification.[6]

When the credit crisis emerged in mid-2007, panic swept through the markets and provoked substantial redemptions by investors, including investors in YieldPlus. Unfortunately for YieldPlus, a substantial portion of its holdings were tied up in long-term bonds. With only 6% of its holdings scheduled to mature within six months, YieldPlus was forced to sell nearly 16% of its assets at distressed prices during the first two weeks of August 2007 to generate sufficient cash to meet its redemption obligations. By 2008, YieldPlus's net asset value ("NAV") had dropped by 28% and its assets had plunged to $1.8 billion, a fraction of its former $13.5 billion portfolio.[7]

On January 11, 2011, the SEC filed a civil enforcement action against Schwab, CSIM and Schwab Investments, the Massachusetts trust that issued shares of YieldPlus to the public. The SEC charged these entities with making misleading statements regarding the Fund and failing to establish, maintain and enforce policies and procedures to prevent the misuse of material nonpublic information. The SEC also charged CSIM and Schwab Investments with deviating from the Fund's concentration policy without obtaining the required shareholder approval. Schwab and CSIM have agreed to pay more than $118 million to settle the SEC's charges.[8] The SEC also individually charged Kimon Daifotis ("Daifotis") and Randall Merk ("Merk"). Daifotis served as YieldPlus's lead portfolio manager and as CSIM's Chief Investment Officer for Fixed Income. Merk served as President of CSIM and as a YieldPlus trustee. The cases against Daifotis and Merk remain pending.[9] Collectively, we will refer to each of these parties as the "Schwab Defendants."

I. Misleading and Deceptive Representations in Marketing Materials and Conference Calls

In mid-2006, before YieldPlus's troubles manifested, high-level executives for Charles Schwab Corporation coordinated a marketing campaign to become more competitive with its so-called "cash equivalent products." These products included money market funds and certificates of deposit ("CDs"). As part of this "cash campaign," the Schwab Defendants, Merk specifically, engineered a marketing strategy that included YieldPlus. They positioned YieldPlus alongside money market funds and CDs in the marketing materials distributed to clients and also made YieldPlus's prospectus electronically available on both Schwab's public website and its "cash page," which could be accessed from its general website. Table 1.0 below illustrates the representations made in these materials (emphasis added).

Table 1.0

Advertising Material	Representation Made by Schwab Defendants[10]
Brochure Mailed to Schwab Clients (Spring 2006)	"In the current uncertain interest rate and investing environment, cash has become an increasingly attractive defensive holding for many investors. *Kimon Daifotis,* chief investment officer and fixed-income portfolio manager of [CSIM], says investors can receive better returns by *using ultra-short bond funds as an alternative to traditional cash holdings, like money market funds and CDs,* though with a *slightly increased risk* to principal."
Schwab Public Website (June 2006)	"Looking for a way to earn better yields on your long-term cash without taking on significantly higher risk? The Schwab Yield Plus Fund . . . can be a smarter alternative to investing in money market and long term bond funds." "Even though the *share price may fluctuate minimally*, [YieldPlus] offer[s] . . . *only marginally higher risk than money market funds*."
Brochure Mailed to Schwab Clients (September 2006)	"If you're looking for a smart *alternative for your cash*, investing in the Schwab YieldPlus Fund could be your answer." "YieldPlus . . . offers higher potential returns than money markets *with only marginally more risk*." "YieldPlus is an actively managed mutual fund consisting primarily of *ultra-short duration bonds that mature frequently* to limit interest rate exposure."
Email to Schwab Investors (September 2006)	"Put your *cash in a strong position with YieldPlus*." "It offers higher potential returns than many money market funds, with *only marginally higher risk*." "YieldPlus primarily consists of ultra-short duration bonds *that mature frequently* to limit interest rate exposure."
Cash Tab on Schwab's Public Website (Late 2006)	"If you're comfortable accepting a *slightly higher amount of risk* in exchange for a return that is generally better than the other *cash equivalent investments*, consider this ultra-short bond fund [YieldPlus]."

In mid-2006, the SEC staff warned the Schwab Defendants that the marketing materials shown above, specifically the portions emphasized, had the potential to mislead investors because the materials unevenly linked YieldPlus to cash equivalent investments without providing adequate clarifying language to stress the considerable differences between ultra-short bond funds and cash equivalents. The Schwab Defendants responded by addressing these differences in YieldPlus's prospectus and chose not to clarify the YieldPlus marketing materials until after the Fund began to decline in 2007.

In its complaint, the SEC stated that supplementing the prospectus "was insufficient to remedy the misleading statements and omissions in [YieldPlus's] offer and sale."[11] It stressed that, contrary to the message sent by the marketing materials, the risk differential between YieldPlus and cash equivalents was not slight or marginal; it was fundamental and significant.[12] The SEC specifically noted that approximately 90% of YieldPlus's holdings could not have been lawfully held by a money market fund. During the relevant time period, the Investment Company Act of 1940, as amended ("1940 Act") required money market funds to maintain an average portfolio maturity of no more than 90 days and prohibited them from acquiring any security with a remaining maturity of more than 397 days.[13] YieldPlus, by contrast, held considerable numbers of bonds with remaining maturities of more than 20 years, and its portfolio's average maturity ranged between 1.5 and 2 years. By holding longer-term bonds, YieldPlus exposed itself to much more liquidity and default risk than a money market fund or CD. Its demise clearly exemplified this additional liquidity risk. YieldPlus was ill-equipped to cope with a rash of redemptions because its slowly maturing securities could not generate immediate cash inflows. Shedding its holdings at depressed prices was the cost of staying afloat.[14]

At its pinnacle in early 2007, the Schwab YieldPlus Fund ("YieldPlus" or the "Fund") boasted $13.5 billion in assets, held over 200,000 accounts, and enjoyed a sterling reputation as one of the highest performing ultra-short bond funds in the market.

The SEC alleged that besides deceptively (or, at least, carelessly) positioning YieldPlus alongside cash equivalent investments, the Schwab Defendants also issued a series of misleading and/or false statements to YieldPlus investors beginning in mid-2007. These statements appeared to be designed to hide ongoing liquidity problems and stem the tide of redemptions. Tables 2.0 and 3.0 below illustrate the differences between what the Schwab Defendants discussed internally, what they chose to communicate externally, and what the SEC alleged be true.

These tables show at least five instances where the Schwab Defendants issued or authorized statements targeted at YieldPlus investors which

Table 2.0 – Internal Discussions and Emails[15]

Date	Context	Message
August 8, 2007	Internal email to Daifotis and Merk from a CSIM employee	"[W]e need flows to stabilize."
August 11, 2007	Email from Daifotis to Merk	"If the Advisor community starts to bail out, who has been stable to this point, we will be in trouble."
August 12, 2007	Email from Daifotis to CSIM employees after he removed redemption information from a Q&A posted on Schwab's public website	"*I don't want anyone to sense that we are having outflows*."
November 2007	Email from an internal CSIM portfolio manager to Daifotis and Merk	"Liquidity is AWFUL . . . period." "[W]e are hostage to the market at this point and can't improve the NAV." "We are selling securities that are 'money-good' high quality assets at depressed prices."

Table 3.0 – External Discussions and Emails[16]

Date	Context	Schwab Defendants' Statement	SEC Allegations
August 14, 2007	During a conference call, advisers asked Daifotis, "How expensive have your redemptions been since the decline?"	"[W]e've got *very, very, very slight* negative flows over the course of the last week or two."	"YieldPlus was experiencing tremendous, unprecedented outflows."
August 16, 2007	During a conference call, Daifotis was asked, "What are the net outflows of the Schwab YieldPlus Fund to date?"	"It's not that much . . . *outflows have been minimal*."	"YieldPlus was experiencing tremendous, unprecedented outflows."
August 2007 through March 2008	Schwab's Web Site	"[YieldPlus's] *short maturity structure* has mitigated much of the price erosion that some other ultrashort bond bonds have experienced."	"YieldPlus did not have a short maturity structure. . . . [I]t held many long-term bonds with stated maturities of twenty years or more." "YieldPlus was performing worse than most of its peers."
November 2007	Internal talking points for Schwab employees for discussions with YieldPlus investors	"[YieldPlus's] management team has *confidence* in the Fund's strategy given our outlook for fixed income markets."	"[T]he portfolio management team's contemporaneous internal discussions stated the opposite."
November 15, 2007	Email sent to Schwab's registered representatives.	"The portfolio managers have *not* been forced into selling securities at distressed prices to meet client redemptions."	The Fund's portfolio managers' internal discussions stated they were selling securities at depressed prices.

allegedly were designed to mislead. As a result, the SEC brought charges under the securities acts' anti-fraud provisions, including Section 17(a)(2)-(3) of the Securities Act of 1933 (the "Securities Act"), Section 10(b) of the Exchange Act of 1934 (the "Exchange Act"), Rule 10b-5 thereunder, Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act"), and Rule 206(4)-8 thereunder.

II. Deviation from Concentration Policy

In 2006, concurrently with the "cash campaign" described above, the Fund began investing heavily in mortgage-backed securities issued by private lenders and not guaranteed by any U.S. government agency ("non-agency MBS").[17] The 1940 Act requires a mutual fund to state its concentration policy in its registration statement and to obtain shareholder approval prior to deviating from its stated concentration policy.[18] YieldPlus's registration statement declared that it would not concentrate its investments in more than 25% of any particular industry.[19] In August 2006, CSIM requested that YieldPlus's trustees re-classify non-agency MBS so that they would no longer be considered a separate "industry," and thus the Fund's investments in non-agency MBS would no longer be constrained by the 25% limit.[20] Without submitting the issue to the shareholders, on August 29, 2006, YieldPlus's trustees, Merk included, acquiesced to this request and approved the reclassification.[21] Soon thereafter, YieldPlus's non-agency MBS holdings grew to nearly 50% of its entire portfolio.[22] The SEC alleged that by amending the definition of "industry" in 2006 to state that non-agency MBS would not comprise a "separate industry for purposes of the Fund's concentration policy,"[23] the Fund deviated from its concentration policy and failed to obtain shareholder approval in advance as required by the 1940 Act.

The SEC also alleged that the Schwab Defendants failed to file the revised registration statement in a proper manner and, therefore, evaded review by the SEC staff of a change that could have been "material" to Fund investors. In November 2006, instead of filing a Form 485A to reflect a "material" change to its concentration policy, which would have been subject to SEC staff review and comments, the Fund filed a Form 485B, which is reserved for non-material changes only. In Table 4.0 is a summary of the change made to the Fund's Statement of Additional Information ("SAI").

Table 4.0 – YieldPlus Registration Statement Turnabout[24]

2001 SAI	2006 SAI
"Based on the characteristics of mortgage-backed securities, *[YieldPlus] has identified mortgage-backed securities issued by private lenders and not guaranteed by U.S. government agencies or instrumentalities as a separate industry for purposes of a fund's concentration policy*. . . . [YieldPlus] will limit its investments in each identified industry to less than 25% of its total assets."	"[YieldPlus] ha[s] determined that mortgage-backed securities issued by private lenders do not have risk characteristics that are correlated to any industry and, *therefore, [YieldPlus] ha[s] determined that mortgage-backed securities issued by private lenders are not part of any industry for purposes of [YieldPlus's] concentration polic[y]*. This means that [YieldPlus] may invest more than 25% of its total assets in privately-issued mortgage backed securities, which may cause [it] to be more sensitive to adverse economic, business or political developments that affect privately-issued mortgaged-backed securities."

As a result of this conduct, the SEC alleged that the Schwab Investments violated Section 13(a) of the 1940 Act for effecting a change in the Fund's concentration policy without shareholder approval. The SEC also charged Schwab and CSIM under Section 48(b) of the 1940 Act for aiding and abetting a violation of Section 34(b) of the 1940 Act, that is, certifying on Form 485B that the concentration policy change was not material when it actually was material.

III. Failure to Prevent Misuse of Material Nonpublic Information

As the credit crisis wore on, in early 2008, several other Schwab-related funds which had invested in YieldPlus learned of its distress based on non-public information that filtered down through the Schwab organization. Shortly after learning of YieldPlus's liquidity issues, these related funds redeemed their investments.[25]

One instance involved Schwab Charitable, a 501(c)(3) public benefit corporation.[26] Schwab Charitable's investment oversight committee decided on March 5, 2008, to recommend that its board redeem Schwab Charitable's $91 million investment in YieldPlus. The board was scheduled to meet and consider the redemption on March 12, 2008. On March 7, however, Schwab Charitable's Chief Operating Officer (the "COO") received an email from a Schwab employee (who was a member of Schwab Charitable's investment oversight committee) that contained a mix of public and non-public information about YieldPlus's decline. Upon receipt of the email, the COO promptly and unilaterally redeemed Schwab Charitable's investment in YieldPlus before the board's scheduled meeting.[27]

The Schwab Target Date Funds, a series of CSIM-managed funds, also redeemed their investments in YieldPlus in March 2008 shortly after receiving information about its liquidity issues. The senior portfolio manager for the Target Date Funds also served as CSIM's Chief Investment Officer for Equities. By virtue of this position, he was present during the regular CSIM meetings between Merk and Daifotis that occurred in February and March 2008. At these meetings, he learned that YieldPlus had severe cash outflow problems, information which was not yet public.[28] He subsequently expedited redemptions on behalf of all of the Target Date Funds that had invested in YieldPlus, redemptions that Merk approved.[29]

These redemptions increased YieldPlus's liquidity problems and contributed to the substantial drop in the Fund's assets. Based on these allegations, the SEC charged CSIM with violating Section 204A of the Advisers Act and Schwab with violating Section 15(g) of the Exchange Act for failing to have adequate policies preventing the misuse of material non-public information.

Lessons Learned

I. Marketing Materials Should Not Downplay Investment Risks

The SEC's reaction to the YieldPlus marketing materials – the printed brochures, email notices to investors, website and investor conference calls – reveals important lessons to other investment advisers. Recall these materials were the product of the Schwab Defendants' decision to include YieldPlus in the Charles Schwab Corporation's general "cash campaign." In so doing, Schwab and CSIM depicted an investment in YieldPlus as a near substitute for an investment in a money market fund or CD. Specifically, YieldPlus was portrayed as an "*alternative to traditional cash holdings*." Schwab

and CSIM downplayed the added risk that comes with investing in securities other than the liquid, short-term government securities in which money market funds traditionally invest. The use of the terms "*slightly*" and "*marginally*" minimized the risks involved in the Fund's portfolio compared to traditional cash equivalents. Most important, the Schwab Defendants did not heed the SEC's early warning to clarify their one-sided materials and failed to stress the considerable differences between ultra-short bond funds and money markets and CDs.

When it comes to marketing materials and advertisements in the adviser universe, a conservative approach should be the standard. Marketing materials should fairly present the increased risks associated with investing in the types of securities in which a fund actually invests, and any comparisons used may not be false or have the potential to mislead. Below are five items that may be helpful to advisers when preparing marketing materials and advertisements:

1. *Medium Does Not Matter:* The anti-fraud provisions of the federal securities laws apply to statements made on a web site or in a conference call in the same way that they apply to other disclosures.[30] Conference calls between portfolio managers and clients should be monitored by a compliance person who is knowledgeable about the fund's operations.
2. *Assume an Unsophisticated Audience:* When evaluating whether an advertisement is misleading, the SEC likely will adopt the viewpoint of a person unskilled and unsophisticated in investment matters. [31] Those supervising and reviewing advertisements should take the same approach.
3. *Balanced Information:* As the SEC made clear, supplemental disclosures in another document, such as a prospectus, generally are not sufficient to cure untruthful or misleading statements in advertisements. If an adviser is recommending one investment product over another, a fair portrayal of both is required in the advertisement itself. As a fiduciary to its clients, an adviser's standard of conduct for its marketing materials is higher than those for normal vendors.[32]
4. *Policies and People:* The SEC's staff has reported that they generally find fewer compliance breaches where advisers have detailed performance and marketing policies/procedures and they segregate responsibility for performance and marketing duties.[33]
5. *Ongoing Review:* The SEC recommends as a best practice that an adviser's performance, marketing and compliance personnel should all conduct on-going and careful reviews of all advertising materials. In addition, all comments made in this review should flow upward to those ultimately responsible for approving and making changes to the advertising materials.[34] As a forensic test, compliance officers should review their fund's annual and semi-annual portfolio holdings, compare them to the disclosures provided to investors in the fund's prospectus, web site and marketing materials, and assess whether the material risks advertised match the current risks faced by the fund. Because portfolio composition changes over time, it is important that the marketing materials are continuously updated to reflect any such changes.

II. Assume Any Change That Could Alter a Fundamental Policy Requires Shareholder Approval

The preamble of 1940 Act states that "the national public interest and the interest of investors are adversely affected" when investment companies "change the character of their business . . . without the consent of their security holders."[35] With this policy in mind, Sections 8(b) and 13(a) of the 1940 Act work together to restrain mutual funds from deviating from certain fundamental policies stated in their registration statements, unless their shareholders approve the deviation. Section 8(b)(1)(E) identifies a fund's concentration policy as one of these fundamental policies. The YieldPlus scenario raises an important question: is a mutual fund's general policy to refrain from concentrating investments in a particular industry so closely related to the *industry classification* used to implement the general concentration policy that Section 13(a) requires shareholder approval before a mutual fund may change how it classifies an industry?[36]

Even before the SEC filed its complaint against the Schwab Defendants in 2011, this issue arose before a federal district court in a private class action lawsuit involving YieldPlus investors. In its amicus

brief to the district court, the SEC maintained that the "identification of an industry . . . is a key part of [a fund's] overall concentration policy."[37] "Changing what constitutes an industry," it argued, "changes [a fund's] recited concentration policy because . . . the concentration policy cannot be implemented without a determination of what is an industry."[38] The two are "functionally intertwined."[39] In an unpublished order, the district court agreed.[40] It held that YieldPlus's trustees' decision to alter the Fund's concentration limit to exclude non-agency MBS as an industry classification *and then increase* its non-agency MBS holdings to nearly 50% of its total assets was a "phenomenal turnabout" and an "entire repudiation" of its previously recited concentration policy.[41] As a result, shareholder approval was required to lawfully effect this change.[42]

Both the SEC and the district court took a functional approach when applying Sections 8(b) and 13(a). Both embraced the following general rule: if a recital appearing somewhere in a fund's registration statement, e.g., a definition of "industry," appears to be so functionally intertwined with a stated fundamental policy, e.g., a general policy not to concentrate in a particular "industry," then approval from the shareholders must be obtained before the fund may effect a change to that particular recital. This includes deviations that take the form of definitional changes.

III. Policies and Procedures to Prevent the Misuse of Material Non-public Information

Preventing the misuse of material non-public information is a fundamental tenet of the Advisers Act. Section 204A expressly requires registered investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of such information about the funds they manage. The SEC alleged that Schwab's broad policy against insider trading was insufficient in four respects:

1. There were no policies in place to review redemptions of YieldPlus shares by all Schwab-related funds, accounts and personnel for compliance with the general insider trading policy;
2. Though certain high-level individuals, e.g., YieldPlus portfolio managers, were required to obtain pre-approval for personal trades of YieldPlus's shares, other individuals whose responsibilities provided them with material non-public information about YieldPlus had no pre-approval obligations;
3. Appropriate barriers concerning non-public and potentially material information were not maintained; and
4. There were no policies or procedures governing redemptions by portfolio managers who advised Schwab's funds-of-funds. As a result, nothing prevented Schwab-related funds from redeeming their investments in YieldPlus in advance of public shareholders.[43]

YieldPlus's investors lost billions of dollars, and the [SEC], in January 2011, brought a civil enforcement action against Charles Schwab & Co., Inc. ("Schwab"), Charles Schwab Investment Management, Inc. ("CSIM"), investment adviser to YieldPlus,[1] Schwab Investments ("Schwab Investments") and certain Schwab executives.

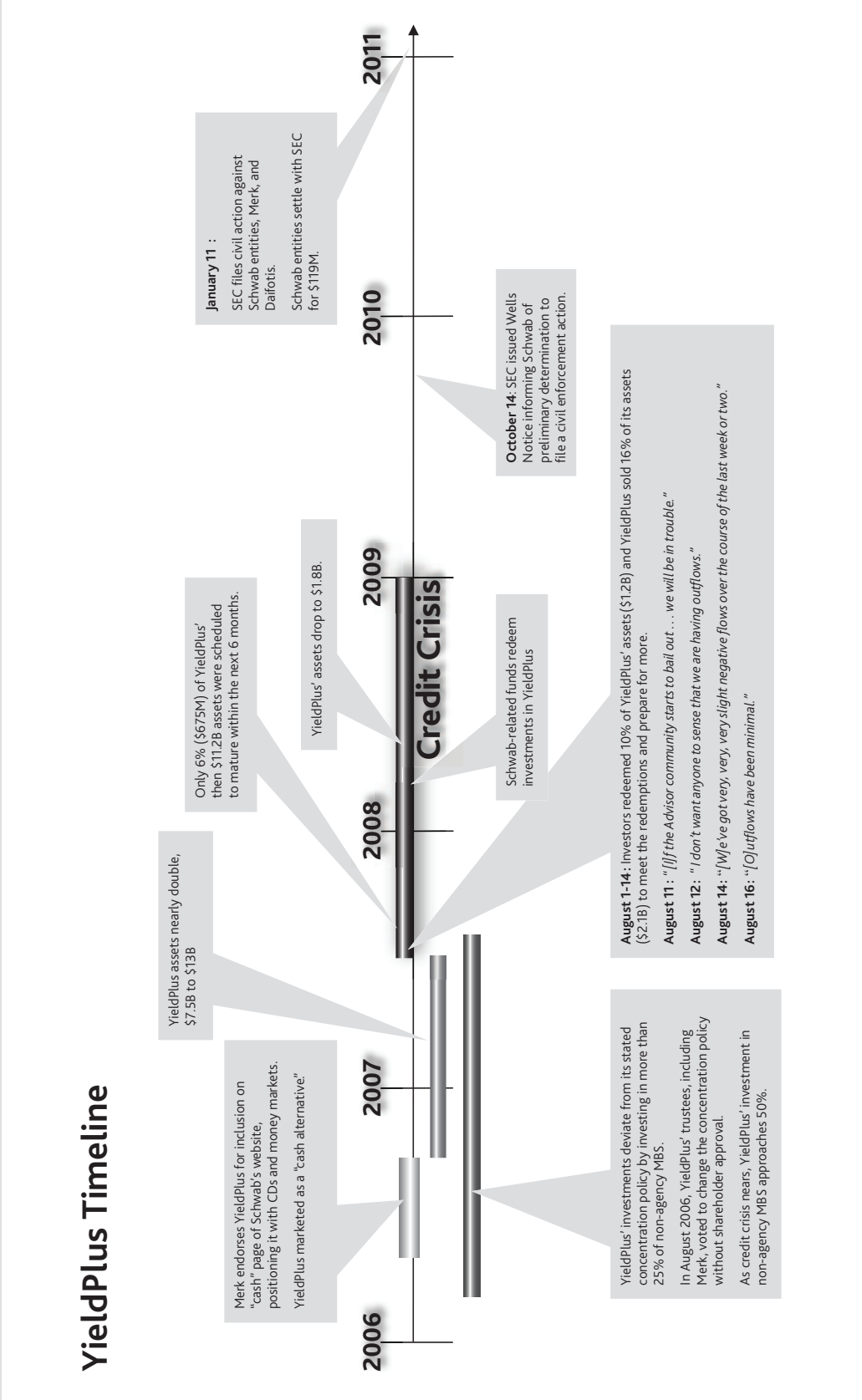
Allegations of non-compliance with Section 204A are quite serious because implication in an insider trading scandal has significant costs. Monetary penalties are severe and the damage done to the adviser's reputation is worse. In the course of its adviser compliance inspections, the SEC often emphasizes Section 204A procedures and focuses on two questions: (1) are the adviser's procedures for preventing the misuse of non-public information adequate for the particular business of the adviser?; and (2) if the procedures are adequate, are the procedures adequately followed and objectively reviewed?[44] Because the SEC expects each adviser to tailor its policies and procedures to its particular business, the SEC has not issued any definitive guidelines specifying what measures safely fall within the strictures of Section 204A.[45] Given the high cost of non-compliance, the following is a list of basic guidelines and measures an adviser's compliance officer may consider helpful:

1. *Centralize:* An adviser should appoint a single person to centralize responsibility, oversee compliance with insider trading policies, and serve as a resource to employees.[46]

2. *Provide Written Policy and Procedure Statements:* An adviser should provide each of its employees a written statement explaining the ethical, business, and legal reasons for avoiding insider trading and what constitutes "material non-public" information. An adviser should have its employees confirm that they received, read, and understood the statement of policies. It is good practice to periodically re-circulate these statements and request that the employees again attest to their receipt and understanding.[47]
3. *Continuing Education:* An adviser should ensure its employees receive ongoing instruction regarding what types of conflict-of-interest situations to be wary of and to ensure they understand any recent developments in the law.[48]
4. *"Chinese Walls":* An adviser should institute some physical or organizational barrier to restrict access to material non-public information.[49] The SEC has stated that it typically finds less compliance problems with firms that segregate their respective departments.
5. *Review Employee Trading:* An adviser should monitor and possibly restrict its employees' trading activities. The SEC recommends as a best practice that an adviser require all persons who have access to non-public information to trade securities through identifiable accounts to enable monitoring.[50] This can be done by requiring employees to trade their personal accounts through a pre-approved broker-dealer firm that provides the adviser with electronic access to view the employees' account statements. The adviser also may consider requiring employees to obtain pre-approval of any personal securities trade, including a trade in any mutual fund managed by the adviser, rather than adhering strictly to the law which requires pre-approvals only for employees' investments in private placements or initial public offerings.[51]
6. *Code of Ethics:* The SEC recommends as a best practice that an adviser amend its code of ethics to cover, and thus require reporting of, trades by persons who have access to information about a fund's or client's portfolio.[52] Many advisers treat all employees as "access persons" to limit confusion over who must report.
7. *Exception Reports:* An adviser should maintain a report that documents all of the transactions made by any employee in securities on any restricted list, watch list, or pre-approval list, so that the adviser may present the report to subsequent examiners and better explain why a transaction was permitted.[53]
8. *"Need to Know":* An adviser should share material non-public information only with those employees who "need to know" this information.[54]
9. *Disaster Recovery Plan:* An adviser should create a policy setting forth rules it will follow if one of the funds it manages experiences financial turmoil or closes. This policy should prohibit the adviser and its affiliates from using their discretion to redeem clients from a fund experiencing extreme troubles, until after a prospectus supplement or "sticker" has been filed, notifying investors of the problems faced by the fund. For example, YieldPlus investors likely should have been warned in a prospectus sticker that, as a result of a change in industry classification, the Fund's portfolio was concentrated in non-agency MBS which were not as liquid as the ultra-short debt obligations previously held by the Fund. If a problem persists to the extent that a fund's board determines to close the fund, the fund's adviser and its affiliates should not be permitted to redeem from the liquidating fund until after the a prospectus sticker has been filed, notifying investors that the fund's portfolio will be liquidated.

Conclusion

First, marketing materials should adequately and fairly portray the risks of investing in a fund, based on its current portfolio holdings. Comparisons among investment products should be balanced and may not be false or designed to mislead investors or to downplay risks. Second, shareholder approval must be obtained before implementing any change to a fundamental investment policy adopted by a mutual fund, including any definitional changes that materially could alter a fund's stated fundamental policy. Lastly, an adviser should have, implement and monitor specific written policies and procedures governing redemptions by related funds or accounts, and should continuously monitor trading by employees throughout the organization who may have access to material non-public information.


YieldPlus Timeline
2006
2007
2008
2009
2010
2011
Credit Crisis
Merk endorses YieldPlus for inclusion on "cash" page of Schwab's website, positioning it with CDs and money markets.
YieldPlus marketed as a 'cash alternative."
YieldPlus assets nearly double, $7.5B to $13B
YieldPlus' investments deviate from its stated concentration policy by investing in more than 25% of non-agency MBS.
In August 2006, YieldPlus' trustees, including Merk, voted to change the concentration policy without shareholder approval.
As credit crisis nears, YieldPlus' investment in non-agency MBS approaches 50%.
Only 6% ($675M) of YieldPlus' then $11.2B assets were scheduled to mature within the next 6 months.
YieldPlus' assets drop to $1.8B.
Schwab-related funds redeem investments in YieldPlus
August 1-14: Investors redeemed 10% of YieldPlus' assets ($1.2B) and YieldPlus sold 16% of its assets ($2.1B) to meet the redemptions and prepare for more.
August 11: *"[I]f the Advisor community starts to bail out . . . we will be in trouble."*
August 12: *" I don't want anyone to sense that we are having outflows."*
August 14: *"[W]e've got very, very, very slight negative flows over the course of the last week or two."*
August 16: *"[O]utflows have been minimal."*
October 14: SEC issued Wells Notice informing Schwab of preliminary determination to file a civil enforcement action.
January 11 :
SEC files civil action against Schwab entities, Merk, and Daifotis.
Schwab entities settle with SEC for $119M.

ENDNOTES

1 CSIM is a wholly-owned subsidiary of the Charles Schwab Corporation. Schwab is a wholly-owned subsidiary of Schwab Holdings, Inc., which in turn is a wholly-owned subsidiary of the Charles Schwab Corporation. See Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Charles Schwab Investment Management, Charles Schwab & Co., Inc., and Schwab Investments, Jan. 11., 2011, at 2-3, available at, http://www.sec.gov/news/press/2011/2011-7.htm (hereinafter "Cease-and-Desist Order").

2 Schwab: paid the price for YieldPlus 'pimple', Westlaw News and Insight, Securities Litigation, Feb. 3, 2011, available at http://westlawnews.thomson.com/Securities_Litigation/News/2011/02_-_February/Schwab__paid_the_price_for_YieldPlus__pimple_/.

3 See Ultra-Short Bond Funds: Know Where You're Parking Your Money, available at http://www.sec.gov/investor/pubs/ultra-short_bond_funds.htm (highlighting differences between ultra-short bond funds and other investments); Cease-and-Desist Order, supra note 1, at 3 n.3.

4 Marc Levinson, Guide to Financial Markets, 73-74 (5th ed. 2010).

5 Id.

6 Cease-and-Desist Order, supra note 1, at 3 n.3; see also Complaint, Securities and Exchange Commission v. Charles Schwab Investment Management, Inc.; Charles Schwab & Co., Inc.; and Schwab Investments, No. 11-0136 (N.D. Cal. 2011) (hereinafter "Complaint I"); see also Complaint, Securities and Exchange Commission v. Kimon P. Daifotis and Randall Merk, No. 11-0137 (N.D. Cal. 2011) (hereinafter "Complaint II"). Both complaints are available at http://www.sec.gov/news/press/2011/2011-7.htm.

7 Complaint I, supra note 6, at 4-5; Complaint II, supra note 6, at 2,5.

8 Press Release, SEC, SEC Charges Schwab Entities and Two Executives With Making Misleading Statements: Schwab Entities to Pay More Than $118M to Settle SEC Charges (Jan. 11, 2011) available at http://www.sec.gov/news/press/2011/2011-7.htm; see also Cease-and-Desist Order, supra note 1, at 3 n.3.

9 In a federal district court order handed down on June 6, 2011, the district court dismissed several of the eight claims originally brought by the SEC against Dafoitis and Merk. See Securities and Exchange Commission v. Daifotis, 2011 WL 2183314 (N.D. Cal. 2011, June 6, 2011).

10 Complaint II, supra note 6, at, 21-25.

11 Complaint I, supra note 6, at 5.

12 Complaint II, supra note 6, at 9.

13 Complaint II, supra note 6, at 9.

14 Complaint II, supra note 6, at 9-10.

15 Complaint II, supra note 6, at 39, 42.

16 Complaint II, supra note 6, at 40-47.

17 Complaint I, supra note 6, at 9.

18 Sections 8, 13(a) of the Investment Company Act of 1940, as amended.

19 Complaint I, supra note 6, at 9.

20 Complaint I, supra note 6, at 9.

21 Complaint I, supra note 6, at 9.

22 Complaint I, supra note 6, at 9.

23 Brief for SEC as Amicus Curiae Supporting Plaintiffs, In Re Charles Schwab Corp. Securities Litigation at 4-5, 2010 WL 1261705 (N.D. Cal. 2010) (C-08-01510-WHA) (hereinafter "Amicus Brief for SEC") (reproduces text of YieldPlus's registration statement changes).

24 See Amicus Brief for SEC, supra note 23, at 4-5 (emphasis in original).; In Re Charles Schwab Corp. Securities Litigation, 2010 WL 1261705, *2-3 (N.D. Cal. 2010, March 30, 2010) (hereinafter "Private Schwab Litigation Case").

25 Complaint I, supra note 6, at 13-15.

26 Complaint I, supra note 6, at 14.

27 Complaint I, supra note 6, at 13-15.

28 Complaint I, supra note 6, at 13-15.

29 Complaint II, supra note 6, at 48.

30 See SEC Exchange Act Release No. 34-58288 at 26, SEC Guidance on the Use of Company Websites (August 4, 2008).

31 See SEC v. C.R. Richmond & Co., 565 F.2d 1101 (9th Cir. 1977).

32 Thomas P. Lemke and Gerald T. Lins, Securities Law Handbook Series Regulation of Investment Advisers §§ 2:33 and 2:63 (2011 ed.) (hereinafter "Lemke").

33 See 2009 CCOutreach Regional Seminars, The Evolving Compliance Environment: Examination Focus Areas, April 2009, p. 18, available at http://www.sec.gov/info/iaiccco/iaiccco-resources.htm.

34 See Lori A. Richards, Speech by SEC Staff: Compliance Issues for Investment Advisers Today, April 28, 2003 (transcript available at http://www.sec.gov/news/speech/spch042803lar.htm).

35 Section 1(b)(6) of the Investment Company Act of 1940, as amended.

36 See generally Brief for The Investment Company Institute as Amicus Curiae Supporting Plaintiffs, In Re Charles Schwab Corp. Securities Litigation, 2010 WL 1261705 (N.D. Cal. 2010) (C-08-01510-WHA) (arguing that the trustees of a mutual fund generally have the authority to change particular industry classifications used by the fund without shareholder approval).

37 See Amicus Brief for SEC, supra note 23, at 12.

38 See Amicus Brief for SEC, supra note 23, at 12.

39 See Amicus Brief for SEC, supra note 23, at 9, 12.

40 Private Schwab Litigation Case, supra note 24, at *6.

41 Id. at *3, *6.

42 Id. at *2, *6-7.

43 Complaint I, *supra* note 6, at 13-14.

44 Lemke, *supra* note 32, at §2:169.

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*

49 Lemke, *supra* note 32, at §2:169.

50 SEC Advisers Act Release No. 2204 (December 17, 2003) at n.56 (hereinafter "Advisers Release 2204").

51 Lemke, *supra* note 32, at §2:169.

52 Advisers Release 2204, *supra* note 50, at n.56.

53 Lemke, *supra* note 32, at §2:169.

54 *Id.*