



October 20, 2010

**VIA COURIER**

Filing Desk  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**DOUGLAS P. DICK**

douglas.dick@dechert.com  
+1 202 261 3305 Direct  
+1 949 681 8647 Fax

40-33

Re: Filing Pursuant to Section 33 of the Investment Company Act of 1940 – Schwab Investments

Dear Sir or Madam:

On behalf of Schwab Investments (the "Fund"), pursuant to Section 33 of the Investment Company Act of 1940, enclosed is a copy of the following three complaints filed by beneficial owners of the Fund's shares:

- First Amended Complaint, Northstar Financial Advisors, Inc. v. Schwab Investments et al., No. 08-cv-04119 (N.D. Cal.);
- Second Amended Complaint, Northstar Financial Advisors, Inc. v. Schwab Investments et al., No. 08-cv-04119 (N.D. Cal.); and
- Verified Shareholder Derivative Complaint, William Downs v. Randall W. Merk, et al., No. CGC-10-497353 (Cal. Sup. Ct.).

If you have any questions regarding this filing, please contact me at 202.261.3305.

Please acknowledge receipt of this filing by date-stamping the enclosed copy of this letter and returning it in the envelope provided.

Sincerely,

Douglas P. Dick  
DPD

cc: Christine Pierangeli



Branch 16  
811-6200



**SUPERIOR COURT OF CALIFORNIA  
COUNTY OF SAN FRANCISCO**

**Document Scanning Lead Sheet**

Mar-02-2010 4:09 pm

Case Number: CGC-10-497353

Filing Date: Mar-02-2010 3:55

Juke Box: 001 Image: 02777780

**COMPLAINT**

**WILLIAM DOWNS VS. RANDALL W. MERK et al**

001C02777780

**Instructions:**

Please place this sheet on top of the document to be scanned.

**SUMMONS  
(CITACION JUDICIAL)**

FOR COURT USE ONLY  
(SOLO PARA USO DE LA CORTE)

**NOTICE TO DEFENDANT:  
(AVISO AL DEMANDADO):**

See Exhibit A

**YOU ARE BEING SUED BY PLAINTIFF:  
(LO ESTÁ DEMANDANDO EL DEMANDANTE):**

**WILLIAM DOWNS, Derivatively on Behalf of Nominal Defendant  
SCHWAB YIELDPLUS FUND**

**NOTICE!** You have been sued. The court may decide against you without your being heard unless you respond within 30 days. Read the information below.

You have 30 CALENDAR DAYS after this summons and legal papers are served on you to file a written response at this court and have a copy served on the plaintiff. A letter or phone call will not protect you. Your written response must be in proper legal form if you want the court to hear your case. There may be a court form that you can use for your response. You can find these court forms and more information at the California Courts Online Self-Help Center ([www.courtinfo.ca.gov/selfhelp](http://www.courtinfo.ca.gov/selfhelp)), your county law library, or the courthouse nearest you. If you cannot pay the filing fee, ask the court clerk for a fee waiver form. If you do not file your response on time, you may lose the case by default, and your wages, money, and property may be taken without further warning from the court.

There are other legal requirements. You may want to call an attorney right away. If you do not know an attorney, you may want to call an attorney referral service. If you cannot afford an attorney, you may be eligible for free legal services from a nonprofit legal services program. You can locate these nonprofit groups at the California Legal Services Web site ([www.lawhelpcalifornia.org](http://www.lawhelpcalifornia.org)), the California Courts Online Self-Help Center ([www.courtinfo.ca.gov/selfhelp](http://www.courtinfo.ca.gov/selfhelp)), or by contacting your local court or county bar association. NOTE: The court has a statutory lien for waived fees and costs on any settlement or arbitration award of \$10,000 or more in a civil case. The court's lien must be paid before the court will dismiss the case. **¡AVISO!** Lo han demandado. Si no responde dentro de 30 días, la corte puede decidir en su contra sin escuchar su versión. Lea la información a continuación.

Tiene 30 DÍAS DE CALENDARIO después de que le entreguen esta citación y papeles legales para presentar una respuesta por escrito en esta corte y hacer que se entregue una copia al demandante. Una carta o una llamada telefónica no lo protegen. Su respuesta por escrito tiene que estar en formato legal correcto si desea que procesen su caso en la corte. Es posible que haya un formulario que usted pueda usar para su respuesta. Puede encontrar estos formularios de la corte y más información en el Centro de Ayuda de las Cortes de California ([www.sucorte.ca.gov](http://www.sucorte.ca.gov)), en la biblioteca de leyes de su condado o en la corte que le quede más cerca. Si no puede pagar la cuota de presentación, pida al secretario de la corte que le dé un formulario de exención de pago de cuotas. Si no presenta su respuesta a tiempo, puede perder el caso por incumplimiento y la corte le podrá quitar su sueldo, dinero y bienes sin más advertencia.

Hay otros requisitos legales. Es recomendable que llame a un abogado inmediatamente. Si no conoce a un abogado, puede llamar a un servicio de remisión a abogados. Si no puede pagar a un abogado, es posible que cumpla con los requisitos para obtener servicios legales gratuitos de un programa de servicios legales sin fines de lucro. Puede encontrar estos grupos sin fines de lucro en el sitio web de California Legal Services, ([www.lawhelpcalifornia.org](http://www.lawhelpcalifornia.org)), en el Centro de Ayuda de las Cortes de California, ([www.sucorte.ca.gov](http://www.sucorte.ca.gov)) o poniéndose en contacto con la corte o el colegio de abogados locales. AVISO: Por ley, la corte tiene derecho a reclamar las cuotas y los costos exentos por imponer un gravamen sobre cualquier recuperación de \$10,000 ó más de valor recibida mediante un acuerdo o una concesión de arbitraje en un caso de derecho civil. Tiene que pagar el gravamen de la corte antes de que la corte pueda desechar el caso.

The name and address of the court is:  
(El nombre y dirección de la corte es):

San Francisco Superior Court  
400 McAllister Street, San Francisco, CA 94102

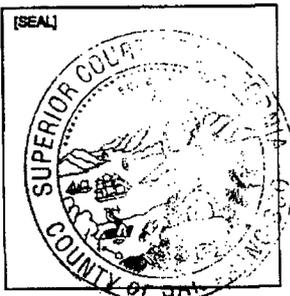
CASE NUMBER:  
(Número del Caso):  
**CGC-10-497353**

The name, address, and telephone number of plaintiff's attorney, or plaintiff without an attorney, is:  
(El nombre, la dirección y el número de teléfono del abogado del demandante, o del demandante que no tiene abogado, es):  
Nichole Browning, 580 California Street, Suite 1750, San Francisco, CA 94104; (415) 400-3000

DATE: March 2, 2010  
(Fecha)

Clerk, by  
(Secretario) **P NATTY** Deputy  
(Adjunto)

(For proof of service of this summons, use Proof of Service of Summons (form POS-010).)  
(Para prueba de entrega de esta citación use el formulario Proof of Service of Summons, (POS-010)).



**NOTICE TO THE PERSON SERVED:** You are served

1.  as an individual defendant.
2.  as the person sued under the fictitious name of (specify):
3.  on behalf of (specify):  
under:  CCP 416.10 (corporation)  CCP 416.60 (minor)  
 CCP 416.20 (defunct corporation)  CCP 416.70 (conservatee)  
 CCP 416.40 (association or partnership)  CCP 416.90 (authorized person)  
 other (specify):
4.  by personal delivery on (date):

**EXHIBIT A**

**RANDALL W. MERK, GEORGE M. PEREIRA, EVELYN S. DILSAVER, KIMON  
DAIFOTIS, CHARLES R. SCHWAB, MARIANN BYERWALTER, WILLIAM A. HASLER,  
GERALD B. SMITH, DONALD R. STEPHENS, MICHAEL W. WILSEY, DONALD F.  
DORWARD, ROBERT G. HOLMES, SCHWAB INVESTMENTS, CHARLES SCHWAB  
INVESTMENT MANAGEMENT, INC., and CHARLES SCHWAB & CO., INC., Defendants,  
and SCHWAB YIELDPLUS FUND, Nominal Defendant.**

ATTORNEY OR PARTY WITHOUT ATTORNEY (Name, State Bar number, and address):  
Nichole Browning (251937)  
Barroway Topaz Kessler Meltzer & Check, LLP  
580 California Street, Suite 1750  
San Francisco, CA 94104  
TELEPHONE NO: (415) 400-3000 FAX NO:  
ATTORNEY FOR (Name): Plaintiff

**FILED**  
FOR COURT USE ONLY  
Superior Court of California  
County of San Francisco

MAR - 2 2010

CLERK OF THE COURT  
BY: Param Nalt  
Deputy Clerk

SUPERIOR COURT OF CALIFORNIA, COUNTY OF San Francisco  
STREET ADDRESS: 400 McAllister Street  
MAILING ADDRESS:  
CITY AND ZIP CODE: San Francisco, 94102  
BRANCH NAME:

CASE NAME:  
William Downs, et al. v. Randall W. Merk, et al.

**CIVIL CASE COVER SHEET**  
 **Unlimited** (Amount demanded exceeds \$25,000)  
 **Limited** (Amount demanded is \$25,000 or less)

**Complex Case Designation**  
 Counter  Joinder  
Filed with first appearance by defendant (Cal. Rules of Court, rule 3.402)

CASE NUMBER: **CGC-10-497353**  
JUDGE:  
DEPT:

Items 1-6 below must be completed (see instructions on page 2).

1. Check one box below for the case type that best describes this case:

- |   |  |   |
|---|--|---|
| <p><b>Auto Tort</b></p> <p><input type="checkbox"/> Auto (22)</p> <p><input type="checkbox"/> Uninsured motorist (46)</p> <p><b>Other PI/PD/WD (Personal Injury/Property Damage/Wrongful Death) Tort</b></p> <p><input type="checkbox"/> Asbestos (04)</p> <p><input type="checkbox"/> Product liability (24)</p> <p><input type="checkbox"/> Medical malpractice (45)</p> <p><input type="checkbox"/> Other PI/PD/WD (23)</p> <p><b>Non-PI/PD/WD (Other) Tort</b></p> <p><input type="checkbox"/> Business tort/unfair business practice (07)</p> <p><input type="checkbox"/> Civil rights (08)</p> <p><input type="checkbox"/> Defamation (13)</p> <p><input type="checkbox"/> Fraud (16)</p> <p><input type="checkbox"/> Intellectual property (19)</p> <p><input type="checkbox"/> Professional negligence (25)</p> <p><input type="checkbox"/> Other non-PI/PD/WD tort (35)</p> <p><b>Employment</b></p> <p><input type="checkbox"/> Wrongful termination (36)</p> <p><input type="checkbox"/> Other employment (15)</p> | <p><b>Contract</b></p> <p><input type="checkbox"/> Breach of contract/warranty (06)</p> <p><input type="checkbox"/> Rule 3.740 collections (09)</p> <p><input type="checkbox"/> Other collections (09)</p> <p><input type="checkbox"/> Insurance coverage (18)</p> <p><input checked="" type="checkbox"/> Other contract (37)</p> <p><b>Real Property</b></p> <p><input type="checkbox"/> Eminent domain/Inverse condemnation (14)</p> <p><input type="checkbox"/> Wrongful eviction (33)</p> <p><input type="checkbox"/> Other real property (26)</p> <p><b>Unlawful Detainer</b></p> <p><input type="checkbox"/> Commercial (31)</p> <p><input type="checkbox"/> Residential (32)</p> <p><input type="checkbox"/> Drugs (38)</p> <p><b>Judicial Review</b></p> <p><input type="checkbox"/> Asset forfeiture (05)</p> <p><input type="checkbox"/> Petition re: arbitration award (11)</p> <p><input type="checkbox"/> Writ of mandate (02)</p> <p><input type="checkbox"/> Other judicial review (39)</p> | <p><b>Provisionally Complex Civil Litigation (Cal. Rules of Court, rules 3.400-3.403)</b></p> <p><input type="checkbox"/> Antitrust/Trade regulation (03)</p> <p><input type="checkbox"/> Construction defect (10)</p> <p><input type="checkbox"/> Mass tort (40)</p> <p><input type="checkbox"/> Securities litigation (28)</p> <p><input type="checkbox"/> Environmental/Toxic tort (30)</p> <p><input type="checkbox"/> Insurance coverage claims arising from the above listed provisionally complex case types (41)</p> <p><b>Enforcement of Judgment</b></p> <p><input type="checkbox"/> Enforcement of judgment (20)</p> <p><b>Miscellaneous Civil Complaint</b></p> <p><input type="checkbox"/> RICO (27)</p> <p><input type="checkbox"/> Other complaint (not specified above) (42)</p> <p><b>Miscellaneous Civil Petition</b></p> <p><input type="checkbox"/> Partnership and corporate governance (21)</p> <p><input type="checkbox"/> Other petition (not specified above) (43)</p> |
|---|--|---|

2. This case  is  is not complex under rule 3.400 of the California Rules of Court. If the case is complex, mark the factors requiring exceptional judicial management:
- |   |  |
|---|--|
| a. <input type="checkbox"/> Large number of separately represented parties  | d. <input type="checkbox"/> Large number of witnesses  |
| b. <input checked="" type="checkbox"/> Extensive motion practice raising difficult or novel issues that will be time-consuming to resolve | e. <input type="checkbox"/> Coordination with related actions pending in one or more courts in other counties, states, or countries, or in a federal court |
| c. <input type="checkbox"/> Substantial amount of documentary evidence  | f. <input type="checkbox"/> Substantial postjudgment judicial supervision  |
3. Remedies sought (check all that apply): a.  monetary b.  nonmonetary; declaratory or injunctive relief c.  punitive
4. Number of causes of action (specify):
5. This case  is  is not a class action suit.
6. If there are any known related cases, file and serve a notice of related case. (You may use form CM-015.)

Date: March 2, 2010  
Nichole Browning

(TYPE OR PRINT NAME)

(SIGNATURE OF PARTY OR ATTORNEY FOR PARTY)

**NOTICE**

- Plaintiff must file this cover sheet with the first paper filed in the action or proceeding (except small claims cases or cases filed under the Probate Code, Family Code, or Welfare and Institutions Code). (Cal. Rules of Court, rule 3.220.) Failure to file may result in sanctions.
- File this cover sheet in addition to any cover sheet required by local court rule.
- If this case is complex under rule 3.400 et seq. of the California Rules of Court, you must serve a copy of this cover sheet on all other parties to the action or proceeding.
- Unless this is a collections case under rule 3.740 or a complex case, this cover sheet will be used for statistical purposes only.

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BARROWAY TOPAZ KESSLER  
MELTZER & CHECK, LLP  
Nichole Browning (251937)  
580 California Street, Suite 1750  
San Francisco, CA 94104  
Telephone: (415) 400-3000  
-and-  
Eric L. Zagar (250519)  
Michael J. Hynes  
Tara P. Kao  
280 King of Prussia Road  
Radnor, PA 19087  
Phone: (610) 667-7706  
Fax: (610) 667-7056

*Attorneys for Plaintiff*

**SUPERIOR COURT OF CALIFORNIA  
COUNTY OF SAN FRANCISCO**

WILLIAM DOWNS, Derivatively on  
Behalf of Nominal Defendant SCHWAB  
YIELDPLUS FUND,  
  
Plaintiff,  
  
v.  
  
RANDALL W. MERK, GEORGE M.  
PEREIRA, EVELYN S. DILSAVER, KIMON  
DAIFOTIS, CHARLES R. SCHWAB,  
MARIANN BYERWALTER, WILLIAM A.  
HASLER, GERALD B. SMITH, DONALD R.  
STEPHENS, MICHAEL W. WILSEY,  
DONALD F. DORWARD, ROBERT G.  
HOLMES, SCHWAB INVESTMENTS,  
CHARLES SCHWAB INVESTMENT  
MANAGEMENT, INC., and CHARLES  
SCHWAB & CO., INC.,  
  
Defendants,  
  
and  
  
SCHWAB YIELDPLUS FUND,  
  
Nominal Defendant.

**SUMMONS ISSUED  
FILED**  
San Francisco County Superior Court

MAR - 2 2010

**CLERK OF THE COURT**  
By: *[Signature]* Deputy Clerk  
**P. NATT**

Case No. **CGC - 10 - 497353**

**VERIFIED SHAREHOLDER DERIVATIVE  
COMPLAINT**

JURY TRIAL DEMANDED

**CASE MANAGEMENT CONFERENCE SET**

**JUL 30 2010 9<sup>00</sup> AM  
DEPARTMENT 212**

1 Plaintiff William Downs ("Plaintiff"), by the undersigned attorneys, submits this Verified  
2 Shareholder Derivative Complaint (the "Complaint") against the defendants named herein, and  
3 alleges upon personal knowledge with respect to himself, and upon information and belief based  
4 upon, *inter alia*, a review of public filings, press releases and reports, and an investigation  
5 undertaken by Plaintiff's counsel, as to all other allegations herein, as follows:

6 **NATURE OF THE ACTION**

7 1. This is a shareholder derivative action brought for the benefit of nominal defendant  
8 Schwab YieldPlus Fund (the "Fund") against certain of its current and former Trustees, certain  
9 current and former executive officers, and certain Schwab entities, seeking to remedy defendants'  
10 breaches of fiduciary duties.

11 2. On or about September 1, 2004, the Fund filed with the Securities and Exchange  
12 Commission ("SEC") on Form N-1A and disseminated to investors a Registration Statement.  
13 Thereafter, on or about November 12, 2004, the Fund filed with the SEC on Form N-1A and  
14 disseminated to investors another Registration Statement. Three days later, on November 15,  
15 2004, the Fund filed with the SEC a Prospectus (collectively, these documents are referred to as the  
16 "2004 Prospectus"). Each year thereafter, the Fund filed a Registration Statement between  
17 September and November, along with a Prospectus dated November 15. These Prospectuses  
18 explicitly incorporated by reference a Statement of Additional Information ("SAI") and the Fund's  
19 Annual Report for each year. The Registration Statements, Prospectuses and SAIs, collectively,  
20 for each year between 2005 and 2008 will be referred to hereinafter as the "2005 Prospectus,"  
21 "2006 Prospectus," "2007 Prospectus," and the "2008 Prospectus."

22 3. Moreover, since November 2004 defendants continuously offered various  
23 advertising materials and sales materials, and created web pages with information about the Fund.  
24 These sales materials, advertisements and web pages constitute part of the 2004 Prospectus, 2005  
25 Prospectus, 2006 Prospectus, 2007 Prospectus, and/or the 2008 Prospectus.

26 4. The 2004 Prospectus, 2005 Prospectus, 2006 Prospectus, 2007 Prospectus, and the  
27 2008 Prospectus, individually and collectively, will be referred to as the "Offering Materials."  
28



1           11. Defendant Randall W. Merk ("Merk") is the President and Chief Executive Officer  
2 ("CEO") of the Fund and has been an officer of the Fund since 2007. He has been the Executive  
3 Vice President and President of Investment Management Services, Charles Schwab & Co., Inc. and  
4 the Executive Vice President of Charles Schwab & Co., Inc. since 2002. He has been the President  
5 and CEO of Charles Schwab Investment Management, Inc. since 2007. He is also a director of  
6 Charles Schwab Asset Management (Ireland) Limited and Charles Schwab Worldwide Funds PLC.

7           12. Defendant George M. Pereira ("Pereira") is the Treasurer and Principal Financial  
8 Officer ("CFO") of the Fund and has been an officer of the Fund since 2004. He is the Senior Vice  
9 President and CFO of Charles Schwab Investment Management, Inc. and the CFO of Laudus Trust  
10 and Laudus Institutional Trust. He is also a Director of Charles Schwab Worldwide Fund, PLC  
11 and Charles Schwab Asset Management (Ireland) Limited.

12           13. Defendant Evelyn S. Dilsaver ("Dilsaver") was President and CEO of the Fund until  
13 November 15, 2006. Dilsaver was a member of The Charles Schwab Corporation from December  
14 of 1991 and held various senior management positions within the organization, including  
15 Executive Vice President of the Charles Schwab Corporation and President and CEO of Charles  
16 Schwab Investment Management. Prior to becoming President and CEO of Charles Schwab  
17 Investment Management, from July 2003 to July 2004, Dilsaver held the position of Senior Vice  
18 President, Asset Management Products and Services.

19           14. Defendant Kimon Daifotis ("Daifotis") served as the Chief Investment Officer of  
20 fixed income of Schwab Investments and as the Manager of the Fund from October 1999 until  
21 approximately June 13, 2008. Daifotis also served as Senior Vice President and Head of Fixed  
22 Income Portfolio Management at Schwab Management.

23           15. Defendants Merk, Pereira, Dilsaver and Daifotis are collectively referred to  
24 hereinafter as the "Officer Defendants."

25           16. Defendant Charles R. Schwab ("Charles Schwab") has served as a Trustee of the  
26 Fund since 1991. He founded Charles Schwab & Co., Inc., principal underwriter to the Fund, in  
27 1971 and became Chairman in 1978. He has served as Chairman and Director of The Charles  
28 Schwab Corporation since 1986. He has also served as a Director of Charles Schwab Investment

1 Management, Inc. since 1989 and was appointed as Chairman in 1991. He has served as Chairman  
2 and CEO of Schwab (SIS) Holdings, Inc. (I) and Schwab International Holdings, Inc. since 1996.  
3 He has also been the Director and CEO of Schwab Holdings, Inc. since 1999 and Chairman of  
4 Charles Schwab Bank since 2003. Defendant Schwab signed the Offering Materials.

5 17. Defendant Mariann Byerwalter ("Byerwalter") has served as a Trustee of the Fund  
6 since 2000. She has also been a member of the Audit Committee and Governance Committee of  
7 the Fund's Board of Trustees (the "Board") since at least 2009. Byerwalter signed the Offering  
8 Materials.

9 18. Defendant William A. Hasler ("Hasler") has served as a Trustee of the Fund since  
10 2000. He has also been the Chairman of the Governance Committee and a member of the Audit  
11 Committee of the Board since at least 2009. Hasler signed the Offering Materials.

12 19. Defendant Gerald B. Smith ("Smith") has served as a Trustee of the Fund since  
13 2000. He has also been the Chairman of the Investment and Oversight Committee ("Oversight  
14 Committee") of the Board and a member of the Marketing, Distribution & Shareholder Servicing  
15 Committee ("Shareholder Servicing Committee") of the Board since at least 2009. Smith signed  
16 the Offering Materials.

17 20. Defendant Donald R. Stephens ("Stephens") has served as a Trustee of the Fund  
18 since 1991. He has also been the Chairman of the Oversight Committee since at least 2009.  
19 Stephens signed the Offering Materials.

20 21. Defendant Michael W. Wilsey ("Wilsey") has served as a Trustee of the Fund since  
21 1991. He has also been the Chairman of the Governance Committee since at least 2009. Wilsey  
22 signed the Offering Materials.

23 22. Defendant Donald F. Dorward ("Dorward") served as a Trustee of the Fund. Upon  
24 information and belief, Dorward served as a Trustee of the Fund from 1989 until 2007. Dorward  
25 signed the Offering Materials.

26 23. Defendant Robert G. Holmes ("Holmes") served as a Trustee of the Fund. Upon  
27 information and belief, Holmes served as a Trustee of the Fund form 1989 until 2007. Holmes  
28 signed the Offering Materials.

1           24. Defendants Charles Schwab, Byerwalter, Hasler, Smith, Stephens, Wilsey, Dorward  
2 and Holmes are collectively referred to hereinafter as the "Trustee Defendants."

3           25. Defendants Merk, Pereira, Dilsaver, Daifotis, Charles Schwab, Byerwalter, Hasler,  
4 Smith, Stephens, Wilsey, Dorward and Holmes are collectively referred to hereinafter as the  
5 "Individual Defendants."

6           26. Defendant Schwab Investments is a Massachusetts Business Trust located at 101  
7 Montgomery Street, San Francisco, California, 94104. The Fund is a series of Schwab  
8 Investments. Schwab Investments is the Registrant for the Fund, the issuer of the Fund's shares,  
9 and performed trust services for the Fund.

10          27. Defendant Charles Schwab Investment Management ("Schwab Investment  
11 Management") is located at 101 Montgomery Street, San Francisco, California, 94104. Schwab  
12 Investment Management is the asset management arm of the Charles Schwab Corporation, and  
13 oversees the administration and asset management of the Fund. Additionally, Schwab Investment  
14 Management receives a management fee from the Fund. According to the Registration Statements,  
15 this management fee included an annual fee of 0.64% of the YieldPlus Investor Share's average net  
16 assets, and 0.49% of the YieldPlus Select Share's average net assets. Upon information and belief,  
17 Schwab Investment Management received over \$75 million in fees over the relevant period.

18          28. Defendant Charles Schwab & Co., Inc. ("Schwab & Co.") is located at 101  
19 Montgomery Street, San Francisco, California, 94104, and is the parent company of Schwab  
20 Investments. Schwab & Co. was the principal underwriter and distributor of the Fund's shares and  
21 was the agent of the Trust for the purpose of the continuous offering of the Fund's shares.

22          29. Defendants Schwab Investments, Schwab Investment Management and Schwab &  
23 Co., are collectively referred to hereinafter as the "Schwab Party Defendants."

24          30. The Individual Defendants and the Schwab Party Defendants are referred to  
25 hereinafter as the "Defendants."

26           **DUTIES OF THE INDIVIDUAL DEFENDANTS AND SCHWAB PARTY DEFENDANTS**

27          31. By reason of their positions as officers and/or trustees of the Fund and because of  
28 their ability to control the business and corporate affairs of the Fund, the Individual Defendants

1 owed the Fund and its shareholders the fiduciary obligations of good faith, trust, loyalty, and due  
2 care, and were and are required to use their utmost ability to control and manage the Fund in a fair,  
3 just, honest, and equitable manner. The Individual Defendants were and are required to act in  
4 furtherance of the best interests of the Fund and its shareholders so as to benefit all shareholders  
5 equally and not in furtherance of their personal interest or benefit. Each trustee and officer of the  
6 Fund owes to the Fund and its shareholders the fiduciary duty to exercise good faith and diligence  
7 in the administration of the affairs of the Fund and in the use and preservation of its property and  
8 assets, and the highest obligations of fair dealing.

9 32. The Individual Defendants, because of their positions of control and authority as  
10 trustees and/or officers of the Fund, were able to and did, directly and/or indirectly, exercise  
11 control over the wrongful acts complained of herein.

12 33. To discharge their duties, the officers and trustees of the Fund were required to  
13 exercise reasonable and prudent supervision over the management, policies, practices and controls  
14 of the Fund. By virtue of such duties, the officers and trustees of the Fund were required to, among  
15 other things:

- 16 a. exercise good faith in ensuring that the affairs of the Fund were  
17 conducted in an efficient, business-like manner so as to make it  
18 possible to provide the highest quality performance of the Fund;  
19 b. exercise good faith in ensuring that the Fund was operated in a  
20 diligent, honest and prudent manner and complied with all applicable  
21 federal and state laws, rules, regulations and requirements; and  
22 c. when put on notice of problems with the Fund's business practices  
23 and operations, exercise good faith in taking appropriate action to  
24 correct the misconduct and prevent its recurrence.

25 34. As the Fund's issuer, asset manager, underwriter and distributor, the Schwab Party  
26 Defendants likewise owed to the Fund the fiduciary duties of good faith, trust, loyalty and due care.

### 27 SUBSTANTIVE ALLEGATIONS

28 35. Between September and November of 2004, defendants filed with the SEC on Form  
N-1A the 2004 Prospectus.

36. Each year thereafter, between September and November, defendants filed with the  
SEC on Form N-1A the 2005 Prospectus, 2006 Prospectus, 2007 Prospectus and 2008 Prospectus.

1 Additionally, defendants offered various advertising materials and sales materials, and created web  
2 pages with information about the Fund. These materials all constituted part of the Offering  
3 Materials.

4 37. Under the terms of the Offering Materials, defendants agreed to seek shareholder  
5 approval, via the affirmative votes of a majority of the Fund's outstanding shares, prior to making  
6 any fundamental change in the Fund's investment policy.

7 38. The 2004 Prospectus made a number of representations about the Fund. For  
8 example, it stated that "the Fund seeks high current income with minimal changes in share price,"  
9 and that to achieve this goal, "the Fund primarily invests in investment-grade (high and certain  
10 medium quality, AAA to BBB- or the unrated equivalent as determined by the investment advisor)  
11 bonds." Moreover, the 2004 Prospectus stated that the Fund sought to keep the average duration in  
12 its portfolio at one year or less. Further, the 2004 Prospectus compared the Fund's average total  
13 returns to the "Lehman US Short Treasury 9-12 months" index.

14 39. The 2004 Prospectus also stated that the Fund would seek shareholder approval, via  
15 the affirmative votes of a majority of the Fund's outstanding shares, prior to making any  
16 fundamental change in investment policy. The 2004 Prospectus further stated that defendants  
17 would not concentrate more than 25% of the Fund's assets in a particular industry or group of  
18 industries. Defendants stressed that the Fund would remain fully diversified and not concentrated  
19 in any particular industry unless a vote was held to allow such an occurrence.

20 40. The November 15, 2004 Prospectus, as amended September 15, 2005, contained  
21 similar assertions.

22 41. The 2005 Prospectus contained many of the same assertions as the 2004 Prospectus.  
23 Additionally, this prospectus stated that "the Fund is less vulnerable to market timing strategies  
24 than other types of fixed income or equity mutual funds."

25 42. Upon information and belief, beginning in 2006, the Individual Defendants and the  
26 Schwab Party Defendants caused the Fund to invest 28.9% of its holdings in MBSs. This action  
27 caused the Fund to have more than a 25% concentration in a particular industry, contrary to what  
28 was permitted by the Offering Materials. At no time prior to this investment decision did

1 defendants hold a shareholder vote or receive shareholder approval for the excess concentration, as  
2 required under the terms of the Offering Materials.

3 43. Defendants attempted to circumvent the investment concentration requirements by  
4 filing an SAI on September 1, 2006. This SAI, which amended the 2005 Prospectus, redefined the  
5 term "single industry," such that the Fund would be able to hold a limitless amount of MBSs.  
6 Once again, defendants did not hold a shareholder vote or receive shareholder approval before  
7 implementing this change.

8 44. The Fund's over-concentration in MBSs only accelerated as time went on. Upon  
9 information and belief, by May 31, 2007, 46.5% of the Fund's assets were invested in MBSs. By  
10 February 28, 2008, a majority of the Fund's assets, 50.1%, were invested in MBSs. Once again,  
11 these impermissible investments were made without holding a shareholder vote or receiving  
12 shareholder approval for the excess concentration in MBSs or the fundamental change in  
13 investment policy from focusing on short term investment-grade bonds to focusing on much riskier  
14 and longer term MBSs.

15 45. By 2008, the average duration of the Fund's securities was in actuality more than  
16 one year (and was closer to two years), in contrast to defendants' assertions that the average  
17 duration of the Fund's securities was one year or less. Similarly, the overconcentration in these  
18 long term MBSs and ABSs caused the Fund to no longer truly be an ultrashort bond fund, even  
19 though defendants continued to promote the Fund as such.

20 46. Due to these improper investments in MBSs and ABSs, and the resulting write-  
21 downs to their lowered market values, the Fund's net asset value ("NAV") suffered. The long-  
22 standing NAV of the Fund was approximately \$9.70 per share, but by August 1, 2008, the Fund's  
23 NAV had dropped to \$6.18 per share, a 35% drop since July of that year. By defendants' own  
24 admission, the Fund's assets as of March 20, 2008 were \$2.5 billion, representing a severe decline  
25 from the \$13 billion in assets on May 30, 2007, less than a year earlier.

26 47. This extreme loss in the Fund's NAV led Morningstar analyst Miriam Sjobom to  
27 refer to the Fund as "an unmitigated disaster." She further stated that even though "it's designed to  
28

1 be one of the more reliable holdings in a portfolio, its sizable stakes in nonagency mortgage- and  
2 asset-backed bonds, including some backed by subprime loans, have proved treacherous.”

3 48. The Individual Defendants’ and the Schwab Party Defendants’ failure to obtain  
4 shareholder approval prior to the monumental change in the Fund’s investment policy and  
5 investment concentrations, along with the improper investing itself, was a breach of their  
6 obligations under the Offering Materials and their fiduciary duties to the Fund and caused the Fund  
7 to sustain heavy damages, as alleged herein.

8 **THE INDIVIDUAL DEFENDANTS’ AND SCHWAB PARTY DEFENDANTS’ BREACHES**  
9 **OF FIDUCIARY DUTIES**

10 49. The Fund’s fundamental change in its investment objective to a high concentration  
11 of exceptionally risky MBSs and ABSs, and the failure to obtain shareholder approval prior to such  
12 a change, were the direct result of the Individual Defendants’ and the Schwab Party Defendants’  
13 breaches of fiduciary duties.

14 50. In breach of their fiduciary duties, the Individual Defendants and Schwab Party  
15 Defendants knowingly caused or allowed the Fund to implement these changes without first  
16 providing shareholders with proper notice or holding a vote seeking shareholder approval, as  
17 required by the Fund’s Offering Materials.

18 51. In particular, the Individual Defendants and Schwab Party Defendants failed in good  
19 faith to:

- 20 a. Properly notify shareholders of the fundamental change in the Fund’s  
21 investment objective and concentration policy; and  
22 b. Obtain shareholder approval before implementing the fundamental  
23 change in the Fund’s investment objective and concentration policy.

24 52. Through their positions of authority over the Fund and/or their signing of the  
25 Offering Materials, the Individual Defendants knew that they were required to properly notify  
26 shareholders and obtain shareholder approval before implementing a fundamental change in the  
27 Fund’s investment objective and concentration policy.

28 53. In breach of their fiduciary duties of good faith and loyalty, the Individual  
Defendants and Schwab Party Defendants willfully ignored the terms set forth by the Offering

1 Materials, failing to follow the requirements contained therein, and thus breached their fiduciary  
2 duties.

3 54. The Individual Defendants and Schwab Party Defendants further breached their  
4 fiduciary duties by concealing from shareholders the Fund's excessive concentration in risky MBSs  
5 and ABSs, *e.g.*, by sending holding reports to investors that misleadingly listed security coupon  
6 payment dates instead of maturity dates, and continuing to market the Fund as an ultrashort bond  
7 fund even after a majority of the Fund's assets were invested in long-term MBSs and ABSs.

8 55. As a direct and proximate result of the Individual Defendants' and Schwab Party  
9 Defendants' breaches of fiduciary duties, the Fund has sustained significant damages.

#### 10 DERIVATIVE AND DEMAND ALLEGATIONS

11 56. Plaintiff incorporates by reference and realleges each and every allegation set forth  
12 above, as though fully set forth herein.

13 57. Plaintiff brings this action derivatively in the right and for the benefit of the Fund to  
14 redress the Individual Defendants' and Schwab Party Defendants' breaches of fiduciary duties.

15 58. Plaintiff is a shareholder of the Fund, was a shareholder of the Fund at the time of  
16 the wrongdoing alleged herein, and has been a shareholder of the Fund continuously since that  
17 time.

18 59. Plaintiff will adequately and fairly represent the interests of the Fund and its  
19 shareholders in enforcing and prosecuting its rights.

20 60. On November 10, 2009, more than 90 days ago, Plaintiff made a demand (the  
21 "Demand") on the Board to commence an action against the Individual Defendants and the Schwab  
22 Party Defendants. A copy of Plaintiff's Demand is attached hereto as Exhibit A. As of the filing  
23 of this Complaint the Board has not taken action as demanded.

#### 24 COUNT I

#### 25 AGAINST THE INDIVIDUAL DEFENDANTS AND THE SCHWAB PARTY 26 DEFENDANTS FOR BREACH OF FIDUCIARY DUTIES

27 61. Plaintiff repeats and realleges each and every allegation contained above as if fully  
28 set forth herein.



**VERIFICATION**

I, Bill Downs, hereby verify that I have authorized the filing of the attached Verified Shareholder Derivative Complaint, that I have reviewed the Complaint, and that the facts therein are true and correct to the best of my knowledge, information and belief.

I declare under penalty that the foregoing is true and correct.

DATE:

3/1/2010



Bill Downs



November 10, 2009

**VIA FEDEX**

Mr. Randall W. Merk  
President and Chief Executive Officer  
Schwab YieldPlus Fund  
101 Montgomery Street  
San Francisco, CA 94104

**Re: Shareholder Demand**

Dear Mr. Merk:

This firm represents William Downs (the "Shareholder"), a holder of shares of the Schwab YieldPlus Fund (the "Fund"). I write on behalf of the Shareholder to demand that the Board of Trustees of the Fund (the "Board") take action to remedy breaches of fiduciary duties by the Trustees, certain executive officers of the Fund, and certain Schwab entities, as described herein.

As you are aware, by reason of their positions as officers and/or trustees of the Fund and because of their ability to control the business affairs of the Fund, the officers and trustees of the Fund owe the Fund and its shareholders the fiduciary obligations of loyalty, good faith and due care. The Shareholder believes that the following officers and/or trustees of the Fund violated these core fiduciary duty principles, causing the Fund to suffer damages: President, Chief Executive Officer ("CEO") and Trustee Randall W. Merk, Treasurer and Principal Financial Officer George M. Pereira, former President and CEO Evelyn S. Dilsaver, former Chief Investment Officer Kimon Daifotis; Trustees Charles R. Schwab, Mariann Byerwalter, William A. Hasler, Gerald B. Smith, Donald R. Stephens, and Michael W. Wilsey, and former Trustees Donald F. Dorward and Robert G. Holmes (collectively, the "Trustees and Officers"). The shareholder also believes that Schwab Investments, Charles Schwab Investment Management, Inc. and Charles Schwab & Co., Inc. (collectively, the "Schwab Parties") breached their fiduciary obligations to the Fund.

The Shareholder contends that the Trustees, Officers and Schwab Parties knowingly caused or allowed the Fund to register, market and sell itself as a stable, "ultrashort" bond fund that was a safe alternative to cash, was designed to invest primarily in investment grade bonds with a duration of one year or less, and which had minimal risk of a fluctuating share price. The registration statements and prospectuses for the Fund (the "offering materials") stated that the Fund's investment policy could only be changed by a vote of a majority of a fund's outstanding shares. The offering materials also stated that the Fund could not "concentrate" in any particular

Mr. Randall W. Merk  
November 10, 2009  
Page 2



industry, which the SEC defines as investing 25% or more of a Fund's assets "in an industry or group of industries."

Beginning in 2006, the Fund exceeded the 25% limitation on investing in a single industry or group of industries when it invested 28.9% of its holdings in mortgage backed securities ("MBS") and asset backed securities ("ABS"). The Fund did not seek or receive shareholder approval to exceed the 25% concentration limitation. In September 2006, again without a shareholder vote, Schwab Investments retroactively amended the Fund's prospectus to redefine the term "single industry" so that the 25% concentration limitation would not apply to the Fund's MBS holdings. In 2007 and 2008 the Fund invested over 45% of the Fund's assets in MBSs and ABSs, again without seeking or securing shareholder approval to exceed the 25% concentration limitation. This had the effect of turning the Fund into a much riskier investment than the offering materials described the Fund to be.

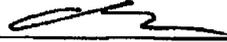
The Shareholder contends that the Trustees, Officers and Schwab Parties knowingly caused or allowed the Fund to: (1) fundamentally change the investment strategy and duration objective of the Fund by investing in long term risky securities; (2) send holding reports to investors which misleadingly listed security coupon payment dates instead of maturity dates, which obscured the true portfolio holdings and the duration of investments contained in the Fund; (3) become overly concentrated in a single risky sector as the Fund increasingly invested in risky MBSs and ABSs with long duration periods; (4) misleadingly market itself as an ultrashort bond fund as it increasingly invested in longer term MBSs and ABSs; (5) misprice and overstate a material portion of the Fund's assets as those assets deteriorated in value and liquidity; and (6) utilize inconsistent asset descriptions to obscure the true nature of the securities in the Fund's portfolio. The Shareholder maintains that each of the Trustees and Officers breached their fiduciary duties by engaging in the aforementioned conduct, which resulted in the Fund sustaining a severe loss in value.

On behalf of the Shareholder, I hereby demand that the Board take action against each of the Trustees, Officers and Schwab Parties to recover the damages described herein for the benefit of the Fund and to correct the deficiencies in the Fund's internal controls that allowed the misconduct to occur.

If within a reasonable period after the receipt of this letter, the Board has not commenced an action as demanded herein, or in the event that the Board refuses to commence an action as demanded herein, the Shareholder will commence a shareholder derivative action on behalf of the Fund seeking appropriate relief.

Sincerely,

BARROWAY TOPAZ KESSLER  
MELTZER & CHECK, LLP

  
Eric L. Zagar

ELZ/ck

*811-6200  
Branch 16*



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6 Facsimile: 415.433.6382

7 **Local Counsel**

8 [Additional Counsel on Signature Page]

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UNITED STATES DISTRICT COURT  
NORTHERN DISTRICT OF CALIFORNIA

NORTHSTAR FINANCIAL ADVISORS,  
INC., on Behalf of Itself and all Others  
Similarly Situated,  
  
Plaintiff,  
  
v.  
  
SCHWAB INVESTMENTS and  
CHARLES SCHWAB INVESTMENT  
MANAGEMENT, INC.,  
  
Defendants.

Case No. C-08-4119 SI  
CLASS ACTION  
**FIRST AMENDED COMPLAINT FOR  
VIOLATION OF THE INVESTMENT  
COMPANY ACT OF 1940**  
JURY TRIAL DEMANDED

1 Plaintiff, for its First Amended Class Action Complaint, alleges the following upon  
2 personal knowledge as to itself and its own acts, and as to all other matters upon information and  
3 belief, based upon the investigation made by its attorneys, which included a review of Securities  
4 and Exchange Commission (“SEC”) filings, news reports and other publicly available materials.

5 **NATURE OF THE ACTION**

6 1. This action is brought by Northstar, individually, and on behalf of persons who  
7 owned shares of the Schwab Total Bond Market Fund (the “Fund”) (Ticker: SWLBX) at any time  
8 from August 31, 2007 to the present, and were damaged thereby.

9 2. The action is brought against Schwab Investments and Charles Schwab  
10 Management, Inc. for causing the Fund to deviate from its fundamental investment objective to  
11 track the Lehman Brothers U.S. Aggregate Bond Index (the “Index”) (Ticker: LBSTRUU).  
12 Section 8 of the Investment Company Act of 1940 (the “ICA”) directs an investment company to  
13 recite in its Registration Statement “all investment policies of the registrant . . . , which are  
14 changeable only if authorized by shareholder vote,” as well as all policies that “the registrant  
15 deems matters of fundamental policy.” 15 U.S.C. § 80a-8(b) (2) & (3). Section 13 prohibits a  
16 registered investment company from deviating from any such policies “unless authorized by the  
17 vote of a majority of its outstanding voting securities.” 15 U.S.C. § 80a-13.

18 3. The Fund deviated from its stated investment objective by investing a material  
19 percentage of its portfolio in high risk non-U.S. agency collateralized mortgage obligations  
20 (“CMOs”). The non-U.S. agency CMOs were not part of the Lehman Index and were substantially  
21 more risky than the U.S. agency securities and other instruments that comprised the Index.

22 4. The Fund also deviated from its stated fundamental investment objective by  
23 investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed  
24 securities and CMOs. The Fund’s investment objectives prohibited any concentration of  
25 investments greater than 25% in any industry (other than if necessary to track the Index).

26 5. Defendants’ deviation from the Fund’s investment objective exposed the Fund and  
27 its shareholders to tens of millions of dollars in losses stemming from a sustained decline in the  
28

1 value of non-agency mortgage-backed securities. The Fund's deviation from its stated investment  
2 objective caused investors to suffer a negative 12.64% differential in total return for the Fund  
3 compared to the Index for the period August 31, 2007 through February 27, 2009, consisting of a  
4 negative total return of 4.80% for the Fund compared to a positive total return of 7.85% for the  
5 Index over that same period (including interest payments).

#### 6 JURISDICTION AND VENUE

7 6. This Court has jurisdiction over the subject matter of this action under § 44 of the  
8 Investment Company Act of 1940 (15 U.S.C. § 80a-43), 28 U.S.C. §§ 1331, 1332(d)(2), and 1367.  
9 The plaintiff is diverse from at least one of the defendants and the amount in controversy exceeds  
10 \$5 million.

11 7. Venue is properly laid in this District under 15 U.S.C. § 80a-43, and 28 U.S.C. §  
12 1391(b). Many of the acts giving rise to the violations of law complained of herein, including the  
13 dissemination to shareholders of the Registration Statements, Proxy Statements, and Prospectuses,  
14 referenced herein occurred in this District.

#### 15 PARTIES

16 8. Plaintiff Northstar Financial Advisors, Inc. ("Northstar") is a New Jersey  
17 corporation with offices at 46 Beachmont Terrace, North Caldwell, NJ 07006.

18 9. Northstar is a registered investment advisory and financial planning firm serving  
19 both institutional and individual clients. Northstar manages both discretionary and non-  
20 discretionary accounts on behalf of investors in its role as an investment advisor.

21 10. With respect to its discretionary accounts, which form approximately 50% of its  
22 assets under management, Northstar retains discretion over investment decisions.

23 11. Northstar had at all relevant times herein purchased and sold securities on behalf of  
24 its clients as an independent investment advisor through Charles Schwab's Institutional Advisor  
25 Platform.

26 12. Northstar, in purchasing and/or selling shares in the Fund, relied on defendants'  
27 representations as to the Fund's investment objectives and policies.

28

1 13. On or about August 31, 2007, Northstar had 239,290 shares of the Fund under its  
2 management.

3 14. Northstar operates under a fee-based structure based on the total value of assets  
4 under management. Northstar is customarily paid on a quarterly basis a .5% to 1.0% annualized  
5 management fee based on the valuation of assets under management, including the reported net  
6 asset value ("NAV") of the shares of the Fund under Northstar's management. Northstar suffered  
7 actual financial injury from the diminution of its management fee as a result of the  
8 underperformance of the Fund against the Index subsequent to August 31, 2007.

9 15. By way of Assignment of Claim dated December 8, 2008 (the "Assignment"),  
10 Henry Holz, a client of Northstar who owned 4,181.093 shares of the Fund as of August 31, 2007,  
11 assigned to Northstar "all of the Assignor's right, title and interest in any claim that the Assignor  
12 has or could have against Schwab Investments, Charles Schwab & Co., Inc., Charles Schwab  
13 Investment Management, Inc. and Schwab Total Bond Market Fund ...."

14 16. Defendant Schwab Investments (the "Trust") has its headquarters at 101  
15 Montgomery Street, San Francisco, CA 94104. Schwab Investments is an investment trust  
16 organized under Massachusetts law and is a registered investment company under the ICA. The  
17 Trust consists of a series of mutual funds, including the Fund. The Trust is managed by a Board of  
18 Trustees. The Trust and its Board of Trustees are responsible for filing with the SEC and  
19 disseminating to investors documents regarding the Fund. The Trust and its Board of Trustees are  
20 also responsible for supervising the Fund's investment advisor and monitoring the Fund's  
21 compliance with its stated investment objectives and policies.

22 17. Defendant Charles Schwab Investment Management, Inc. ("Investment Advisor" or  
23 "Schwab Management") has its headquarters at 101 Montgomery Street, San Francisco, CA 94104.  
24 Schwab Management is the investment advisor to the Fund. As the Investment Advisor, Schwab  
25 Management receives a management fee from the Fund. The Investment Advisor's management  
26 fee is 0.25% of the Fund's net assets, or approximately \$3.5 million per year. In addition the Fund  
27 incurs .28% of net assets in other expenses, for a total annual operating expense of .53%. The  
28

1 Investment Advisor is responsible for adhering to the Fund's stated investment objectives and  
2 policies. The Investment Advisor is organized under Massachusetts law.

3 18. The Schwab Total Bond Market Fund is a series of Schwab Investments and a  
4 member of the Charles Schwab Family of Funds. The Fund is managed by the Trust and advised  
5 by the Investment Advisor.

6 19. The Fund issues redeemable securities. The value of its shares is computed daily by  
7 taking the assessed market value of all portfolio securities, adding the assessed value of other assets  
8 and liabilities, and dividing the result by the number of shares outstanding. The Fund reports its  
9 portfolio holdings to investors on a semi-annual basis in reports issued as of August and February.  
10 The Fund also reports its portfolio holdings as of May and November in Form N-Q filings with the  
11 SEC, which are not mailed to investors. The Fund does not report the dates or prices at which it  
12 purchases or sells securities.

13 20. The Trust and the Investment Advisor are under the common control of The Charles  
14 Schwab Corp., a publicly traded corporation.

15 **CLASS ACTION ALLEGATIONS**

16 21. Plaintiff brings this action as a class action pursuant to Federal Rules of Civil  
17 Procedure 23(a) and (b)(3), individually and on behalf of a class consisting of all person or entities  
18 who owned shares of the Fund at any time from August 31, 2007 to the present, and suffered  
19 damages as a result therefore. Excluded from the Class are the defendants herein, any subsidiaries  
20 or affiliates of the defendants in which defendants or its affiliates have a controlling ownership  
21 interest, officers and directors of any of the defendants, heirs, successors and assigns of any of the  
22 defendants or their officers and directors, and any entity in which any defendant has a controlling  
23 ownership interest.

24 22. The members of the Class are so numerous that joinder of all members is  
25 impracticable. While the exact number of members of the Class is unknown to Plaintiff at this time  
26 and can only be ascertained through appropriate discovery, the Fund had over \$1.5 billion in assets  
27 as of August 31, 2007, and 150 million shares outstanding. Plaintiff thereby concludes that there  
28

1 are thousands of members located throughout the United States in the proposed Class. Record  
2 owners and other members of the Class may be identified from records maintained by the  
3 Registrant or its transfer agent and may be notified of the pendency of this action by mail.

4 23. Plaintiff's claims are typical of the claims of the members of the Class as all  
5 members of the Class are similarly affected by defendants' wrongful conduct in violation of federal  
6 and state laws that is complained of herein.

7 24. Northstar has standing to pursue this claim for money damages as assignee of  
8 Holz's claim and in its own right because it suffered direct financial injury as a result of the Fund's  
9 deviation from its stated fundamental investment objectives and policies (and other claims alleged  
10 herein). Northstar's financial injury and entitlement to recovery are derivative of the Class' claims.  
11 Northstar cannot prove its own financial injury and entitlement to recovery without first proving  
12 the Class' financial injury and entitlement to recovery.

13 25. Plaintiff will fairly and adequately protect the interests of the members of the Class  
14 and has retained counsel competent and experienced in class litigation.

15 26. Common questions of law and fact exist as to all members of the Class and  
16 predominate over any questions solely affecting individual members of the Class. Among the  
17 questions of law and fact common to the Class are:

- 18 (a) Whether the Trust or Investment Advisor caused the Fund to deviate from an  
19 investment objective or policy that could only be changed by a shareholder vote;
- 20 (b) Whether the Trust or Investment Advisor were obligated to cause the Fund to track  
21 the Lehman Brothers U.S. Aggregate Bond Index using an indexing strategy;
- 22 (c) Whether the Fund's investments tracked the Lehman Brothers U.S. Aggregate Bond  
23 Index using an indexing strategy;
- 24 (d) Whether the Trust or Investment Advisor concentrated investments in the Fund of in  
25 excess of 25% of its total assets in any one industry;
- 26 (e) Whether non-agency mortgage-backed securities comprise one or more than one  
27 "industry."
- 28

- 1 (f) Whether agency and non-agency mortgage-backed securities comprise one or more  
2 than one “industry.”
- 3 (g) Whether the Trust’s acts as alleged herein violated the ICA;
- 4 (h) Whether the Investment Advisor caused the Fund to violate the ICA;
- 5 (i) Whether members of the Class are third party beneficiaries of the investment  
6 advisory contract between the Trust and the Investment Advisor;
- 7 (j) Whether the Trust or the Investment Advisor owed members of the Class fiduciary  
8 duties;
- 9 (k) Whether the Trust or the Investment Advisor violated fiduciary duties to Class  
10 members; and
- 11 (l) Whether the members of the Class have sustained damages, and, if so, what is the  
12 proper measure thereof.

13 27. A class action is superior to all other available methods for the fair and efficient  
14 adjudication of this controversy since joinder of all members is impracticable. As the damages  
15 suffered by any individual Class member may be relatively small, the expense and burden of  
16 individual litigation make it impossible for members of the Class to redress individually the wrongs  
17 done to them. There will be no difficulty in managing this action as a class action.

18 **SUBSTANTIVE ALLEGATIONS**  
19 **Background and History Prior to the 1997 Shareholder Vote**

20 28. The Schwab Total Bond Market Fund (SWLBX) was initiated on March 5, 1993  
21 under a predecessor name – the Schwab Long-Term Government Bond Fund (the “Government  
22 Bond Fund”) -- as an actively managed bond fund.

23 29. According to the Prospectus for the Government Bond Fund dated December 30,  
24 1994, as amended June 30, 1995, the “investment objective” of the Government Bond Fund was  
25 “to provide a high level of current income consistent with preservation of capital by investing  
26 primarily in securities issued or guaranteed by the United States Government, its agencies or  
27 instrumentalities and repurchase agreements covering those securities.”

28

1           30.    The June 30, 1995 Prospectus also stated that “[the] Fund’s investment objective ...  
2 is fundamental and cannot be changed without approval by holders of a majority of the Fund’s  
3 outstanding voting shares.”

4           31.    The Prospectus added that “U.S. Government Securities are generally viewed by the  
5 Investment Manager as being among the safest of debt securities with respect to the timely  
6 payment of principal and interest....”

7           32.    Schwab was unable to successfully market the Government Bond Fund.

8           33.    As of August 31, 1997, after more than four years of operations, the Government  
9 Bond Fund only had \$24.8 million in investment assets.

10                           **The Formation of the Schwab Total Bond Market Index Fund**

11           34.    On July 25, 1997, Schwab Investments mailed to investors in the Government Bond  
12 Fund a Proxy Statement on SEC Form 14A with respect to a shareholder vote “[t]o amend [the]  
13 Fund’s fundamental investment objective resulting in changing the Fund from [a] Government  
14 bond fund[] to [a] bond index fund[] that would include Government and other fixed income  
15 securities” (at 2).

16           35.    The Proxy Statement (at 14) informed investors that the Board of Trustees of the  
17 Fund was proposing to change the Fund’s then existing investment objective from attempting “to  
18 provide a high level of current income consistent with preservation of capital by investing  
19 primarily in securities issued or guaranteed by the U.S. Government” to a “proposed investment  
20 objective ... to attempt to provide a high level of current income consistent with preservation of  
21 capital by seeking to track the investment results of a particular bond index through the use of an  
22 indexing strategy.”

23           36.    The Proxy Statement added (at 3) that “[i]f its proposed investment objective is  
24 approved, the Total Bond Fund would invest in a portfolio of fixed-income securities that seeks to  
25 track the Lehman Brothers Aggregate Bond Index.”

26           37.    The Lehman Index was described in the Proxy Statement (at 18) as “a broad market-  
27 weighted index which encompasses the following classes of investment grade fixed-income  
28

1 securities: U.S. Treasury and agency securities, corporate bonds, international (dollar-  
2 denominated) bonds, agency mortgage-backed securities, and asset-backed securities.”

3 38. The Lehman Index is a proprietary Lehman Brothers index, consisting of over 9,000  
4 separate instruments whose exact composition is not generally available to investors. The  
5 composition of the Index changes from time-to-time.

6 39. The Proxy Statement stated with respect to mortgage-backed securities and asset-  
7 backed securities (at 21) that “[t]he primary risk of these securities is ‘prepayment risk.’ Namely  
8 that during periods of changing interest rates, the payment streams in the underlying pools will be  
9 paid faster ... than anticipated.”

10 40. The Proxy Statement further described (at 22) the “investment process of indexing”  
11 by stating that the Fund “would be unable to hold all of the individual issues which comprise the  
12 [Index] because of the large number of securities in the [Index],” but that the “Fund would hold a  
13 portfolio of fixed-income securities that is managed to closely approximate [the] Index’s  
14 ‘characteristics’ of coupon rate, duration, sector, quality and optionality (or convexity)”:

15 If the proposed investment objective is approved, the Funds would not be managed  
16 according to traditional methods of “active” investment management, which involve  
17 the buying and selling of securities based upon economic, financial, and market  
18 analyses and investment judgment. Instead, the Investment Manager would utilize a  
19 “passive” or “indexing” investment approach, to attempt to track the investment  
20 performance of each Fund’s Index through statistical sampling and other procedures.  
The Funds would be unable to hold all of the individual issues which comprise the  
Indexes because of the large number of securities in the Indexes. Each Fund would  
hold a portfolio of fixed-income securities that is managed to closely approximate its  
Index’s “characteristics” of coupon rate, duration, sector, quality and optionality (or  
convexity).

21 41. The Proxy Statement assured investors (at 22) that “[b]efore purchasing or selling a  
22 security, the Investment Manager would analyze each security’s characteristics and determine  
23 whether purchasing or selling the security would help the Fund’s portfolio approximate the  
24 characteristics of the Index”:

25 Before purchasing or selling a security, the Investment Manager would analyze each  
26 security’s characteristics and determine whether purchasing or selling the security  
27 would help the Fund’s portfolio approximate the characteristics of the Index. As a  
28 result, when the Fund’s portfolio as a whole is considered, the Fund’s performance  
and risk is expected to be similar to its Index’s performance and risk.

1 For example, with respect to the "sector characteristic," if U.S. Treasury and agency  
2 securities represent approximately 60% of an Index's interest rate risk, then  
3 approximately 60% of the respective Fund's interest rate risk would come from such  
4 securities. Similarly, if corporate bonds represent 20% of the Fund's interest rate  
5 risk, then they would represent approximately 20% of the Fund's interest rate risk.  
6 This technique is expected to enable each Fund to track the coupon income and price  
7 movements of its respective Index, while minimizing transaction, custodial and  
8 accounting costs.

9 42. The 1997 Proxy Statement represented (at 23) that the Investment Manager would  
10 seek a 90% correlation between the Fund and the Index:

11 Over the long term, the Investment Manager will seek a correlation between the  
12 performance of each Fund, as measured by its net asset value, including the value of  
13 its dividend and capital gain distributions, and that of its Index of 0.9 or better. A  
14 correlation of 1.0 would indicate perfect correlation, but since each Fund incurs  
15 operating expenses, unlike its respective Index, a perfect correlation is unlikely to be  
16 achieved. The Investment Manager will monitor the performance of each Fund  
17 versus that of its Index on a regular basis. If a tracking error develops, each Fund is  
18 rebalanced to help bring it in line with the Index. In the unlikely event that a  
19 correlation of 0.9 or better is not achieved, the Board of Trustees of a Fund will  
20 consider alternative arrangements.

21 43. The 1997 Proxy Statement described (at 2) Schwab's rationale for proposing that  
22 the Fund be changed to an index fund and the Fund's appeal to passive investors who were seeking  
23 "broad bond portfolio diversification" and "a consistent investment style," as follows:

24 Schwab has long been an advocate of indexing as an investment strategy. The Board  
25 of Trustees believes the proposed bond index funds will offer customers many  
26 benefits through the use of an indexing strategy. These benefits include: broad bond  
27 portfolio diversification, a consistent investment style, and potentially lower trading  
28 costs as a result of lower portfolio turnover and fewer transactions, over the long  
term. And, all other things being equal, lower costs can translate into higher returns.

The objective of an index fund, unlike an actively managed fund, is to closely track  
the total return of a benchmark or index for a particular market, or market sector.  
Because both proposed Funds plan to invest in a larger number and broader range of  
bonds, the Funds should provide investors a more broadly diversified bond fund  
investment for their asset allocation plan. The proposed bond index funds could  
represent excellent choices for the core component of an investor's bond fund  
holdings and could fulfill the bond portion of an asset allocation plan, whether that  
plan calls for a longer-term or short-term bond fund.

44. The 1997 Proxy Statement (at 2) stated that because investors would not be required  
to actively monitor and assess the investment selections of the Fund's Investment Advisor (which  
was charged with the responsibility of following the Index), the bond index fund "should give a  
broader appeal to a larger number of investors."

1 In addition, the Board of Trustees believes that the proposed bond index funds should  
2 have a broader appeal to a larger number of investors. This would permit the Funds  
3 to be marketed more effectively, creating economies of scale if assets grow. These  
economies could be achieved by spreading the Funds' fixed costs over a larger asset  
base, which would potentially lower the Funds' operating expenses.

4 45. The Proxy Statement sought to assure investors (at 4) that the change to an indexing  
5 strategy would not then increase the risk profile of the Fund because 80% of the Fund's assets  
6 would still be invested on a current basis in U.S. government or agency bonds, and given the then  
7 current composition of the Index, 15% of the portfolio would be invested in investment grade  
8 corporate bonds, 4% in international (dollar-denominated bonds), and 1% in asset-backed  
9 securities:

10 As shown in the two preceding charts, as of June 30, 1997, both of the proposed  
11 index Funds would maintain significant positions in U.S. Treasury and agency, and  
12 agency mortgage-backed securities – 85.0% for the Short-Term Bond Market Index  
Fund and 80.0% for the Total Bond Market Index Fund.

13 The non-U.S. Treasury/agency securities represented in both indices are all  
14 investment grade and quite diversified. As a result, both index Funds are expected to  
15 maintain relatively low levels of credit risk. However, given that U.S. Treasury and  
agency securities have the lowest credit risk compared to other types of fixed income  
securities, the portfolio management team anticipates that the proposed Funds would  
have a slightly higher level of credit risk than the current Funds.

16 46. The July 25, 1997 Proxy Statement also proposed a change in the Fund's  
17 "fundamental investment policies and investment restrictions" regarding concentration of  
18 investments.

19 47. Previously, the Fund's fundamental investment policies and investment restrictions  
20 barred investments of "25% or more of the value of its total assets ... in any industry" (excluding  
21 investments in U.S. government, agency, or instrumentality securities):

22 Each Fund may not:

23 Purchase securities (other than securities issued or guaranteed by the U.S.  
24 Government, its agencies or instrumentalities) if, as a result of such purchase, 25% or  
25 more of the value of its total assets would be invested in any industry. Securities  
issued by governments or political subdivisions or authorities of governments are not  
considered to be securities subject to this industry concentration restriction.

26 48. The proposed change incorporated the definition of "concentration" under the  
27 Investment Company Act of 1940, and gave the Fund discretion to concentrate investments of  
28 greater than 25% of total assets in any industry if necessary to track the Lehman Index:

1 Each Fund may not concentrate investments in a particular industry or group of  
2 industries, or within one state (except with respect to the Total Bond Market Index  
3 Fund and the Short Term Bond Market Index Fund, to the extent that the index which  
4 each Fund seeks to track is also so concentrated) as concentration is defined under the  
Investment Company Act of 1940 or the rules or regulations thereunder, as such  
statute, rules or regulations may be amended from time to time.

5 49. The rationale of the proposed change, according to the Proxy Statement, was to  
6 incorporate the SEC's interpretation of the term "concentration" from the Investment Company Act  
7 of 1940 (which at the time was and remains 25%) to give the Fund greater flexibility in the event  
8 of future changes in interpretation:

9 The current self-designated restriction specifically limits a Fund's investments to less  
10 than 25% of a Fund's total assets in a particular industry. Under the Proposal, this  
11 current self-designated restriction will be eliminated and replaced by a more flexible  
12 proposed restriction. The proposed restriction would continue to prevent each Fund  
13 from "concentrating" its investments in a single industry or in a state, except if the  
14 Index that the Fund tracks is "concentrated" in a particular industry or state. Further,  
15 to provide flexibility, the concept of "concentration" in a Fund's proposed restriction  
16 is articulated so as to always track the current meaning of "concentration" under the  
17 1940 Act.

18 At present, "concentration" is interpreted under the 1940 Act in a manner consistent  
19 with each Fund's current self-designated restriction (25% or more). However, in  
20 order to achieve greater flexibility (if for instance the percentage limitation were to be  
21 changed by the SEC), the proposed restriction would eliminate the specific  
22 percentage reference and instead define the term "concentration" with respect to the  
23 meaning conferred under the 1940 Act. Because the present interpretation of the  
24 percentage limit of "concentration" under the 1940 Act is the same as the current  
25 concentration restriction, it is not expected that there would be any immediate impact  
26 on a Fund's operations as a result of approving this aspect of the proposed  
27 concentration restriction. Any future change in operations would occur only if the  
28 SEC staff changed its interpretation of what constitutes "concentration."

29 50. There has been no subsequent change in the SEC's interpretation of what constitutes  
30 "concentration."

31 51. On September 25, 1997, Schwab Investments reported that the shareholders of the  
32 Schwab Government Fund had approved the amendment to the Fund's "fundamental investment  
33 objective ... to allow [the] Fund to pursue an indexing strategy":

34 As a result of the amendment referenced in Item No. 1 above, as of November 1,  
35 1997, the name of the Schwab Short/Intermediate Government Bond Fund will be  
36 changed to the Schwab Short-Term Bond Market Index Fund, and the name of the  
37 Schwab Long-Term Government Bond Fund will be changed to the Schwab Total  
38 Bond Market Index Fund. As a result of the shareholder vote, each Fund's  
fundamental investment objective is amended to allow each Fund to pursue an  
indexing strategy. The Schwab Short-Term Bond Market Index Fund will seek to

1 track the Lehman Brothers Short (1-5) Government/Corporate Index and the Schwab  
2 Total Bond Market Index Fund will seek to track the Lehman Brothers Aggregate  
Bond Index. Each index is market-weighted and designed to track the performance of  
broad segments of the bond market.

3 52. Schwab Investments further reported that shareholders approved the change in the  
4 Fund's fundamental investment policies and restrictions with respect to the concentration of  
5 investments.

6 53. The Registration Statement and Prospectus dated January 15, 1998 for the Total  
7 Bond Fund and the Schwab Short-Term Total Bond Market Index Fund (at page 10), issued after  
8 the 1997 shareholder vote, reiterated the Fund's investment objective to track a bond index:

9 INVESTMENT OBJECTIVES:

10 Each Fund's investment objective is to attempt to provide a high level of current  
11 income consistent with preservation of capital by seeking to track the investment  
12 results of a particular bond index through the use of an indexing strategy.  
Each Fund's investment objective is fundamental, which means that it may be  
changed only by vote of a majority of a Fund's shareholders.

13 54. The Prospectus further stated (at 10) that the Lehman Brothers Aggregate Bond  
14 Index was the index against which the Total Bond Fund would be tracked:

15 THE INDEXES are the Lehman Brothers Mutual Fund Short (1-5)

16 Government/Corporate Index (the Short-Term Index) for the Short Bond Fund and  
17 the Lehman Brothers Aggregate Bond Index (the Aggregate Bond Index) for the  
Total Bond Fund.

18 55. That same recitation of the Fund's investment objective was contained in  
19 subsequent Prospectuses for the Fund, as well as in Statements of Additional Information  
20 incorporated by reference into the Prospectuses.

21 56. A Statement of Additional Information (or "SAI") contains a more comprehensive  
22 discussion of material facts than is contained in a Prospectus.

23 57. The Fund's conversion to an indexing strategy was a success, as net assets increased  
24 from \$24 million as of August 31, 1997 to \$1.5 billion as of August 31, 2007.

25 58. Schwab Investments, in the August 31, 1998 Reports to shareholders emphasized  
26 the conservative nature of the Fund's indexed securities:

27 Schwab's Bond Index Funds seek to track the total returns of broadly diversified  
28 bond indices. And because index funds generally result in lower portfolio turnover  
and fewer transactions—and therefore lower trading costs—you could potentially

1 realize higher returns.

2 In addition to some of the same benefits of equity index funds, including broad  
3 diversification, lower expenses, consistent investment style and straightforward  
4 choices, bond index funds can also provide the added benefit of high credit-quality  
5 investments. Schwab's Bond Index Funds are designed to maintain high credit-  
6 quality standards because the indices they seek to track primarily comprise U.S.  
7 Treasuries, government agency securities and government agency mortgage-backed  
8 securities; the remaining bonds in the indices are investment-grade corporate bonds  
9 rated AAA through BBB the four highest credit ratings. [Emphasis added.]

6 59. The government agency mortgage-backed securities referenced in the Fund's SEC  
7 documents and included in the Lehman Index were issued by the Governmental National Mortgage  
8 Association ("Ginnie Mae"), the Federal National Mortgage Association ("Fannie Mae") and the  
9 Federal Home Loan Mortgage Corporation ("Freddie Mac"). Ginnie Mae, Fannie Mae, and  
10 Freddie Mac are U.S. Government agencies (also known as Government Sponsored Enterprises  
11 ("GSEs")) established by Congress to facilitate residential mortgage loans.

12 60. The GSEs purchased and securitized mortgage loans that met established criteria for  
13 creditworthiness.

14 61. The government agency mortgage-backed securities referenced in the 1998 Annual  
15 Report as contained in the Index were fixed income pass-through securities, in which all principal  
16 and interest on the underlying mortgages is passed through to the mortgage-backed securities  
17 investor.

18 62. The type of securities that could be acquired by those agencies are restricted by their  
19 government charters.

20 63. Ginnie Mae benefits from an express U.S. Government guarantee of payment on its  
21 securities.

22 64. Both Fannie Mae and Freddie Mac benefit from an implied U.S. Government  
23 guarantee of payment on its securities by virtue of their status as U.S. chartered institutions.

24 65. The mortgage-backed securities issued by Ginnie Mae, Fannie Mae and Freddie  
25 Mac, and maintained in the Lehman Index, had the highest credit quality among mortgage-backed  
26 securities.

27 66. The Statement of Additional Information dated May 6, 2002, reported that the Fund  
28 had changed its name to the Schwab Total Bond Market Fund:

1 Prior to May 6, 2002, . . . Schwab Total Bond Market Fund was named Schwab Total  
2 Bond Market Index Fund.

3 67. In the ordinary course of defendants' business, this Statement of Additional  
4 Information was not mailed to investors.

5 68. The May 6, 2002 Statement of Additional Information, incorporated by reference  
6 into the May 6, 2002 Prospectus, continued to state that the Fund's investment objective was  
7 unchanged and could only be changed by a majority shareholder vote, which had not occurred:

8 Each fund's investment objective is to attempt to provide a high level of current  
9 income consistent with preservation of capital by seeking to track the investment  
10 results of a particular bond index through the use of an indexing strategy.

11 \* \* \*

12 The indexes are the Lehman Brothers Mutual Fund Short (1-5 Year) U.S.  
13 Government/Credit Index for the Schwab Short-Term Bond Market Fund (the Short-  
14 Term Index), and the Lehman Brothers U.S. Aggregate Bond Index for the Schwab  
15 Total Bond Market Fund (the U.S. Aggregate Bond Index).

16 \* \* \*

17 The U.S. Aggregate Bond Index is a market-capitalization weighted index of  
18 investment-grade debt securities with maturities of greater than one year.

19 \* \* \*

20 Each fund's investment objective may be changed by vote of a majority of its  
21 outstanding voting shares.

22 69. Schwab Investments issued a further Registration Statement and Prospectus with  
23 regard to the Fund dated November 15, 2003.

24 70. Beginning with that Prospectus and in subsequent Prospectuses issued by Schwab  
25 Investments with respect to the Fund, including the Prospectus dated June 13, 2008, defendants  
26 prominently reported in large type-face at the front of the Prospectus that the Fund was "designed  
27 to offer high current income by tracking the performance of the Lehman Brothers U.S. Aggregate  
28 Bond Index" and was "intended for investors seeking to fill the fixed income component of their  
asset allocation plan":

THE SCHWAB TOTAL BOND MARKET FUND TM is designed to offer high  
current income by tracking the performance of the Lehman Brothers U.S. Aggregate  
Bond Index. The fund invests primarily in a diversified portfolio of investment-grade  
debt instruments. The fund is intended for investors seeking to fill the fixed income

1 component of their asset allocation plan.

2 71. The Statement of Additional Information attached to the November 15, 2003  
3 Prospectus – and all subsequent Statements of Additional Information -- reaffirmed that the Fund  
4 would continue to track the Index until that investment objective was changed by shareholder vote:

5 Each fund's investment objective is to attempt to provide a high level of  
6 current income consistent with preservation of capital by seeking to track the  
investment results of a particular bond index through the use of an indexing strategy.

7 \* \* \*

8 The indexes are the Lehman Brothers Mutual Fund Short (1-5 Year) U.S.  
9 Government/Credit Index for the Schwab Short-Term Bond Market Fund (the Short-  
Term Index), and the Lehman Brothers U.S. Aggregate Bond Index for the Schwab  
Total Bond Market Fund (the U.S. Aggregate Bond Index).

10 The Short-Term Index is a market-capitalization weighted index of investment-grade  
11 debt securities with maturities between one and five years. The U.S. Aggregate Bond  
Index is a market-capitalization weighted index of investment-grade debt securities of  
12 greater than one year.

13 \* \* \*

14 Each fund's investment objective may be changed by vote of a majority of its  
outstanding voting shares.

15 72. From August 31, 1997 through August 31, 2007, the Fund substantially performed  
16 in a manner that was consistent with the Index, returning an annualized rate of 5.75% compared to  
17 6.04% for the Index -- within the 10% deviation anticipated by the Investment Manager.

18 73. As stated in the Fund's annual and semi-annual reports, this degree of deviation  
19 between the Fund and the Index occurred "mainly because, unlike the Index, the Fund incurs  
20 operating expenses and trading costs and must keep a small part of its assets in cash for paying  
21 expenses and processing shareholder orders."

22 **The Fund Substantially Deviates From Its Stated Investment Objective**

23 74. The Fund first reported a material deviation from the Index in its Semi-Annual  
24 Report for the period ended February 29, 2008:

25 The Schwab Total Bond Market Fund returned 3.41% underperforming  
26 Lehman Brothers U.S. Aggregate Bond Index, which was up 5.67%. Risk aversion  
27 and forced selling in the fixed income market, combined with persistent volatility,  
impacted the fund as investors remained cautious of all non-Government securities  
28 irrespective of underlying credit quality. Under these conditions of extreme  
volatility, U.S. Treasuries outperformed all other fixed income securities.

1 During the period, the financial markets experienced liquidity and confidence issues  
2 as the collapse of the subprime mortgage market and related credit turmoil cascaded  
3 into other sectors. Correspondingly, a reprising of risk premiums and a flight to  
4 quality across all segments of the fixed income market contributed to downward  
5 pricing pressure, with prices for many non-U.S. Treasury securities falling regardless  
6 of their quality or fundamentals. In order to maintain liquidity, many investors were  
7 forced to sell high quality assets at depressed prices. This selling pressure occurred at  
8 the same time demand for non-U.S. Treasury securities was weakest, and as a result  
9 prices were driven down even further.

6 75. Investors in the Fund, however, could not anticipate from this Report that the Fund  
7 would continue to deviate from the Index. Among other things, the Prospectus dated September  
8 15, 2007 had stated that “the Fund primarily invests in a diversified portfolio of debt investments  
9 that is designed to track the performance of the Lehman Brothers U.S. Aggregate Bond Index” and  
10 that “[y]our investment follows the bond market, as measured by the index. The fund is designed  
11 to follow the performance of the index during upturns as well as downturns.” The November 15,  
12 2007 Statement of Additional Information also reiterated that the Fund’s “investment objective is  
13 to attempt to provide a high level of current income consistent with preservation of capital by  
14 seeking to track the investments results of [the Index] through the use of an indexing strategy.”

15 76. The Trust had informed investors in the 1997 Proxy Statement (at 23) that some  
16 volatility in the Fund against the Index may not be totally avoidable, and that “if a tracking error  
17 develops, each Fund is rebalanced to help bring it in line with the Index.”

18 77. The Fund had also consistently tracked the Index for the prior decade since  
19 inception.

20 78. Accordingly, it was not apparent to investors at that time, who thought they were  
21 holding a conservative index fund, that the Trust and Investment Advisor had engaged in a risky  
22 strategy of concentrating the Fund’s portfolio in non-agency CMOs that deviated materially from  
23 the government and government agency securities that comprised a majority of the Index.

24 79. From 2002 until June 2008, Kimon Daifotis acted as the senior vice president and  
25 chief investment officer of the Investment Advisor, responsible for the overall management of the  
26 Fund. On June 13, 2008, the Trust filed a Supplement to the Fund’s Prospectus dated November  
27 15, 2007, stating that Jeffrey Mortimer was then responsible for the overall management of the  
28 Fund. No explanation was given by defendants, in the Prospectus or elsewhere, for replacing

1 Daifotis as Fund manager. Investors were not informed that Daifotis had engaged in an investment  
2 strategy that was inconsistent with the Fund's stated investment objectives and policies.

3 80. In fact, however, the Fund's underperformance against the Index did continue  
4 subsequent to February 29, 2008. From August 31, 2007 through February 27, 2009, the Fund  
5 experienced a negative total return of 4.80% compared to a positive 7.85% total return for the  
6 Index – a total underperformance of 12.64% in absolute terms (including interest payments).

7 81. The Fund's deviation in performance from the Index was caused by the Fund's  
8 investment of 27.3% of assets as of February 29, 2008 in non-agency collateralized mortgage  
9 obligations ("CMOs").

10 82. The CMOs in the Fund's portfolio were not issued by government agencies. Rather  
11 they were issued by financial institutions through subsidiaries and backed by residential loans that  
12 did not conform to the agencies' high loan underwriting requirements.

13 83. Moreover, non-agency CMOs purchased by the Investment Manager for the Fund  
14 represented tranches of mortgage-backed securities, such as principal only or interest only  
15 payments, and were significantly more risky than the agency-issued mortgage-backed securities  
16 that were part of the index. Included in the Fund's portfolio were CMOs sponsored by such  
17 subprime lenders as Citigroup, Merrill Lynch, Countrywide, Bear Stearns, IndyBank, Lehman, and  
18 Washington Mutual.

19 84. This concentration of investments in mortgage backed securities was in violation of  
20 the Fund's stated investment objectives that the Fund's assets not be concentrated more than 25%  
21 in any one industry (except as required by the Index).

22 85. Subsequent analyses of other bond index funds that represent that they track the  
23 Lehman Bros. Aggregate Bond Index indicates that as of February 29, 2008, the Lehman  
24 Government Index had a 0% weighting in non-agency mortgage-backed securities, and a 37%  
25 weighting in agency mortgage-backed securities.

26 86. Moreover, according to the February 28, 2008 Semi-Annual Report, the Fund was  
27 invested 45.4% in agency and non-agency mortgage backed securities.

28

1 87. By November 30, 2008, the Fund had lessened its exposure to non-agency CMOs to  
2 3.4% of total assets. The liquidation of the non-agency CMO portfolio coincided with a further  
3 deviation in performance of the Fund.

4 88. Defendants have taken the position, as stated in the Statement of Additional  
5 Information dated November 15, 2007, as amended June 13, 2008 (at 6), to justify the Fund's  
6 over-concentration in non-agency mortgage-based securities and CMOs, that non-agency  
7 mortgage-backed securities "are not part of any industry for purposes of a fund's concentration  
8 policy":

9 Based on the characteristics of mortgage-backed securities, the funds have  
10 determined that mortgage-backed securities issued by private lenders and not  
11 guaranteed by U.S. government agencies or instrumentalities are not part of any  
12 industry for purposes of a fund's concentration policy. This means that a fund may  
13 invest more than 25% of its total assets in privately-issued mortgaged-backed  
14 securities, which may cause the fund to be more sensitive to adverse economic,  
15 business or political developments that affect privately-issued mortgage-backed  
16 securities.

17 89. Defendants recognized, however, as stated in the November 15, 2007, as amended  
18 June 13, 2008 (at 6) (quoted immediately above), that the non-agency investments "may cause the  
19 fund to be more sensitive to adverse economic, business or political developments that affect  
20 privately-issued mortgage-backed securities" and accordingly should be classified as within one  
21 industry.

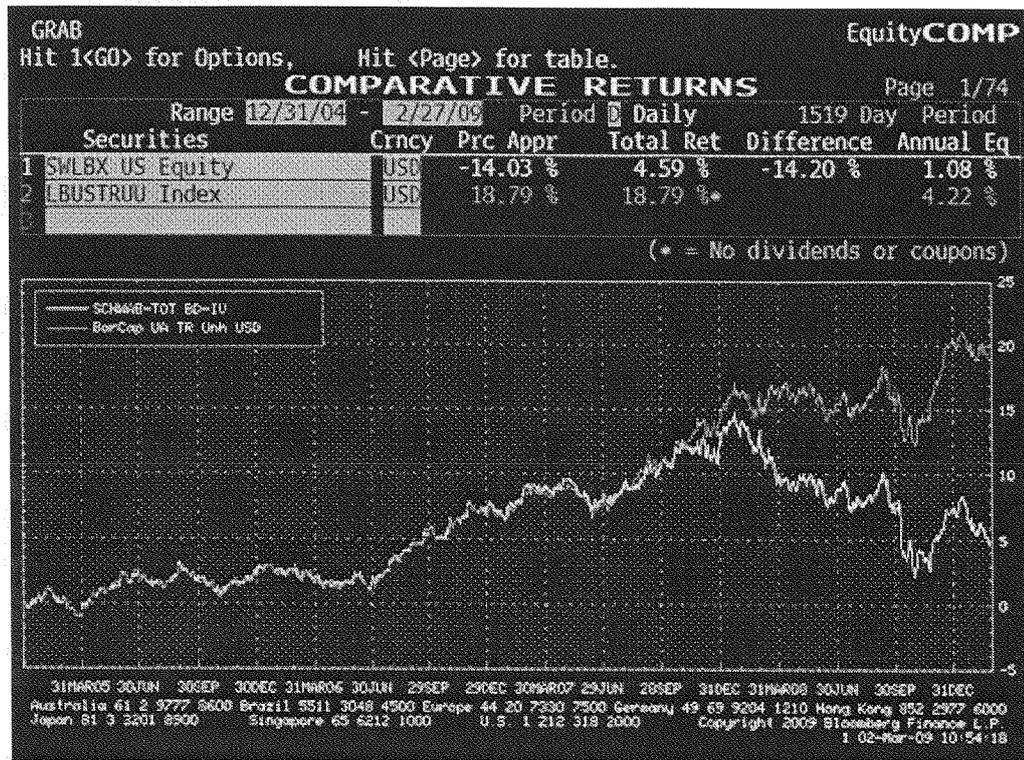
22 90. The Fund's investment in CMOs were made at a time when there was increased  
23 concern with the quality of mortgage lending.

24 91. For example, on June 28, 2007, the Department of Treasury, Federal Reserve  
25 System, Federal Deposit Insurance Corp., and National Credit Union Administration, issued a joint  
26 Statement on Subprime Mortgage Lending "to address subprime mortgage products and lending  
27 practices."

28 92. The Fund's investment in CMOs at this time, in light of all circumstances, was  
speculative, irresponsible and a gross deviation from the Fund's fundamental investment policies  
and a breach of the defendants' fiduciary duties.

93. The attached chart prepared on a Bloomberg terminal, comparing the Schwab

1 Fund's change in total return to the Lehman Index's change in total return over the period  
 2 December 31, 2004 through February 27, 2009, demonstrates how closely correlated the Schwab  
 3 Bond Fund was to the Index until approximately August 31, 2007 and how dramatically the Bond  
 4 Fund has deviated from the Index thereafter:



1 94. The magnitude of under performance between the Fund and the Index were not the  
2 result of unforeseen economic circumstances, but rather the gross deviation by the Investment  
3 Manager from the Fund's stated investment objective, by investing 45.4% of the Fund's total assets  
4 in mortgage-backed-securities and 27.3% of the Fund's total assets in non-agency CMOs.

5 **COUNT I:**

6 **ON BEHALF OF THE CLASS FOR VIOLATION OF**  
7 **SECTION 13(A) OF THE INVESTMENT COMPANY ACT**  
8 **(ON BEHALF OF THE CLASS AGAINST THE TRUST)**

9 95. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs  
10 as if fully set forth herein. This Count is asserted on behalf of members of the Class for violation  
11 of § 13(a) of the ICA, 15 U.S.C. § 80a-13(a).

12 96. The Trust caused the Fund to deviate from the Fund's investment policy that was  
13 changeable only by a shareholder vote, and a deviation from a policy recited in the Funds'  
14 Registration Statement as a "fundamental investment policy" in that, as detailed above, the Fund  
15 failed to invest in bond securities that tracked the Lehman Brothers U.S. Aggregate Bond Index  
16 and invested more than 25% of its assets in investments concentrated in one industry.

17 97. The above-noted investments made in violation of a stated fundamental investment  
18 policy caused significant losses to the Fund's shareholders, as alleged above. As described above,  
19 plaintiff and other members of the Class have suffered substantial damages in connection with  
20 losses in the Funds' value that resulted from the Funds' deviation from their stated fundament  
21 investment policy.

22 **COUNT II:**

23 **ON BEHALF OF THE CLASS FOR BREACH OF FIDUCIARY DUTY**  
24 **(ON BEHALF OF THE CLASS AGAINST BOTH DEFENDANTS)**

25 98. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs  
26 as if fully set forth herein. This Count is asserted against Schwab Investments (the Trust) and  
27 Charles Schwab Investment Management, Inc. (the Investment Advisor). Both of the defendants  
28 owed fiduciary duties to Class members.

99. This Count is asserted under California law. The relationship of Class members to  
the defendants is not as a shareholder to the corporation, but rather as an investor in the Fund to the

1 Trust (charged with responsibility for managing the Fund) and to the Investment Advisor (charged  
2 with responsibility for investing the Fund's assets). Class members are not shareholders of the  
3 Trust, but rather are shareholders of the Fund. Because the defendants are headquartered in San  
4 Francisco, California and the principal activities of the defendants with respect to this Count took  
5 place in California, California has the principal interest in applying its law to this claim. Count II  
6 is viable under Massachusetts law, as well.

7 100. The Trust is a registered investment company and the sponsor of the Fund. The  
8 Trust was responsible for the oversight of the Fund's investments, the oversight of the activities of  
9 the Investment Advisor, and the accuracy of the Trust's SEC filings. The Trust was also  
10 responsible for the Fund's compliance with its stated investment objectives. The Trust had  
11 discretion to operate the Fund, subject to the Fund's stated fundamental investment policies, and  
12 Class members were reliant on the Trust for the operations of the Fund.

13 101. The Trust and its Board of Trustees' fiduciary obligations to the Class were  
14 summarized in the Schwab Investments Definitive Proxy Statement for the Fund, filed with the  
15 SEC on March 24, 2000, as follows (at 5):

16 102. The Board of Trustees is responsible for protecting the interests of the funds'  
17 shareholders. The Board meets regularly to review the funds' activities, contractual arrangements  
18 and performance.

19 103. Charles Schwab, personally, in his letter to shareholders appended to the August 31,  
20 2007 Annual Report filed by the Trust with the SEC, on behalf of all Schwab-related entities,  
21 thanked the Fund's shareholders for "entrusting us with their assets."

22 104. The Trust further acknowledged in its August 31, 2007 Annual Report to  
23 Shareholders (at 71) that "as part of their fiduciary duties with respect to fund fees, fund boards are  
24 required to evaluate the material factors applicable to their decision to approve an investment  
25 advisory agreement."

26 105. The Investment Advisor owed Class members a fiduciary duty to manage the  
27 Fund's assets with the care and prudence of a professional in like circumstances and to adhere to  
28

1 the Fund's investment objective and policies. Given the disparity of access to information and  
2 expertise in investment matters, Class members relied on the Investment Advisors' diligence and  
3 good faith.

4 106. By virtue of their relationship with plaintiff and the members of the Class, the Trust  
5 and the Investment Advisor were each in a fiduciary relationship with plaintiff and the members of  
6 the Class to act in good faith and with utmost loyalty to plaintiff and the members of the Class, to  
7 protect the interests of the Fund and its shareholders, and to refrain from doing anything that would  
8 cause injury to the Fund or deprive plaintiff and the members of the Class of profit or advantage to  
9 which they were otherwise entitled.

10 107. The Trust repeatedly stated that the Fund was "intended for investors seeking to fill  
11 the fixed income component of their asset allocation plan." The Investment Advisor was aware of  
12 that statement and recognized that Class members were relying on its management of the Fund.

13 108. Defendants acknowledge on the "Charles Schwab" website that Schwab  
14 Investments, by creating the Fund and recommending that the Fund be used in an investment plan  
15 "to fill the fixed income component of [investors'] asset allocation plan" were acting in a fiduciary  
16 capacity: "Professional investors consider creating an investment plan vital for performing their  
17 fiduciary duty to clients." See "Investing Principle 1: A Blueprint for Success," by Mark W.  
18 Riepe, CFA, Senior Vice President, Schwab Center for Financial Research, March 10, 2008.

19 109. Defendants breached their fiduciary duties to plaintiff and the members of the Class  
20 by the acts and omissions set forth above in violation of the Fund's stated investment objective and  
21 policies.

22 110. By virtue of the wrongful conduct of defendants, plaintiff and the members of the  
23 Class sustained money damages in connection with their ownership of shares in the Fund.

24 **COUNT III:**

25 **FOR BREACH OF CONTRACT**  
26 **(ON BEHALF OF THE CLASS AGAINST THE TRUST)**

27 111. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs  
28

1 as if fully set forth herein. This Count is asserted on behalf of members of the Class for breach of  
2 contract.

3 112. The 1997 Proxy Statement (at 14) formed the terms of a contract between Schwab  
4 Investments and investors in the Fund that if investors voted in favor of changing the Fund's  
5 fundamental investment objective to seek "to track the investment results of the [Index] through  
6 use of an indexing strategy" that the Trust would cause the Fund to conform with that objective.  
7 Investors in the Fund accepted that offer by voting in favor of the change in investment objective.  
8 See Proxy Statement at 3 ("[T]he Total Bond Market Index Fund ... would seek to track the  
9 Lehman Brothers Aggregate Bond Index.").

10 113. The Proxy Statement sets forth in detail the meaning of the term "indexing strategy"  
11 that could only be changed by shareholder vote. Thus, for example, page 22 of the Proxy Statement  
12 assured investors that "[b]efore purchasing or selling a security, the Investment Manager would  
13 analyze each security's characteristics and determine whether purchasing or selling the security  
14 would help the Fund's portfolio approximate the characteristics of the Index."

15 114. The Proxy Statement also formed the terms of a contract whereby the Trust  
16 covenanted that subject to shareholder vote, the Fund "may not" "[p]urchase securities (other than  
17 securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities) if, as a  
18 result of such purchase, 25% or more of the value of its assets would be invested in any industry."

19 115. The Fund's shareholders accepted the terms of that contract by voting in favor of  
20 that fundamental investment policy.

21 116. Subsequent to the 1997 proxy vote, the Trust continued to offer shares in the Fund  
22 pursuant to the terms of a contract that the Trust would cause the Fund to continue to adhere to its  
23 fundamental investment objectives and policies contained in the 1997 Proxy Statement and  
24 reiterated in Prospectuses and in Statements of Additional Information (as quoted above).  
25 Investors accepted the terms of that contract by purchasing shares in the Fund.

26 117. The terms of that contract are contained in the 1997 Proxy Statement, which  
27 established the contractual relationship between the Trust and Class members, and were reiterated  
28

1 in the Trust's subsequent SEC filings, including the January 15, 1998 Prospectus, and the May 6,  
2 2002 Statement of Additional Information ("SAI").

3 118. The Trust violated the terms of the contract with the Fund's shareholders as set forth  
4 in the 1997 Proxy Statement and subsequent prospectuses and SAIs, as more fully described above,  
5 by directing the purchases or allowing the Investment Advisor to direct the purchases of securities  
6 that deviated from the composition of the Lehman Brothers U.S. Aggregate Bond Index and caused  
7 the Fund to concentrate more than 25% of its net assets in mortgage backed securities, including  
8 CMOs, without a subsequent shareholder vote.

9 119. By virtue of the wrongful conduct of defendants, plaintiff and the members of the  
10 Class sustained money damages in connection with their ownership of shares in the Fund.

11 **COUNT IV:**

12 **FOR BREACH OF COVENANT OF GOOD FAITH AND FAIR DEALING**  
13 **(ON BEHALF OF THE CLASS AGAINST BOTH DEFENDANTS)**

14 120. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs  
15 as if fully set forth herein. This Count is asserted on behalf of members of the Class for breach of  
16 the covenant of good faith and fair dealing.

17 121. Defendants have a common law duty of good faith and fair dealing with respect to  
18 investors in the Fund.

19 122. Defendants violated the covenant of good faith and fair dealing by inducing  
20 investors to purchase and hold shares in the Fund by stating that it was the Fund's fundamental  
21 investment objective, changeable only by a shareholder vote, to track the Lehman Index, and to  
22 invest no more than 25% of the Fund's total assets in any one industry.

23 123. Defendants, in violation of the covenant of good faith and fair dealing, engaged in  
24 speculation with the Fund's assets by investing more than 25% of the Fund's total assets in CMO  
25 securities that were not contained in the Lehman Index.

26 124. By virtue of the wrongful conduct of defendants, plaintiff and the members of the  
27 Class sustained money damages in connection with their ownership of shares in the Fund.

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1  
2 **COUNT V:**

3 **THIRD PARTY BENEFICIARY OF THE INVESTMENT ADVISORY AGREEMENT**  
4 **(ON BEHALF OF THE CLASS AGAINST THE INVESTMENT ADVISOR)**

5 125. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs  
6 as if fully set forth herein.

7 126. The Investor Advisor managed the investments of the Fund pursuant to an  
8 Investment Advisory Agreement between the Investor Advisor and the Trust.

9 127. The Investment Advisory Agreement required the Investment Advisor, among other  
10 things, to manage the Fund consistent with the Fund's fundamental investment objectives and  
11 policies.

12 128. The shareholders of the Fund were third party beneficiaries of that Agreement.  
13 Class members were known and intended beneficiaries of the Investment Advisory Agreement.

14 129. Inasmuch as the Trust issues and redeemed shares of the Fund on a daily basis at its  
15 reported NAV, if the Investment Advisor managed the Fund in a manner that was inconsistent with  
16 the Fund's fundamental investment objectives and policies, the Fund's shareholders would be  
17 subject to direct financial injury.

18 130. The Investor Advisor breached the terms of its Investment Advisory Agreement  
19 with the Trust by failing to manage the Fund's assets in a manner consistent with the Fund's  
20 fundamental investment objectives and policies by investing in securities, including non-agency  
21 CMOs, which deviated from the securities contained in the Index, and by concentrating greater  
22 than 25% of the Fund's assets in non-agency CMOs.

23 131. Class members suffered actual and direct financial damages as a result of the  
24 Investment Advisor's failure to manage the Fund's assets in a manner consistent with the Fund's  
25 fundamental investment objectives and policies.

**COUNT VI:**

**VIOLATIONS OF THE CALIFORNIA BUS. & PROF. CODE  
§§ 17200 ET SEQ. ON BEHALF OF NORTHSTAR  
(ON BEHALF OF NORTHSTAR AGAINST BOTH DEFENDANTS)**

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3  
4 132. Plaintiff repeats and realleges the allegations contained in the foregoing paragraphs  
5 as if fully set forth herein.

6 133. This Count is asserted by Northstar against the Trust and the Investment Advisor.

7 134. Defendants engaged in "unlawful" business acts and practices in violation of the  
8 UCL by violating federal law, and state common law, including but not limited to Section 13(a) of  
9 the Investment Company Act, breach of contract, and breach of fiduciary duties. Northstar  
10 reserves the right to identify additional violations of California and/or federal law by the Fund  
11 caused by these defendants as further investigation and discovery warrants.

12 135. Northstar was a Schwab independent investor advisor that was paid a management  
13 fee based on the reported asset values of its clients' Schwab accounts on a quarterly basis.  
14 Northstar's method of compensation was common among Schwab independent investment  
15 advisors. Defendants had actual knowledge that Schwab independent investment advisors were  
16 compensated on this basis..

17 136. Defendants knew that by causing the Fund to deviate from its fundamental  
18 investment objectives and policies, defendants would cause investors in the Fund, as well as  
19 Schwab independent investor advisors such as Northstar, who purchased shares of the Fund for  
20 their clients, to suffer financial harm.

21 137. All of the wrongful conduct alleged herein occurred and continues to occur in the  
22 conduct of these defendants' businesses. These defendants' wrongful conduct is part of a pattern  
23 or generalized course of conduct that has been repeated in the State of California on a continuing  
24 basis. The defendants' conduct thus impacts the public interest.

25 138. As a proximate result of the defendants' wrongful conduct, Northstar sustained  
26 money damages in connection with losses in the Fund's value that resulted from the Fund's  
27 deviation from its stated fundamental investment policies.

28 139. Northstar's claim is derivative of the Class's claims in that Northstar will be

1 required to prevail on the Class's claims in order to prevail on its claim, individually.

2 140. Northstar requests that this Court enter such orders and judgments as may be  
3 necessary to restore to any person in interest any money that may have been acquired by means of  
4 such unfair competition, as provided in California Business & Professions Code §§ 17203 and  
5 Civil Code § 3345, and for such relief as set forth in the Prayer for Relief.

6 **PRAYER FOR RELIEF**

7 WHEREFORE, plaintiff prays for relief and judgment, as follows:

8 A. Determining that this action is a proper class action and certifying plaintiff Northstar  
9 as a representative of the Class under Rule 23 of the Federal Rules of Civil Procedure;

10 B. Appointing Wolf Popper LLP and Greenbaum Rowe Smith & Davis LLP as Class  
11 Counsel;

12 C. Awarding compensatory damages in favor of plaintiff and the members of the Class  
13 against all defendants, jointly and severally, for all damages sustained as a result of defendants'  
14 wrongdoing, in an amount to be proven at trial, including interest thereon;

15 D. Disgorging from defendants for the benefit of the Class any management or other  
16 fees forfeited by Defendants' deviation from the Fund's fundamental investment objectives;

17 E. Awarding plaintiff and the Class their reasonable costs and expenses incurred in  
18 this action, including counsel fees and expert fees;

19 F. Awarding recessionary damages; and

20 G. Such equitable, injunctive or other relief as deemed appropriate by the Court.

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**JURY DEMAND**

Plaintiff hereby demands a trial by Jury.

Dated: March 2, 2009

By: /s Christopher T. Heffelfinger  
CHRISTOPHER T. HEFFELFINGER (118058)

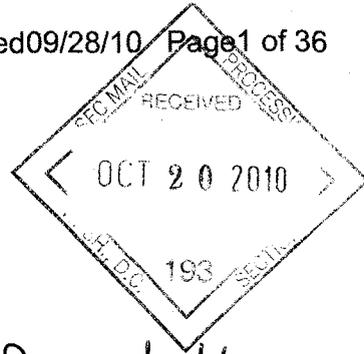
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7 *Attorneys for Plaintiff Northstar Financial Advisors, Inc.*

8 [Additional Counsel on Signature Page]

9 **UNITED STATES DISTRICT COURT**  
10 **NORTHERN DISTRICT OF CALIFORNIA**

12 NORTHSTAR FINANCIAL  
13 ADVISORS, INC., on Behalf of Itself  
and all Others Similarly Situated,  
14  
Plaintiff,  
15  
v.  
16 SCHWAB INVESTMENTS;  
and MARIANN BYERWALTER,  
17 DONALD F. DORWARD, WILLIAM  
A. HASLER, ROBERT G. HOLMES,  
18 GERALD B. SMITH, DONALD R.  
STEPHENS, MICHAEL W. WILSEY,  
19 CHARLES R. SCHWAB, RANDALL  
W. MERK, JOSEPH H. WENDER and  
20 JOHN F. COGAN as TRUSTEES OF  
SCHWAB INVESTMENTS; and  
21 CHARLES SCHWAB INVESTMENT  
MANAGEMENT, INC.  
22  
Defendants.

) Case No. 08-cv-04119 LHK  
)  
) CLASS ACTION  
)  
) **SECOND AMENDED CLASS ACTION**  
) **COMPLAINT**  
)  
) JURY TRIAL DEMANDED

24  
25 Plaintiff, for its Second Amended Class Action Complaint, alleges the following upon  
26 personal knowledge as to itself and its own acts, and upon information and belief as to all other  
27 matters, based upon the investigation made by its attorneys, which included a review of  
28

1 Securities and Exchange Commission (“SEC”) filings, news reports and other publicly  
2 available materials.

3 **NATURE OF THE ACTION**

4 1. This action is brought by Northstar Financial Advisors, Inc., individually, and  
5 on behalf of persons who owned shares of the Schwab Total Bond Market Fund (the “Fund” or  
6 “Index Fund”) (Ticker: SWLBX) at any time from August 31, 2007 through February 27, 2009,  
7 and were damaged thereby.

8 2. This action is brought against Schwab Investments, the members of the Board of  
9 Trustees of Schwab Investments, and Charles Schwab Management, Inc. for violating  
10 shareholders’ rights and causing the Fund to deviate from its fundamental investment objective  
11 to “seek to track the investment results” of the Lehman Brothers U.S. Aggregate Bond Index  
12 (the “Index”) (Ticker: LBUSTRUU) “through the use of an indexing strategy.”

13 3. The Fund deviated from its stated investment objective by investing a material  
14 percentage of its portfolio in high risk non-U.S. agency collateralized mortgage obligations  
15 (“CMOs”). The non-U.S. agency CMOs were not part of the Lehman Index and were  
16 substantially more risky than the U.S. agency securities and other instruments that comprised  
17 the Index.

18 4. The Fund also deviated from its stated fundamental investment objective by  
19 investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed  
20 securities and CMOs. The Fund’s investment objectives prohibited any concentration of  
21 investments of “25% or more of the value of the total assets in any industry” (other than if  
22 necessary to track the Index).

23 5. Defendants’ deviation from the Fund’s investment objective exposed the Fund  
24 and its shareholders to tens of millions of dollars in losses stemming from a sustained decline in  
25 the value of non-agency mortgage-backed securities. The Fund’s deviation from its stated  
26 investment objective caused investors to suffer a negative 12.64% differential in total return for  
27 the Fund compared to the Index for the period August 31, 2007 through February 27, 2009,  
28

1 consisting of a negative total return of 4.80% for the Fund compared to a positive total return of  
2 7.85% for the Index over that same period (including interest payments).

### 3 JURISDICTION AND VENUE

4 6. This Court has jurisdiction over the subject matter of this action under 28 U.S.C.  
5 §§1332(d)(2) and 1367. The plaintiff is diverse from at least one of the defendants and the  
6 amount in controversy exceeds \$5 million.

7 7. Venue is properly laid in this District under 28 U.S.C. § 1391(b). Many of the  
8 acts giving rise to the violations of law complained of herein, including the dissemination to  
9 shareholders of the Registration Statements, Proxy Statements, and Prospectuses referenced  
10 herein occurred in this District.

### 11 PARTIES

12 8. Plaintiff Northstar Financial Advisors, Inc. ("Northstar") is a New Jersey  
13 corporation with offices at 46 Beachmont Terrace, North Caldwell, NJ 07006.

14 9. Northstar is a registered investment advisory and financial planning firm serving  
15 both institutional and individual clients. Northstar manages both discretionary and non-  
16 discretionary accounts on behalf of investors in its role as an investment advisor.

17 10. With respect to its discretionary accounts, which form approximately 50% of its  
18 assets under management, Northstar retains discretion over investment decisions.

19 11. Northstar had at all relevant times herein purchased and sold securities on behalf  
20 of its clients as an independent investment advisor through Charles Schwab's Institutional  
21 Advisor Platform.

22 12. Northstar, in purchasing and/or selling shares in the Fund, relied on defendants'  
23 contractual and fiduciary obligations with respect to the Fund's investment objectives and  
24 policies.

25 13. On or about August 31, 2007, Northstar had 239,290 shares of the Fund under  
26 its management.

27 14. Northstar operates under a fee-based structure based on the total value of assets  
28 under management. Northstar is customarily paid on a quarterly basis a .5% to 1.0%

1 annualized management fee based on the valuation of assets under management, including the  
2 reported net asset value (“NAV”) of the shares of the Fund under Northstar’s management.  
3 Northstar suffered actual financial injury from the diminution of its management fee as a result  
4 of the underperformance of the Fund against the Index subsequent to August 31, 2007.

5 15. By way of Assignment of Claim, dated December 8, 2008 (the “Assignment”),  
6 Henry Holz, a client of Northstar who owned 4,181.093 shares of the Fund as of August 31,  
7 2007, assigned to Northstar “all of the Assignor’s right, title and interest in any claim that the  
8 Assignor has or could have against Schwab Investments, Charles Schwab & Co., Inc., Charles  
9 Schwab Investment Management, Inc. and Schwab Total Bond Market Fund ....” The  
10 Assignment of Claim was amended on September 28, 2010 to include claims asserted against  
11 the Trustees of Schwab Investments.

12 16. Defendant Schwab Investments, at all relevant times since at least 1997, has had  
13 its headquarters at 101 Montgomery Street, San Francisco, CA 94104. Schwab Investments is  
14 an investment trust (the “Trust” or “Schwab Trust”), organized under Massachusetts law and is  
15 a registered investment company under the Investment Company Act of 1940 (the “ICA” or  
16 “Investment Company Act”). The Trust consists of a series of mutual funds, including the  
17 Fund.

18 17. The Schwab Trust is an affiliate of and subject to the control of The Charles  
19 Schwab Corporation (the “Schwab Corp.”), and defendant Charles Schwab, individually  
20 (“defendant Schwab”).

21 18. The Schwab Trust is a legal fiction in that it owns no assets and has no  
22 employees. Rather, the Schwab Trust contracts out all its management and operation functions  
23 to other “Schwab” companies affiliated with the Schwab Corp.

24 19. The Schwab Trust is managed by a Board of Trustees. The Trust and its Board  
25 of Trustees are responsible for filing with the SEC and disseminating to investors documents  
26 regarding the Fund. The Schwab Trust and its Board of Trustees are also responsible for  
27 supervising the Fund’s investment advisor and monitoring the Fund’s compliance with its  
28 stated investment objectives and policies. According to the Statements of Additional

1 Information made available to investors in the Index Fund, the Trustees of the Trust “are  
2 responsible for protecting shareholder interests.”

3 20. Defendants Mariann Byerwalter, Donald F. Dorward, William A. Hasler,  
4 Robert G. Holmes, Gerald B. Smith, Donald R. Stephens, Michael W. Wilsey, Charles R.  
5 Schwab, and Randall W. Merck, were, according to the Fund’s Prospectus dated November 15,  
6 2007, the Trustees of the Fund as of August 31, 2007. The following chart identifies each  
7 Trustee as of August 31, 2007, the Trustee’s length of service, the number of discrete portfolios  
8 in the Schwab fund complex that the Trustee oversaw (with the Fund being one such portfolio),  
9 and the Trustee’s annual compensation derived as a Trustee of Schwab taxable and tax-free  
10 mutual funds:

<u>Name of Trustee</u>	<u>Years of Service</u>	<u>Portfolios Overseen</u>	<u>Annual Compensation</u>
Byerwalter, Mariann	Since 2000	70	\$230,642
Dorward, Donald F.	Since 1989	59	\$202,775
Hasler, William A.	Since 2000	70	\$230,642
Holmes, Robert G.	Since 1989	59	\$202,775
Smith, Gerald B.	Since 2000	59	\$202,775
Stephens, Donald R.	Since 1989	59	\$202,775
Wilsey, Michael W.	Since 1989	59	\$202,775
Schwab, Charles R.	Since 1989	59	N/A
Merck, Randall W.	Since 2005	70	N/A

23 21. According to the Amended Prospectus dated June 13, 2008, defendants  
24 Joseph H. Wender and John F. Cogan joined the Board of Trustees in 2008, replacing  
25 defendants Holmes and Dorward as Trustees. The Trustee defendants are referred to herein in  
26 the aggregate as the Trustees.

27 22. The Fund’s shareholders and shareholders of other Schwab mutual funds are not  
28 required to vote annually or periodically on appointment of Trustees. Rather, those Trustees

1 may be selected by, or selected with the acquiescence of, defendant Schwab and the Schwab  
2 Corp. as controlling persons of the Trust.

3 23. Each Trustee serves with respect to all or substantially all the Schwab mutual  
4 funds, and the Investment Advisor is the investment manager for all the Schwab mutual funds.

5 24. Although the Schwab Trust and the Schwab Trustees were responsible for  
6 reviewing the performance and fees of the Investment Advisor (as defined below) on an annual  
7 basis, in fact, no Schwab Trust or trustee has ever selected a non-Schwab entity as a Schwab  
8 fund's investment manager. Rather, the Trust and Trustees merely serve to rubber-stamp the  
9 determinations made by the Schwab Corp. and defendant Schwab.

10 25. Because Trustee-defendants Schwab and Merk are interested trustees employed  
11 by the Schwab Corp., their compensation is not paid by the Schwab Trust, but rather by the  
12 parent corporation or other affiliates of the Schwab Corp. Defendant Charles Schwab was paid  
13 cash compensation for 2007 of \$6.6 million for his services as Chairman and CEO of the  
14 Schwab Corp.

15 26. Defendant Schwab founded the Schwab Corp. in 1971, and has served as its  
16 Chairman since 1978. Defendant Schwab has also served as Schwab Corp.'s CEO at various  
17 times, including from 2004 through October 2008.

18 27. According to the Schwab Corp.'s Proxy Statement dated May 13, 2010,  
19 defendant Schwab owns approximately 200 million shares, or approximately 17.0% of the  
20 outstanding common stock of the Schwab Corp. That Proxy Statement recites that defendant  
21 Schwab's "vision continues to drive the company's growth."

22 28. Defendant Schwab is also identified in the Proxy Statement as Chairman and  
23 trustee of The Charles Schwab Family of Funds and Schwab Investments, among other Schwab  
24 related entities.

25 29. Defendant Schwab, by virtue of his stock ownership in the Schwab Corp. and  
26 his positions as Chairman and trustee of the Schwab Corp. and affiliated entities, is considered  
27 a controlling person of the Schwab Corp. and its affiliated entities.

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1           30. Defendant Charles Schwab Investment Management, Inc. (the “Schwab  
2 Advisor”), at all relevant times since at least 1997), has had its headquarters at  
3 101 Montgomery Street, San Francisco, CA 94104. The Schwab Advisor is the investment  
4 advisor to the Fund. The Schwab Advisor receives a management fee from the Fund. The  
5 Schwab Advisor’s management fee is 0.25% of the Fund’s net assets, or approximately \$3.5  
6 million per year. In addition, the Index Fund incurs 0.28% of net assets in other expenses, for a  
7 total annual operating expense of 0.53%. The Schwab Advisor is responsible for preserving  
8 shareholders’ voting rights and adhering to the Fund’s stated investment objectives and  
9 policies. The Investment Advisor is organized under Delaware law. The Investment Advisor is  
10 wholly owned by the Schwab Corp., and is under the control of the Schwab Corp. and  
11 defendant Schwab.

12           31. The Index Fund is a series of the Schwab Trust and a member of the Charles  
13 Schwab Family of Funds. The Index Fund is managed by the Schwab Trust and advised by the  
14 Schwab Advisor.

15           32. The Index Fund issues redeemable securities. Sales of the shares of the Index  
16 Fund can only be made by the Schwab Trust to investors pursuant to a Registration Statement  
17 and Prospectus filed with the SEC. Investors in the Schwab Fund cannot sell or trade shares  
18 among themselves.

19           33. Each investor in the Fund has an individual, indivisible interest in the assets of  
20 the Fund based on the ratio of its shares to the total number of shares outstanding. Investors in  
21 the Fund can buy or sell shares on a daily basis. The value of the Fund’s shares is computed  
22 daily by taking the assessed market value of all portfolio securities, adding the assessed value  
23 of other assets and liabilities, and dividing the result by the number of shares outstanding. The  
24 Index Fund reports its portfolio holdings to investors on a semi-annual basis in reports issued as  
25 of August and February. The Index Fund also reports its portfolio holdings as of May and  
26 November in Form N-Q filings with the SEC, which are not mailed to investors. The Fund  
27 does not report the dates or prices at which it purchases or sells securities.

28



1           39. Northstar has standing to pursue this claim for money damages as assignee of  
2 Holz's claim and in its own right because it suffered direct financial injury as a result of the  
3 Fund's deviation from its stated fundamental investment objectives and policies (and other  
4 claims alleged herein). Northstar's financial injury and entitlement to recovery are derivative  
5 of the Class' claims. Northstar cannot prove its own financial injury and entitlement to  
6 recovery without first proving the Class' financial injury and entitlement to recovery.

7           40. Plaintiff will fairly and adequately protect the interests of the members of the  
8 Class and has retained counsel competent and experienced in class litigation.

9           41. Common questions of law and fact exist as to all members of the Class and  
10 predominate over any questions solely affecting individual members of the Class. Among the  
11 questions of law and fact common to the Class are:

- 12           (a) Whether the Schwab Trust or the Schwab Advisor caused the Index Fund to  
13 deviate from an investment objective or policy that could only be changed by a  
14 shareholder vote;
- 15           (b) Whether the Schwab Trust or the Schwab Investment Advisor were obligated to  
16 cause the Fund to track the Lehman Brothers U.S. Aggregate Bond Index using  
17 an indexing strategy;
- 18           (c) Whether the Index Fund's investments tracked the Lehman Brothers U.S.  
19 Aggregate Bond Index using an indexing strategy;
- 20           (d) Whether the Schwab Trust or Investment Advisor concentrated investments in  
21 the Fund in excess of 25% of its total assets in any one industry;
- 22           (e) Whether non-agency mortgage-backed securities comprise one or more than one  
23 "industry;"
- 24           (f) Whether agency and non-agency mortgage-backed securities comprise one or  
25 more than one "industry;"
- 26           (g) Whether members of the Class are third party beneficiaries of the investment  
27 advisory contract between the Schwab Trust and the Schwab Advisor;
- 28

- 1 (h) Whether the Schwab Trust or the Schwab Advisor owed members of the Class  
2 fiduciary duties;
- 3 (i) Whether the Schwab Trust or the Schwab Advisor violated fiduciary duties to  
4 Class members; and
- 5 (j) Whether the members of the Class have sustained damages, and, if so, what is  
6 the proper measure thereof.

7 42. A class action is superior to all other available methods for the fair and efficient  
8 adjudication of this controversy since joinder of all members is impracticable. As the damages  
9 suffered by any individual Class member may be relatively small, the expense and burden of  
10 individual litigation make it impossible for members of the Class to redress individually the  
11 wrongs done to them. There will be no difficulty in managing this action as a class action.

12 **SUBSTANTIVE ALLEGATIONS**  
13 **Background and History Prior to the 1997 Shareholder Vote**

14 43. The Schwab Total Bond Market Fund was initiated by the Schwab Trust on  
15 March 5, 1993 under a predecessor name – the Schwab Long-Term Government Bond Fund  
16 (the “Government Bond Fund”) – as an actively managed bond fund.

17 44. According to the Prospectus for the Government Bond Fund, dated  
18 December 30, 1994, as amended June 30, 1995, the “investment objective” of the Government  
19 Bond Fund was “to provide a high level of current income consistent with preservation of  
20 capital by investing primarily in securities issued or guaranteed by the United States  
21 Government, its agencies or instrumentalities and repurchase agreements covering those  
22 securities.”

23 45. The June 30, 1995 Prospectus also stated that “[the] Fund’s investment objective  
24 ... is fundamental and cannot be changed without approval by holders of a majority of the  
25 Fund’s outstanding voting shares.”

26 46. The Prospectus added that “U.S. Government Securities are generally viewed by  
27 the Investment Manager as being among the safest of debt securities with respect to the timely  
28 payment of principal and interest[.]”

1 47. Schwab was unable to successfully market the Government Bond Fund.

2 48. As of August 31, 1997, after more than four years of operations, the  
3 Government Bond Fund only had \$24.8 million in investment assets.

4 **The Formation of the Schwab Total Bond Market Index Fund**

5 49. On July 25, 1997, the Schwab Trust mailed to investors in the Government  
6 Bond Fund a Proxy Statement on SEC Form 14A with respect to a shareholder vote “[t]o  
7 amend [the] Fund’s fundamental investment objective resulting in changing the Fund from [a]  
8 Government bond fund[ ] to [a] bond index fund[ ] that would include Government and other  
9 fixed income securities.” The Proxy Statement stated that “[t]he changes proposed will give  
10 your Fund the opportunity to take advantage of the many benefits offered by an indexing  
11 strategy, including a more diversified bond portfolio.”

12 50. The Proxy Statement informed investors that the Board of Trustees of the Fund  
13 was proposing to change the Fund’s then-existing investment objective from attempting “to  
14 provide a high level of current income consistent with preservation of capital by investing  
15 primarily in securities issued or guaranteed by the U.S. Government” to a “proposed  
16 investment objective ... to attempt to provide a high level of current income consistent with  
17 preservation of capital by seeking to track the investment results of a particular bond index  
18 through the use of an indexing strategy.”

19 51. The Proxy Statement added that “[i]f its proposed investment objective is  
20 approved, the Total Bond Fund would invest in a portfolio of fixed-income securities that seeks  
21 to track the Lehman Brothers Aggregate Bond Index.”

22 52. The Proxy Statement listed, as Proposal 2, “Amending Each Funds’  
23 Fundamental Investment Objective,” gave a detailed description of the meaning and  
24 significance of the proposed amendments and formed the terms of a contract to provide  
25 shareholders with voting rights in that those “fundamental investment objectives” were only  
26 changeable by shareholder vote.

27 53. The Lehman Index was described in the Proxy Statement as “a broad market-  
28 weighted index which encompasses the following classes of investment grade fixed-income

1 securities: U.S. Treasury and agency securities, corporate bonds, international (dollar-  
2 denominated) bonds, agency mortgage-backed securities, and asset-backed securities.”

3 54. The Lehman Index is a proprietary Lehman Brothers index, consisting of over  
4 9,000 separate instruments whose exact composition is not generally available to investors.  
5 The composition of the Index changes from time-to-time.

6 55. Because the individual bonds in the Lehman Index may be illiquid and cannot  
7 be (at least at times) purchased at efficient prices, the Proxy Statement explained that the Index  
8 Fund would not necessarily purchase the bonds that were part of the Index but rather would  
9 purchase bonds that “closely approximated the Index’s characteristics.”

10 56. The Proxy Statement described the “investment process of indexing” and  
11 proposed “indexing strategy” by stating that the Fund “would be unable to hold all of the  
12 individual issues which comprise the [Index] because of the large number of securities in the  
13 [Index],” and would not necessarily hold securities that were part of the Index, but that the  
14 “Fund would hold a portfolio of fixed-income securities that is managed to closely approximate  
15 [the] Index’s ‘characteristics’ of coupon rate, duration, sector, quality and optionality (or  
16 convexity)”:

17 If the proposed investment objective is approved, the Funds would not be  
18 managed according to traditional methods of “active” investment management,  
19 which involve the buying and selling of securities based upon economic,  
20 financial, and market analyses and investment judgment. Instead, *the Investment*  
21 *Manager would utilize a “passive” or “indexing” investment approach, to*  
22 *attempt to track the investment performance of each Fund’s Index through*  
23 *statistical sampling and other procedures.* The Funds would be unable to hold all  
24 of the individual issues which comprise the Indexes because of the large number  
25 of securities in the Indexes. *Each Fund would hold a portfolio of fixed-income*  
26 *securities that is managed to closely approximate its Index’s “characteristics” of*  
27 *coupon rate, duration, sector, quality and optionality (or convexity).* [Emphasis  
28 added.]

29 57. The Proxy Statement assured investors that “[b]efore purchasing or selling a  
30 security, the Investment Manager would analyze each security’s characteristics and determine  
31 whether purchasing or selling the security would help the Fund’s portfolio approximate the  
32 characteristics of the Index”:

33 Before purchasing or selling a security, the Investment Manager would analyze  
34 each security’s characteristics and determine whether purchasing or selling the  
35 security would help the Fund’s portfolio approximate the characteristics of the

1 Index. As a result, when the Fund's portfolio as a whole is considered, the Fund's  
performance and risk is expected to be similar to its Index's performance and risk.

2 For example, with respect to the "sector characteristic," if U.S. Treasury and  
3 agency securities represent approximately 60% of an Index's interest rate risk,  
then approximately 60% of the respective Fund's interest rate risk would come  
4 from such securities. Similarly, if corporate bonds represent 20% of the Fund's  
interest rate risk, then they would represent approximately 20% of the Fund's  
5 interest rate risk. This technique is expected to enable each Fund to track the  
coupon income and price movements of its respective Index, while minimizing  
6 transaction, custodial and accounting costs.

7 58. The 1997 Proxy Statement represented that the Schwab Investment Manager  
8 would seek a 90% correlation between the Fund and the Index:

9 Over the long term, the Investment Manager will seek a correlation between the  
performance of each Fund, as measured by its net asset value, including the value  
10 of its dividend and capital gain distributions, and that of its Index of 0.9 or better.  
A correlation of 1.0 would indicate perfect correlation, but since each Fund incurs  
11 operating expenses, unlike its respective Index, a perfect correlation is unlikely to  
be achieved. The Investment Manager will monitor the performance of each  
12 Fund versus that of its Index on a regular basis. If a tracking error develops, each  
Fund is rebalanced to help bring it in line with the Index. In the unlikely event  
13 that a correlation of 0.9 or better is not achieved, the Board of Trustees of a Fund  
will consider alternative arrangements.  
14

15 59. The 1997 Proxy Statement described Schwab's rationale for proposing that the  
16 Fund be changed to an index fund and the Fund's appeal to passive investors who were seeking  
17 "broad bond portfolio diversification" and "a consistent investment style," as follows:

18 Schwab has long been an advocate of indexing as an investment strategy. The  
Board of Trustees believes the proposed bond index funds will offer customers  
19 many benefits through the use of an indexing strategy. These benefits include:  
broad bond portfolio diversification, a consistent investment style, and potentially  
20 lower trading costs as a result of lower portfolio turnover and fewer transactions,  
over the long term. And, all other things being equal, lower costs can translate  
21 into higher returns.

22 The objective of an index fund, unlike an actively managed fund, is to closely  
track the total return of a benchmark or index for a particular market, or market  
23 sector. Because both proposed Funds plan to invest in a larger number and  
broader range of bonds, the Funds should provide investors a more broadly  
24 diversified bond fund investment for their asset allocation plan. The proposed  
bond index funds could represent excellent choices for the core component of an  
25 investor's bond fund holdings and could fulfill the bond portion of an asset  
allocation plan, whether that plan calls for a longer-term or short-term bond fund.  
26

27 60. The 1997 Proxy Statement stated that because investors would not be required to  
actively monitor and assess the investment selections of the Fund's Investment Advisor (which  
28

1 was charged with the responsibility of following the Index), the bond index fund “should have  
2 a broader appeal to a larger number of investors.”

3 In addition, the Board of Trustees believes that the proposed bond index funds  
4 should have a broader appeal to a larger number of investors. This would permit  
5 the Funds to be marketed more effectively, creating economies of scale if assets  
6 grow. These economies could be achieved by spreading the Funds’ fixed costs  
7 over a larger asset base, which would potentially lower the Funds’ operating  
8 expenses.

9 61. The Proxy Statement sought to assure investors that the change to an indexing  
10 strategy would not increase the risk profile of the Fund (which at the time was holding  
11 approximately 100% of its assets in securities issued or guaranteed by the U.S. Government)  
12 because 80% of the Fund’s assets would still be invested on a current basis in U.S. government  
13 or agency bonds, and given the then current composition of the Index, 15% of the portfolio  
14 would be invested in investment grade corporate bonds, 4% in international (dollar-  
15 denominated bonds), and 1% in asset-backed securities:

16 As shown in the two preceding charts, as of June 30, 1997, both of the proposed  
17 index Funds would maintain significant positions in U.S. Treasury and agency,  
18 and agency mortgage-backed securities – 85.0% for the Short-Term Bond Market  
19 Index Fund and 80.0% for the Total Bond Market Index Fund.

20 The non-U.S. Treasury/agency securities represented in both indices are all  
21 investment grade and quite diversified. As a result, both index Funds are  
22 expected to maintain relatively low levels of credit risk. However, given that U.S.  
23 Treasury and agency securities have the lowest credit risk compared to other types  
24 of fixed income securities, the portfolio management team anticipates that the  
25 proposed Funds would have a slightly higher level of credit risk than the current  
26 Funds.

27 62. The Proxy Statement added that bond securities issued by the U.S. government  
28 and its agencies were of the highest credit quality:

29 The risks associated with U.S. Treasury and agency securities, generally  
30 considered the least risky form of fixed-income security in terms of credit risks,  
31 are detailed in the Funds’ current prospectus.

32 . . . .

33 Although a higher return is expected from corporate bonds, these securities will  
34 generally not be of the same credit quality and risk as U.S. Treasury and agency  
35 securities because they are not issued or guaranteed as to principal and interest by  
36 the federal government or its agencies or instrumentalities.

1           63.     The July 25, 1997 Proxy Statement also proposed a change (Proposal No. 3) in  
2 the Fund's "fundamental investment policies and investment restrictions" regarding  
3 concentration of investments.

4           64.     Previously, the Fund's fundamental investment policies and investment  
5 restrictions barred investments of "25% or more of the value of its total assets ... in any  
6 industry" (excluding investments in U.S. government, agency, or instrumentality securities):

7           Each Fund may not:

8           Purchase securities (other than securities issued or guaranteed by the U.S.  
9 Government, its agencies or instrumentalities) if, as a result of such purchase,  
10 25% or more of the value of its total assets would be invested in any industry.  
11 Securities issued by governments or political subdivisions or authorities of  
governments are not considered to be securities subject to this industry  
concentration restriction.

12           65.     The proposed change incorporated the definition of "concentration" under the  
13 Investment Company Act of 1940, and gave the Fund discretion to concentrate investments of  
14 greater than 25% of total assets in any industry only if necessary to track the Lehman Index:

15           Each Fund may not concentrate investments in a particular industry or group of  
16 industries, or within one state (except with respect to the Total Bond Market  
17 Index Fund and the Short Term Bond Market Index Fund, to the extent that the  
index which each Fund seeks to track is also so concentrated) as concentration is  
18 defined under the Investment Company Act of 1940 or the rules or regulations  
thereunder, as such statute, rules or regulations may be amended from time to  
time.

19           66.     The rationale for the proposed change, according to the Proxy Statement, was to  
20 incorporate the SEC's interpretation of the term "concentration" from the Investment Company  
21 Act of 1940 (which at the time was and remains 25%) to give the Fund greater flexibility in the  
22 event of future SEC changes in interpretation:

23           The current self-designated restriction specifically limits a Fund's investments to  
24 less than 25% of a Fund's total assets in a particular industry. Under the  
25 Proposal, this current self-designated restriction will be eliminated and replaced  
26 by a more flexible proposed restriction. The proposed restriction would continue  
27 to prevent each Fund from "concentrating" its investments in a single industry or  
in a state, except if the Index that the Fund tracks is "concentrated" in a particular  
industry or state. Further, to provide flexibility, the concept of "concentration" in  
a Fund's proposed restriction is articulated so as to always track the current  
meaning of "concentration" under the 1940 Act.

28           At present, "concentration" is interpreted under the 1940 Act in a manner  
consistent with each Fund's current self-designated restriction (25% or more).

1 However, in order to achieve greater flexibility (if for instance the percentage  
2 limitation were to be changed by the SEC), the proposed restriction would  
3 eliminate the specific percentage reference and instead define the term  
4 "concentration" with respect to the meaning conferred under the 1940 Act.  
5 Because the present interpretation of the percentage limit of "concentration"  
6 under the 1940 Act is the same as the current concentration restriction, it is not  
7 expected that there would be any immediate impact on a Fund's operations as a  
8 result of approving this aspect of the proposed concentration restriction. Any  
9 future change in operations would occur only if the SEC staff changed its  
10 interpretation of what constitutes "concentration."

6 67. There has been no subsequent change in the SEC's interpretation of what  
7 constitutes "concentration."

8 68. On September 25, 1997, the Schwab Trust filed a Prospectus Supplement with  
9 the SEC reporting that the shareholders of the Schwab Government Fund and shareholders of  
10 the Schwab Short/Intermediate Government Bond Fund had approved Proposal Nos. 2 and 3,  
11 including the "[a]mendment of each Fund's Fundamental investment objective resulting in  
12 changing each Fund from a Government bond fund to a bond index fund that would include  
13 Government and other fixed income securities."

14 69. The Prospectus Supplement emphasized further that "[a]s a result of the  
15 shareholder vote, each Fund's fundamental investment objective is amended to allow each  
16 Fund to pursue an indexing strategy":

17 As a result of the amendment referenced in Item No. 1 above, as of November 1,  
18 1997, the name of the Schwab Short/Intermediate Government Bond Fund will be  
19 changed to the Schwab Short-Term Bond Market Index Fund, and the name of the  
20 Schwab Long-Term Government Bond Fund will be changed to the Schwab Total  
21 Bond Market Index Fund. As a result of the shareholder vote, each Fund's  
22 fundamental investment objective is amended to allow each Fund to pursue an  
23 indexing strategy. The Schwab Short-Term Bond Market Index Fund will seek to  
24 track the Lehman Brothers Short (1-5) Government/Corporate Index and the  
25 Schwab Total Bond Market Index Fund will seek to track the Lehman Brothers  
26 Aggregate Bond Index. Each index is market-weighted and designed to track the  
27 performance of broad segments of the bond market.

23 70. The Proxy Statement imposed detailed contractual obligations on the Schwab  
24 Trust and the Schwab Advisor on how the Fund would be managed. The Proxy Statement also  
25 created voting rights on behalf of the Fund's existing and future shareholders in that the  
26 investment objectives and fundamental policies could not thereafter be changed without a  
27 majority shareholder vote.

1           71. Defendants' contractual obligations to "seek to track" the Index "through the use  
2 of an indexing strategy," and investors' voting rights, were fundamental to the Index Fund's  
3 shares and appurtenant to each subsequent share issued by the Schwab Trust.

4           72. The Registration Statements and Prospectuses dated November 1, 1997 and as  
5 amended January 15, 1998 for the Total Bond Fund and the Schwab Short-Term Total Bond  
6 Market Index Fund, issued shortly after the 1997 shareholder vote, reiterated the Index Fund's  
7 fundamental indexing strategy "to track" a bond index "through the use of an indexing  
8 strategy" and that the terms of that undertaking could only be modified by shareholder vote:

9           INVESTMENT OBJECTIVES:

10           Each Fund's investment objective is to attempt to provide a high level of current  
11 income consistent with preservation of capital by seeking to track the investment  
12 results of a particular bond index through the use of an indexing strategy.

13           Each Fund's investment objective is fundamental, which means that it may be  
14 changed only by vote of a majority of a Fund's shareholders.

15           73. That same recitation of the Fund's investment objective was contained in  
16 subsequent Prospectuses for the Fund (dated March 17, 1998, November 4, 1998), as well as in  
17 Statements of Additional Information incorporated by reference into those and subsequent  
18 Prospectuses.

19           74. A Statement of Additional Information (or "SAI") contains a more  
20 comprehensive discussion of material facts than is contained in a Prospectus.

21           75. In Prospectuses issued by the Schwab Trust with respect to the Fund, including  
22 Prospectuses dated November 13, 2003; November 15, 2004; November 15, 2005;  
23 November 15, 2006; November 15, 2007; and November 15, 2007, as amended June 13, 2008,  
24 defendants prominently reported in large type-face at the front of the Prospectus that the Fund  
25 was "designed to offer high current income by tracking the performance of the Lehman  
26 Brothers U.S. Aggregate Bond Index" and was "intended for investors seeking to fill the fixed  
27 income component of their asset allocation plan":

28           THE SCHWAB TOTAL BOND MARKET FUND TM is designed to offer high  
current income by tracking the performance of the Lehman Brothers U.S.  
Aggregate Bond Index. The fund invests primarily in a diversified portfolio of

1 investment-grade debt instruments. The fund is intended for investors seeking to  
fill the fixed income component of their asset allocation plan.

2 76. These Prospectuses added with respect to the Index Fund's fundamental  
3 investment policies that:

4 The STATEMENT OF ADDITIONAL INFORMATION (SAI) includes a more  
5 detailed discussion of investment policies and the risks associated with various  
investments. The SAI is incorporated by reference into the prospectus.

6 77. The Statement of Additional Information attached to the November 15, 2003  
7 Prospectus – and all Statements of Additional Information, issued by the Trust with respect to  
8 the Fund, including the SAIs dated November 15, 2005 and November 15, 2006 – reaffirmed  
9 investors' contractual voting rights and that the Index Fund would continue to track the Index  
10 until that investment objective was changed by shareholder vote:

11 Each fund's investment objective is to attempt to provide a high level of current  
12 income consistent with preservation of capital by seeking to track the investment  
results of a particular bond index through the use of an indexing strategy.

13 \* \* \*  
14 The indexes are the Lehman Brothers Mutual Fund Short (1-5 Year) U.S.  
Government/Credit Index for the Schwab Short-Term Bond Market Fund (the  
15 Short-Term Index), and the Lehman Brothers U.S. Aggregate Bond Index for the  
Schwab Total Bond Market Fund (the U.S. Aggregate Bond Index).  
\* \* \*

16 Each fund's investment objective may be changed by vote of a majority of its  
17 outstanding voting shares.

18 78. Schwab actively marketed the Index Fund to investors, on its website  
19 (www.schwab.com) and elsewhere as an index fund. For example, Schwab, in its "On  
20 Investing" magazine for "Spring 2006," described as "The Financial Journal of the Charles  
21 Schwab Corporation," identified the "Schwab Total Bond Market Fund" as a "Bond Index  
22 Fund" and compared its performance to the Dreyfus Bond Market Index Fund.

23 79. Similarly, Schwab's "Mutual Fund Report Card," available on Schwab's  
24 website, as of July 31, 2008, referred to the Fund, and continues to refer to the Fund, as an  
25 "Index Fund."

26 80. The Index Fund's conversion to an indexing strategy was a great success for  
27 Schwab, as net assets increased from \$24 million as of August 31, 1997 to approximately \$1.5  
28 billion as of August 31, 2007.

1           81.    The Schwab Trust, in the August 31, 1998 Annual Report to shareholders (and  
2 repeated in subsequent annual and semi-annual reports to shareholders, including the  
3 semiannual report dated February 29, 2000) reiterated the conservative nature of the Index  
4 Fund's indexed securities:

5           Schwab's Bond Index Funds seek to track the total returns of broadly diversified  
6 bond indices. And because index funds generally result in lower portfolio  
7 turnover and fewer transactions—and therefore lower trading costs—you could  
8 potentially realize higher returns.

9           In addition to some of the same benefits of equity index funds, including broad  
10 diversification, lower expenses, consistent investment style and straightforward  
11 choices, bond index funds can also provide the added benefit of high credit-  
12 quality investments. Schwab's Bond Index Funds are designed to maintain high  
13 credit-quality standards because the indices they seek to track primarily comprise  
14 U.S. Treasuries, government agency securities and government agency mortgage-  
15 backed securities; the remaining bonds in the indices are investment-grade  
16 corporate bonds rated AAA through BBB, the four highest credit ratings.

17           82.    The government agency mortgage-backed securities referenced in the Fund's  
18 SEC documents (including the June 1997 Proxy) and included in the Lehman Index were  
19 issued by the Governmental National Mortgage Association ("Ginnie Mae"), the Federal  
20 National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage  
21 Corporation ("Freddie Mac"). Ginnie Mae, Fannie Mae, and Freddie Mac are U.S.  
22 Government agencies (also known as Government Sponsored Enterprises ("GSEs"))  
23 established by Congress to facilitate residential mortgage loans.

24           83.    The GSEs purchased and securitized mortgage loans that met established criteria  
25 for creditworthiness.

26           84.    The government agency mortgage-backed securities referenced in the 1997  
27 Proxy as contained in the Index were fixed income pass-through securities, in which all  
28 principal and interest on the underlying mortgages is passed through to the mortgage-backed  
29 securities investor.

30           85.    The type of securities that could be acquired by those agencies are restricted by  
31 their government charters.

32           86.    Ginnie Mae benefits from an express U.S. Government guarantee of payment on  
33 its securities.

1           87. Both Fannie Mae and Freddie Mac benefit from an implied U.S. Government  
2 guarantee of payment on their securities by virtue of their status as U.S. chartered institutions.

3           88. The mortgage-backed securities issued by Ginnie Mae, Fannie Mae and Freddie  
4 Mac, and maintained in the Lehman Index, had the highest credit quality among mortgage-  
5 backed securities.

6           89. The Statement of Additional Information dated May 6, 2002, reported that the  
7 Fund had changed its name to the Schwab Total Bond Market Fund:

8                   Prior to May 6, 2002, . . . Schwab Total Bond Market Fund was named Schwab  
9 Total Bond Market Index Fund.

10           90. This Statement of Additional Information was not mailed to investors. No  
11 explanation was given by given by Schwab Trust or Investment Advisor for the change in  
12 name. Upon information and belief, the Schwab Trust was required by the SEC to delete the  
13 word "Index" from the Fund name because the Fund's fundamental investment objective did  
14 not require the Fund to own the actual securities that were part of the Index but rather only to  
15 own those securities that "closely approximated the Index's characteristics."

16           91. The change in Fund name was not approved by Fund shareholders and had no  
17 consequence to investors' contractual voting rights with respect to the Fund's fundamental  
18 investment objectives.

19           92. The May 6, 2002 Statement of Additional Information, incorporated by  
20 reference into the May 6, 2002 Prospectus, and each subsequent (and previous) SAI,  
21 incorporated by reference into each subsequent (and previous) Prospectus, continued to state  
22 that shareholders' voting rights and the Fund's investment objective were unchanged and could  
23 only be changed by a majority shareholder vote, which had not occurred:

24                   Each fund's investment objective is to attempt to provide a high level of current  
25 income consistent with preservation of capital by seeking to track the investment  
26 results of a particular bond index through the use of an indexing strategy.

26   \*           \*           \*

27                   Each fund's investment objective may be changed by vote of a majority of its  
28 outstanding voting shares.

1 93. From August 31, 1997 through August 31, 2007, the Fund substantially  
2 performed in a manner that was consistent with the Index, returning an annualized rate of  
3 5.75% compared to 6.04% for the Index -- within the 10% deviation anticipated by the  
4 Investment Manager.

5 94. As stated in the Fund's annual and semi-annual reports, this degree of deviation  
6 between the Fund and the Index occurred "mainly because, unlike the Index, the Fund incurs  
7 operating expenses and trading costs and must keep a small part of its assets in cash for paying  
8 expenses and processing shareholder orders."

9 **The Fund Substantially Deviates From Its Stated Investment Objective**

10 95. The Fund first reported a material performance deviation from the Index in its  
11 Semi-Annual Report for the period ended February 27, 2008, filed with the SEC on May 6,  
12 2008:

13 The Schwab Total Bond Market Fund returned 3.41% underperforming  
14 Lehman Brothers U.S. Aggregate Bond Index, which was up 5.67%. Risk  
15 aversion and forced selling in the fixed income market, combined with persistent  
16 volatility, impacted the fund as investors remained cautious of all non-  
Government securities irrespective of underlying credit quality. Under these  
conditions of extreme volatility, U.S. Treasuries outperformed all other fixed  
income securities.

17 During the period, the financial markets experienced liquidity and  
18 confidence issues as the collapse of the subprime mortgage market and related  
19 credit turmoil cascaded into other sectors. Correspondingly, a reprising of risk  
20 premiums and a flight to quality across all segments of the fixed income market  
21 contributed to downward pricing pressure, with prices for many non-U.S.  
22 Treasury securities falling regardless of their quality or fundamentals. In order to  
maintain liquidity, many investors were forced to sell high quality assets at  
depressed prices. This selling pressure occurred at the same time demand for  
non-U.S. Treasury securities was weakest, and as a result prices were driven  
down even further.

23 96. Investors in the Fund, however, could not anticipate from this Report that the  
24 Fund would continue to deviate from the Index. Among other things, the Prospectus dated  
25 September 15, 2007 had stated that "the Fund primarily invests in a diversified portfolio of debt  
26 investments that is designed to track the performance of the Lehman Brothers U.S. Aggregate  
27 Bond Index" and that "[y]our investment follows the bond market, as measured by the index.  
28 The fund is designed to follow the performance of the index during upturns as well as

1 downturns.” The November 15, 2007 Statement of Additional Information also reiterated that  
2 the Fund’s “investment objective is to attempt to provide a high level of current income  
3 consistent with preservation of capital by seeking to track the investments results of [the Index]  
4 through the use of an indexing strategy.”

5 97. In fact, the explanation given for the underperformance of the Index Fund  
6 compared to the Index, was the forced selling of securities into a weak bond market, rather than  
7 the violation of shareholders’ voting rights and the deviation of the securities in the Fund from  
8 the Index.

9 98. The Schwab Trust had informed investors in the 1997 Proxy Statement that  
10 some volatility in the Fund against the Index may not be totally avoidable, and that “if a  
11 tracking error develops, each Fund is rebalanced to help bring it in line with the Index.”

12 99. The Fund had also consistently tracked the Index for the prior decade since  
13 inception.

14 100. From 2002 until June 2008, Kimon Daifotis acted as the senior vice president  
15 and chief investment officer of the Investment Advisor, responsible for the overall management  
16 of the Fund. On June 13, 2008, Schwab Investments filed a Supplement to the Fund’s  
17 Prospectus dated November 15, 2007, stating that Jeffrey Mortimer was then responsible for  
18 the overall management of the Fund. No explanation was given by defendants, in the  
19 Prospectus or elsewhere, for replacing Daifotis as Fund Manager. Investors were not informed  
20 that Daifotis had engaged in an investment strategy that was inconsistent with shareholders’  
21 voting rights and the Fund’s stated investment objectives and policies.

22 101. The Fund’s underperformance against the Index continued subsequent to  
23 February 27, 2008 as the Schwab Advisor sought to liquidate the non-agency CMOs into a  
24 weak bond market for high risk securities. From August 31, 2007 through February 27, 2009,  
25 the Fund experienced a negative total return of 4.80% compared to a positive 7.85% total return  
26 for the Index – a total underperformance of 12.64% in absolute terms (including interest  
27 payments).

28

1           102. The Fund's shares had closed on August 31, 2007 at \$9.72 a share.  
2 Accordingly, the 12.63% differential in performance between the Index and the Fund is  
3 equivalent to damages per share of approximately \$1.23.

4           103. The Fund's deviation in performance from the Index was caused by the Fund's  
5 investment of 27.3% of assets as of February 27, 2008 in non-agency collateralized mortgage  
6 obligations ("CMOs").

7           104. The CMOs in the Fund's portfolio were not issued by government agencies.  
8 Rather they were issued by financial institutions through subsidiaries and backed by residential  
9 loans that did not conform to the agencies' high loan underwriting requirements.

10           105. Moreover, non-agency CMOs purchased by the Investment Manager for the  
11 Fund represented tranches of mortgage-backed securities, such as principal only or interest only  
12 payments, and were significantly more risky than the agency-issued mortgage-backed securities  
13 that were part of the Index. Included in the Fund's portfolio were CMOs sponsored by such  
14 subprime lenders as Citigroup, Merrill Lynch, Countrywide, Bear Stearns, IndyBank, Lehman,  
15 and Washington Mutual.

16           106. This concentration of investments in mortgage backed securities was also in  
17 violation of the Fund's stated investment objectives that the Fund's assets not be concentrated  
18 more than 25% in any one industry (except as required by the Index).

19           107. The composition of the Lehman Index is proprietary and not publicly available.  
20 However, subsequent analyses of other bond index funds that represent that they track the  
21 Lehman Bros. Aggregate Bond Index indicates that as of February 27, 2008, the Lehman  
22 Government Index had a 0% weighting in non-agency mortgage-backed securities, and a 37%  
23 weighting in agency mortgage-backed securities.

24           108. Moreover, according to the February 28, 2008 Semi-Annual Report, the Fund  
25 was invested 45.4% in agency and non-agency mortgage backed securities.

26           109. The Fund's investment in non-agency CMOs violated shareholders' voting  
27 rights and the Fund's fundamental investment objective to "seek to track" the Index "through  
28

1 the use of an indexing strategy.” The non-agency CMOs did not “closely approximate” the  
2 “characteristics” of the securities in the Lehman Index.

3 110. By November 30, 2008, the Index Fund had lessened its exposure to non-agency  
4 CMOs to 3.4% of total assets. The liquidation of the non-agency CMO portfolio into an  
5 illiquid bond market for risky securities coincided with the further deviation in performance of  
6 the Fund.

7 111. Defendants have taken the position, as stated in the Statement of Additional  
8 Information dated November 15, 2007, as amended June 13, 2008 , to justify the Fund’s over-  
9 concentration in non-agency mortgage-based securities and CMOs, that non-agency mortgage-  
10 backed securities “are not part of any industry for purposes of a fund’s concentration policy”:

11 Based on the characteristics of mortgage-backed securities, the funds have  
12 determined that mortgage-backed securities issued by private lenders and not  
13 guaranteed by U.S. government agencies or instrumentalities are not part of any  
14 industry for purposes of a fund’s concentration policy. This means that a fund  
15 may invest more than 25% of its total assets in privately-issued mortgaged-backed  
16 securities, which may cause the fund to be more sensitive to adverse economic,  
17 business or political developments that affect privately-issued mortgage-backed  
18 securities.

19 112. Defendants’ determination that non-agency CMOs were not part of an  
20 “industry” was unreasonable, in violation of shareholders’ voting rights, and inconsistent with  
21 the Fund’s stated investment policy that was only changeable by shareholder vote. Defendants  
22 recognized, as stated in the November 15, 2007 Statement of Additional Information, as  
23 amended June 13, 2008 (quoted immediately above), that the non-agency investments “may  
24 cause the fund to be more sensitive to adverse economic, business or political developments  
25 that affect privately-issued mortgage-backed securities” and accordingly should be classified as  
26 within one industry.

27 113. Agency and non-agency CMOs are routinely considered to be part of an  
28 “industry” because they derive their value from real estate holdings.

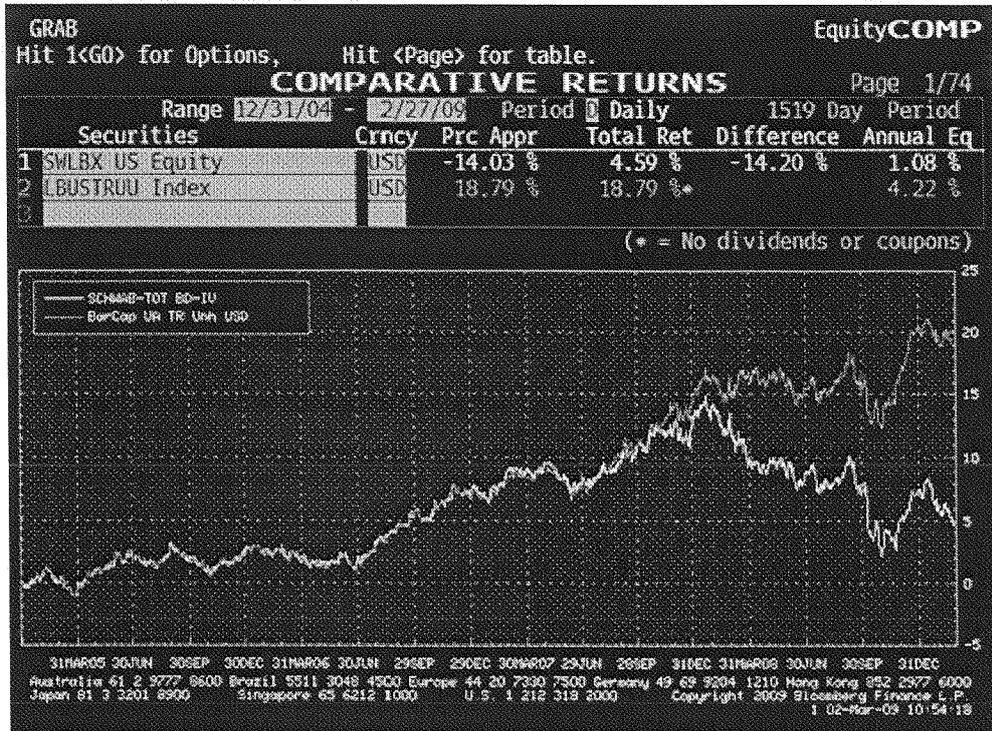
114. Consistent with the 1997 Proxy Statement, defendants were not allowed to  
defeat shareholder’s voting rights by creating unreasonable classifications of an “industry.”

1 115. The Fund's investment in CMOs were made at a time when there was increased  
 2 concern with the quality of mortgage lending.

3 116. For example, on June 28, 2007, the Department of the Treasury, Federal Reserve  
 4 System, Federal Deposit Insurance Corporation, and National Credit Union Administration,  
 5 issued a joint Statement on Subprime Mortgage Lending "to address subprime mortgage  
 6 products and lending practices."

7 117. The Fund's investment in non-agency CMOs at this time, in light of all  
 8 circumstances, was speculative, irresponsible and a gross deviation from the Fund's  
 9 fundamental investment policies and a breach of the defendants' fiduciary duties.

10 118. The attached chart, prepared on a Bloomberg terminal, comparing the Schwab  
 11 Fund's change in total return to the Lehman Index's change in total return over the period  
 12 December 31, 2004 through February 27, 2009, demonstrates how closely correlated the  
 13 Schwab Bond Fund was to the Index until approximately August 31, 2007 and how  
 14 dramatically the Bond Fund deviated thereafter from the Index through February 27, 2009.



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1 and the accuracy of Schwab Investments' SEC filings. The Schwab Trustees are responsible  
2 for discharging the obligations of the Trust. Schwab Investments and the Schwab Trustees  
3 were also responsible for preserving shareholders' voting rights and the Fund's compliance  
4 with its stated investment objectives. Schwab Investments and the Schwab Trustees had  
5 discretion to operate the Fund, subject to shareholders' voting rights and the Fund's stated  
6 fundamental investment policies, and Class members were reliant on Schwab Investments and  
7 the Schwab Trustees for the operations of the Fund.

8 123. The Trustees are liable to investors for gross negligence and reckless disregard  
9 of their obligations to protect shareholder interests and voting rights and to ensure that the  
10 Fund's assets were invested consistent with the Fund's stated fundamental investment  
11 objectives.

12 124. Schwab Investments and its Board of Trustees' fiduciary obligations to the Class  
13 were summarized in the Schwab Investments' Definitive Proxy Statement for the Fund, filed  
14 with the SEC on March 24, 2000, as follows:

15 The Board of Trustees is responsible for protecting the interests of the funds'  
16 shareholders. The Board meets regularly to review the funds' activities,  
contractual arrangements and performance.

17 125. Indeed, Charles Schwab, personally, in his letter to shareholders appended to the  
18 August 31, 2007 Annual Report filed by Schwab Investments with the SEC, on behalf of all  
19 Schwab-related entities, thanked the Fund's shareholders for "entrusting us with their assets."

20 126. Schwab Investments further acknowledged in its August 31, 2007 Annual  
21 Report to Shareholders that "as part of their fiduciary duties with respect to fund fees, fund  
22 boards are required to evaluate the material factors applicable to their decision to approve an  
23 investment advisory agreement."

24 127. The Schwab Advisor had control of the property of the investors and a disparity  
25 of sophistication and access to data about the composition of the Index and the Fund's  
26 securities holdings.

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1           128. The Fund’s prospectus explains that the Investment Advisor provided advisory  
2 services in that it utilized discretion and control to “oversee[ ] the asset management and  
3 administration of the funds.”

4           129. All defendants repeatedly assumed fiduciary obligations in SEC filings  
5 disseminated to shareholders and repeatedly thanked investors for placing their “trust” in  
6 Schwab. *See, e.g.*, Semiannual Report dated February 28, 2007 to Shareholders (Charles  
7 Schwab: “Thank you for placing your trust in SchwabFunds.”); Annual Report to  
8 Shareholders dated August 31, 1998 and Semiannual Report to Shareholders dated February  
9 28, 1999 (Charles Schwab: “We continue to do everything we can to warrant the trust you  
10 have placed in us.”); Annual Report dated August 31, 1999 (“We continue to do our best to  
11 warrant the trust you have placed in us.”); Semiannual Report dated February 28, 2002 (Charles  
12 Schwab: “Thank you for the trust that you have placed in SchwabFunds”); Annual Report,  
13 dated August 31, 2002 (Charles Schwab: “We appreciate your trust and will continue to work  
14 hard to earn it.”); Semiannual Report dated February 28, 2003 (Charles Schwab: “Your  
15 continued trust and support mean a great deal to us, and it’s our goal to respond to them by  
16 doing everything we can to help you meet your financial goals”; and Randall W. Merk  
17 (President and CEO of the Schwab Advisor): “Times of market volatility and uncertainty about  
18 world events seem to demand a heightened level of diligence on the part of investment  
19 professionals. At SchwabFunds we are keenly aware to this, and we’re working hard to uphold  
20 the best interests of our shareholders”); Semiannual Report dated February 27, 2004  
21 (Randall W. Merk: “[T]rust of our shareholders is very important to us, and we invest with  
22 your outcomes in mind. Thank you for investing with us, and once more I want to remind you  
23 that we operate our business with the highest ethical standards and an unwavering commitment  
24 to you.”); Annual Report dated August 31, 2004 (Charles Schwab: “[W]e recognize that your  
25 investment reflects the trust you have placed in those of us responsible for managing your  
26 wealth, and it is a responsibility that we assume with the utmost integrity.”; and  
27 Evelyn Dilsaver (President and CEO of the Schwab Advisor): “[“Y]our trust is very important  
28 to us and I will do all I can to earn and maintain that trust.”).

1           130. Undeniably, the Schwab Trust, the Schwab Trustees, and the Schwab Advisor  
2 owed Class members a fiduciary duty to manage the Fund's assets with the care and prudence  
3 of a professional in like circumstances and to adhere to the Fund's investment objectives and  
4 policies. Given the disparity of access to information and expertise in investment matters,  
5 Class members relied on the Schwab Trust's, the Schwab Trustees', and the Schwab Advisors'  
6 diligence and good faith.

7           131. Schwab Investments repeatedly stated that the Fund was "intended for investors  
8 seeking to fill the fixed income component of their asset allocation plan." The Investment  
9 Advisor was aware of that statement and recognized that Class members were relying on its  
10 management of the Fund.

11           132. The Schwab Trust, the Schwab Trustees, and the Schwab Advisor had actual  
12 knowledge that the funds safeguarded to Schwab for investment were of great significance to  
13 investors and would be used for such once-in-a-lifetime events as to purchase a first home, pay  
14 for college, or retirement.

15           133. Defendants acknowledge on the "Charles Schwab" website that Schwab  
16 Investments, by creating the Fund and recommending that the Fund be used in an investment  
17 plan "to fill the fixed income component of [investors'] asset allocation plan" were acting in a  
18 fiduciary capacity: "Professional investors consider creating an investment plan vital for  
19 performing their fiduciary duty to clients." See "Investing Principle 1: A Blueprint for  
20 Success," by Mark W. Riepe, CFA, Senior Vice President, Schwab Center for Financial  
21 Research, March 10, 2008.

22           134. Defendants breached their fiduciary duties to plaintiff and the members of the  
23 Class by the acts and omissions set forth above in violation of the shareholders' voting rights  
24 and the Fund's stated investment objectives, including the failure to require a majority  
25 shareholder vote prior to deviating from the Fund's stated fundamental investment objectives.

26           135. The Trustees, by failing to review the Fund's portfolio to ensure that it complied  
27 with the Fund's stated fundamental investment objectives that were only changeable by  
28 shareholder vote, acted with gross negligence and with reckless disregard of their obligations.



1           142. The Fund's shareholders accepted the terms of that contract by voting in favor  
2 of those fundamental investment policies.

3           143. Subsequent to the 1997 proxy vote, Schwab Investments continued to offer  
4 shares in the Fund pursuant to the terms of a contract that Schwab Investments would preserve  
5 shareholders' voting rights and cause the Fund to continue to adhere to its fundamental  
6 investment objectives and policies contained in the 1997 Proxy Statement and reiterated in  
7 Prospectuses and in Statements of Additional Information (as quoted above). Investors  
8 accepted the terms of that contract by purchasing shares in the Fund.

9           144. The terms of that contract are contained in the 1997 Proxy Statement, which  
10 established the contractual relationship between Schwab Investments and Class members, and  
11 were reiterated in Schwab Investments' subsequent SEC filings, including the January 15, 1998  
12 Prospectus, and in each subsequent Prospectus and Statement of Additional Information  
13 incorporated by reference into and made a part of the Prospectus.

14           145. The aforesaid provision constituted contractual terms, where existing investors  
15 retained shares and new investors purchased shares in consideration of the contractual  
16 obligations not to change fundamental investment objectives without a shareholder vote.

17           146. Plaintiff and the Class also relied on federal law for the terms of that contract.  
18 Section 8 of the Investment Company Act directs an investment company to recite in its  
19 Registration Statement "all investment policies of the registrant . . . , which are changeable only  
20 if authorized by shareholder vote," as well as all policies that "the registrant deems matters of  
21 fundamental policy." 15 U.S.C. § 80a-8(b) (2) & (3). Section 13 prohibits a registered  
22 investment company from deviating from any such policies "unless authorized by the vote of a  
23 majority of its outstanding voting securities." 15 U.S.C. § 80a 13.

24           147. Schwab Investments violated the terms of the contract with the Fund's  
25 shareholders as set forth in the 1997 Proxy Statement and subsequent prospectuses and SAIs, as  
26 more fully described above, by directing the purchases or allowing the Schwab Advisor to  
27 direct the purchases of securities that deviated from the composition of the Lehman Brothers  
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1 U.S. Aggregate Bond Index and caused the Fund to concentrate more than 25% of its net assets  
2 in mortgage backed securities, including CMOs, without a shareholder vote.

3 148. By virtue of the wrongful conduct of defendants, plaintiff and the members of  
4 the Class sustained injury to their voting rights and money damages in connection with their  
5 ownership of shares in the Fund.

6 **THIRD CAUSE OF ACTION**

7 **FOR BREACH OF COVENANT OF GOOD FAITH AND FAIR DEALING**  
8 **(ON BEHALF OF THE CLASS AGAINST THE TRUST AND THE INVESTMENT**  
9 **ADVISOR DEFENDANTS)**

10 149. Plaintiff repeats and realleges the allegations contained in the foregoing  
11 paragraphs as if fully set forth herein. This Count is asserted on behalf of members of the Class  
12 for breach of the covenant of good faith and fair dealing.

13 150. Defendants have a common law duty of good faith and fair dealing with respect  
14 to investors in the Fund.

15 151. Defendants, in violation of the covenant of good faith and fair dealing, engaged  
16 in speculation with the Fund's assets by investing more than 25% of the Fund's total assets in  
17 CMO securities that were not contained in the Lehman Index, and engaged in such speculation  
18 without a shareholder vote.

19 152. By virtue of the wrongful conduct of defendants, plaintiff and the members of  
20 the Class sustained money damages in connection with their ownership of shares in the Fund.

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**FOURTH CAUSE OF ACTION**

**THIRD PARTY BENEFICIARY OF THE INVESTMENT ADVISORY AGREEMENT  
(ON BEHALF OF THE CLASS AGAINST THE INVESTMENT ADVISOR)**

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3 153. Plaintiff repeats and realleges the allegations contained in the foregoing  
4 paragraphs as if fully set forth herein.

5 154. The Investment Advisor managed the investments of the Fund pursuant to an  
6 Investment Advisory Agreement between the Investment Advisor and Schwab Investments.

7 155. The Investment Advisory Agreement required the Investment Advisor, among  
8 other things, to manage the Fund consistent with the Fund's fundamental investment objectives  
9 and policies.

10 156. The Investment Advisory Agreement between the Schwab Investment Manager  
11 and the Schwab Trust unambiguously charged the Investment Advisor with performing "all  
12 aspects of the operations of the Schwab Funds," which included, but were not limited to:  
13 determining "what securities and other investments will be purchased, retained or sold" by the  
14 Fund; furnishing statistical and research data; preparing the Trust's Annual and Semi-Annual  
15 Reports to shareholders and amendments to its Registration Statements; preparing and filing  
16 Notices with the SEC; keeping and maintaining the financial accounts and records of the Fund;  
17 "generally assist[ing] in all aspects of the operations of the" Fund; and complying "with all  
18 applicable Rules and Regulations of the SEC." The Advisory Agreement also requires the  
19 Investment Advisor to comply with the provisions of the Investment Company Act of 1940 in  
20 buying or selling any portfolio securities.

21 157. Thus, the Advisory Agreement conferred broad obligations upon the Investment  
22 Advisor with respect to the overall management of the Fund – the most fundamental of which  
23 would include management of the Fund in accordance with the Fund's fundamental investment  
24 objectives and policies. It would make little, if any, sense, if the Investment Advisor was free  
25 to deviate from the Fund's fundamental investment objectives during its management of the  
26 Fund.

1           158. The Trust appended a copy of the Investment Advisory Agreement to an  
2 amendment to the Trust's Registration Statement dated December 29, 1997 precisely to inform  
3 class members of its terms.

4           159. The Investment Advisory Agreement provided that it "shall be governed by the  
5 laws of the State of California."

6           160. Defendant Merk routinely wrote letters to the Fund's shareholders contained in  
7 the Fund's annual and semiannual reports and addressed the Fund's shareholders as "Dear  
8 Shareholders."

9           161. In a letter to shareholders in the Schwab Trust's August 31, 2005 Annual Report  
10 to Shareholders, defendant Charles Schwab emphasized the direct obligations and commitment  
11 of the Schwab Investment Managers to the shareholders of the Schwab mutual funds:

12           Schwab Funds is managed by Charles Schwab Investment Management, Inc.,  
13 one of the largest mutual fund managers in the U.S. Our portfolio managers  
14 share a passion for market analysis and use some of the most sophisticated  
15 financial models in the country. I am proud of their depth of experience, which  
16 reflects an average tenure of more than 15 years in the investment industry.  
17 *Furthermore, I am impressed with the commitment that our managers bring to  
18 the stewardship of the funds, for you, their shareholders.* [Emphasis added.]

19           162. The shareholders of the Fund were known and intended third party beneficiaries  
20 of the Investment Advisory Agreement.

21           163. Inasmuch as Schwab Investments issued and redeemed shares of the Fund on a  
22 daily basis at its reported NAV, if the Investment Advisor managed the Fund in a manner that  
23 was inconsistent with the Fund's fundamental investment objectives, the Fund's shareholders  
24 would be subject to direct financial injury.

25           164. The Investment Advisor breached the terms of its Investment Advisory  
26 Agreement with Schwab Investments by violating shareholders' voting rights and failing to  
27 manage the Fund's assets in a manner consistent with the Fund's fundamental investment  
28 objectives by investing in securities, including non-agency CMOs, which deviated from the  
securities contained in the Index, and by concentrating greater than 25% of the Fund's assets in  
non-agency CMOs.

1           165. Class members suffered actual and direct financial damages and injury to their  
2 voting rights, as a result of the Investment Advisor's failure to manage the Fund's assets in a  
3 manner consistent with the Fund's fundamental investment objectives and policies.

4           WHEREFORE, plaintiff prays for relief and judgment, as follows:

5           A. Determining that this action is a proper class action and certifying plaintiff  
6 Northstar as a representative of the Class under Rule 23 of the Federal Rules of Civil  
7 Procedure;

8           B. Appointing Wolf Popper LLP and Greenbaum Rowe Smith & Davis LLP as  
9 Class Counsel;

10          C. Awarding compensatory damages in favor of plaintiff and the members of the  
11 Class against all defendants, jointly and severally, for all damages sustained as a result of  
12 defendants' wrongdoing, in an amount to be proven at trial, including interest thereon;

13          D. Disgorging from defendants for the benefit of the Class any management or  
14 other fees forfeited by Defendants' deviation from the Fund's fundamental investment  
15 objectives;

16          E. Directing the defendants to preserve shareholders' voting rights and comply  
17 with the Fund's fundamental investment objectives;

18          F. Awarding plaintiff and the Class their reasonable costs and expenses incurred in  
19 this action, including counsel fees and expert fees;

20          G. Awarding recessionary damages; and

21          H. Such equitable, injunctive or other relief as deemed appropriate by the Court.

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**JURY DEMAND**

Plaintiff hereby demands a trial by Jury.

Dated: September 28, 2010

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