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# Schwab Managed Account Services™

## Disclosure Brochure

for Clients of Schwab Investor Services

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This wrap fee program brochure provides clients with information about Charles Schwab & Co., Inc. and certain of its managed account programs that should be considered before you become a client of these services. If you have any questions about the contents of this brochure, please contact your Schwab investment professional or call us at 1-800-435-4000. This information has not been approved or verified by any governmental authority.

Additional information about Schwab is also available on the SEC's website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

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## Services, Fees and Compensation

### Introduction

This brochure describes the following managed account programs provided by Charles Schwab & Co., Inc. ("Schwab") for clients of its Schwab Investor Services enterprise: the Managed Account Select® ("Select") program and the Managed Account Connection™ ("Connection") program (Select and Connection are each referred to as a "program").

The Select program allows you to select one or more money managers ("MMs") to manage your account pursuant to a stated investment strategy. These MMs and their investment strategies are evaluated and monitored by Charles Schwab Investment Advisory, Inc. ("CSIA"), an affiliate of Schwab. The MMs in the Select program are not affiliated with Schwab.

The Connection program is a managed account program which includes the following MMs: Charles Schwab Investment Management, Inc. ("CSIM") and Windhaven Investment Management, Inc. ("Windhaven"), both of which are affiliates of Schwab, and Pacific Investment Management Co. LLC ("PIMCO"), which is not affiliated with Schwab. The investment strategies in the Connection program are not evaluated for inclusion in the program by CSIA, although CSIA provides limited due diligence assistance to Schwab with respect to PIMCO.

In each program, an MM manages the investment portfolio in your account (referred to as a "managed account") on a discretionary basis. This means that the MM determines which assets to buy, hold, and sell, subject to any permissible restrictions you may impose on your account. You pay an asset-based fee to participate in each program. The fee covers services provided by Schwab, including the services of a representative to assist you with evaluating and implementing the programs, the custody of securities in your portfolio, the execution of transactions in equity securities by Schwab and the administration of the programs, as well as the discretionary asset management services provided by the MMs. The representative assisting you is normally a Schwab representative, but may also be, in the case of managed accounts grouped at your request with accounts enrolled in the Schwab Private Client™ non-discretionary wrap fee program ("SPC"), employees of Schwab's affiliated investment advisor, Schwab Private Client Investment Advisory, Inc. ("SPCIA"). Collectively, all such representatives are referred to in this brochure as "SRs." The fee does not cover trades executed by broker-dealers other than Schwab in the Select or Connection programs; Schwab is the only broker-dealer used to execute transactions for equity strategies managed by CSIM in the Connection program. Schwab generally will route orders for equity securities to UBS Capital Markets, L.P. or UBS Securities LLC. In addition to the program fees, Schwab may receive separate compensation for some transactions and services as described below. Clients of the programs may include individuals, trusts, charitable organizations, pension and profit-sharing plans, investment clubs, corporations and other business organizations.

The Select and Connection programs are sponsored by Schwab. In the Select program, Schwab selects the MMs and investment strategies that are available in the Select program and monitors the MMs' performance periodically, although you are responsible for monitoring individual transactions in your account. In the Connection program, CSIM utilizes Schwab Equity Ratings® which are provided by Schwab, for CSIM's equity strategies. The Connection program also includes Windhaven Portfolios® managed by Windhaven® and municipal bond ladder strategies managed by PIMCO.

For both programs, Schwab provides custody, execution, reporting, program administration and related services for client accounts. An SR assists you in determining your investment objectives and asset allocation, the program(s) in which to participate and which MMs and investment strategies to select for your accounts. After you open a managed account, an SR will review with you the MMs' performance and your asset allocation at least once a year (or more frequently if necessary because of a change in your situation or investment objectives).

### MM Asset Management Services

Your selection of an MM to manage your account is subject to acceptance by the MM. An MM may decline to manage your account based on your investment objectives, financial situation, requested investment restrictions or other matters. If the MM accepts management of your account, the MM you select will provide discretionary investment advisory services for your account and will be responsible for all investment decisions in your account (except for any reasonable restrictions you may impose on the management of your account, as described below). You will authorize the MM you select to manage your assets on a discretionary basis by purchasing and/or selling individual stocks, bonds, money market instruments, money market funds, or other instruments as and when the MM sees fit without your approval of each transaction. In managing your account, the MM will employ the investment strategy you have chosen for your account. Each MM and its investment strategies are described in the MM's brochure and its MM Profile (see "Information About MMs"). The MM's discretionary authority will remain in full force and effect, even if you become incompetent or disabled, unless revoked or terminated by you in a written notice to Schwab. In your client account application, you agree not to effect trades in your account while an MM is managing the account, and you may be blocked from placing any trades in your account. You should not attempt to place trades in your account unless and until you terminate your MM's authority by giving Schwab at least two business days' notice. MMs are not authorized to withdraw or transfer any money, securities or other property either in your name or otherwise, except as necessary to pay for or execute transactions in your account.

In filling out your client account application, you will provide information about yourself and your investment objectives. Schwab will forward to any MM you designate a copy of your client account application.

You will have the opportunity to impose reasonable restrictions on the management of your account. You may request that specified securities or, in some cases, categories of securities not be purchased for your account, but your MM may decline your requested restriction if your MM deems it unreasonable. The MM managing your account is responsible for implementing and monitoring any restrictions you place on the management of your account. Accounts with investment restrictions may perform differently than accounts without restrictions; performance may be lower or higher for accounts with restrictions than those without restrictions. Since the MM's performance composite typically does not include accounts with restrictions, if your account does have restrictions, then the performance of your account may be different than the MM's performance composite.

Working with an SR, you may have the opportunity to instruct the MM to realize gains or losses in your account for tax reasons. This may include the sale of positions with unrealized losses/gains above a certain amount, or the sale of specified securities. The MM will use reasonable efforts to implement your request to harvest tax losses or gains.

In any and all transactions effected by or through Schwab in your account, Schwab is acting exclusively as a broker-dealer, and not as an investment advisor. Any MM you select is responsible for managing your account under the applicable program in a manner consistent with that MM's stated investment strategy, subject to any reasonable restrictions imposed by you. Schwab is not responsible for the MM's performance, its adherence to its investment strategy or your restrictions, its compliance with applicable laws and regulations, or other matters within the MM's control.

You may contact an MM directly, although it is generally expected that you will direct questions concerning your account to an SR, and that any contact you have with an MM will be facilitated by an SR. You may change MMs or investment strategies, or switch an account from one program to another, at any time by submitting the form prescribed by Schwab for that purpose. An MM also may terminate a relationship with you at any time upon 30 days' notice to you and Schwab.

## SR Services—Change in Your Circumstances

Subject to the availability of the programs to certain account types, an SR will help you determine whether either or both of the programs are appropriate for you, as well as assist you in selecting a particular investment strategy and MM. In deciding whether to participate in the programs, you should review with an SR your financial situation, asset allocation, investment objectives, risk tolerance and time horizon.

If material changes occur to your financial circumstances or investment objectives, or you wish to impose or modify restrictions on the management of your account, you should promptly inform an SR. The SR will respond to your questions and meet with you at least once a year to discuss with you whether the management of your account continues to reflect your investment objectives and financial requirements. Your SR will communicate such information as necessary to the MM managing your account.

## Schwab's Execution Services

The program fee covers execution of equity orders, including exchange-traded funds ("ETFs"), by Schwab, as well as execution of fixed income orders by Schwab on an agency basis, but the program fee does not include execution of orders by Schwab as principal in fixed income securities in the Select program. (In the Connection program, CSIM and Windhaven® do not have fixed income strategies, and PIMCO will generally use broker-dealers other than Schwab for fixed income transactions.) "Principal trades" are trades in which a firm like Schwab sells securities from its own account to a client account or purchases securities for its own account from a client account. When Schwab or another firm acts as principal for its own account, it accepts the risk of market price and liquidity fluctuations when executing customer orders, and attempts to profit from the bid-ask spread for equity transactions and from dealer markups and markdowns for bond transactions.

### Execution of Transactions in Equity Securities

Because the program fee covers execution of orders in equity securities only when executed through Schwab, MMs place most of their orders for the purchase or sale of equity securities (including ETFs) with Schwab; for Connection equity strategies managed by CSIM, you agree in your account application that CSIM will only use Schwab to execute all brokerage transactions (which means you may not receive as high a quality of execution if CSIM used broker-dealers other than Schwab). Schwab generally will route orders for equity securities to UBS Capital Markets, L.P. or UBS Securities LLC (together, referred to as "UBS"), which are not affiliated with Schwab.

Pursuant to an agreement between Schwab's parent company, The Charles Schwab Corporation ("CSCorp"), and UBS, UBS manages the execution of most types of equity, ETF and options trade orders for which customers have not provided specific instructions, and order routing services for most types of directed orders.

Exchanges and broker-dealers frequently offer rebates for customer orders routed to them for execution. Although Schwab does not receive rebates or other payments from UBS, part of the consideration CSCorp received for the sale of its capital markets business to UBS in 2004 related to the services agreements with UBS and Schwab's commitments to route most types of equity, ETF and listed options orders through UBS.

UBS routing and execution services are subject to Schwab's execution quality standards for seeking best execution. In certain circumstances, Schwab itself may route orders directly to a market for execution. Schwab considers a number of factors in evaluating execution quality, including execution price and opportunities for price improvement, market depth and order size, the trading characteristics of the security, speed and accuracy of executions, the availability of efficient and reliable order handling systems, and service levels and the cost of executing orders at a particular market or firm. Price improvement occurs when an order is executed at a price more favorable than the displayed national best bid or offer, and may be available for stocks and ETFs traded on the exchanges and dealer markets, and for listed options.

Schwab regularly monitors the execution quality provided by UBS and the various markets to which UBS and Schwab may route orders, to ensure orders are routed to markets that have provided high-quality executions over time.

### Execution of Transactions in Fixed Income Securities

Fixed income securities generally trade in dealer markets, but some corporate bonds also trade on national securities exchanges. If a fixed income security is traded in the dealer markets, Schwab generally will execute an order for a Select account as principal, unless the MM directs Schwab to execute the orders as agent. The principal transactions include a dealer markup or markdown by Schwab (not included in the program fee). Schwab expects that any MM placing an order for fixed income securities through the Select program will seek quotations from other dealers as well as Schwab. If an MM places an order for fixed income securities with Schwab, Schwab will seek the best price reasonably available at that time by searching our Schwab BondSource® ("SBS") electronic inventory and trading system. Schwab uses SBS except on rare occasions (e.g., for very large orders) in an effort to achieve a better price for clients. SBS accesses an extensive inventory of fixed income securities from Schwab and a network of hundreds of other broker-dealers whose fixed income inventories are included in SBS.

As MMs seek best execution based on net price and other factors, they have the ability to place orders for fixed income securities with dealers other than Schwab. Most MMs managing fixed income investment strategies have advised Schwab that they anticipate placing most of their fixed income orders with dealers other than Schwab (which may include a markup or markdown by those dealers not included in the program fee).

When an MM buys a new bond issue for your account through Schwab acting as principal, Schwab receives a syndicate fee (also known as a dealer concession) which ranges from less than 0.01% to 2% of the par value, or face amount, of the bond, depending on the particular bond issue. The dealer concession is a standard custom and practice regarding payment to syndicate members for distributing, and for providing certain operational services associated with, new issues. Schwab as a dealer receives the same amount for any given new issue as other dealers participating in the same tier of the syndicate, and every new issue buyer (the customer) pays the same price no matter from which dealer a purchase is made.

In the Connection program, PIMCO will generally execute fixed income transactions (in municipal securities) with dealers other than Schwab (although PIMCO is not precluded from executing transactions with Schwab, and Schwab is not precluded from acting as principal in those transactions). Clients will be responsible for any related transaction costs, including, but not limited to, markups or markdowns charged by such other broker-dealers.

### Trades Through Other Broker-Dealers

The program fee does not cover commissions for agency trades that an MM places with a broker-dealer other than Schwab, or markups or markdowns charged by those other broker-dealers on principal trades. (The program fee does cover commissions for equity trades routed by Schwab to UBS.) MMs, therefore, will have an incentive to execute most transactions in equity securities through Schwab. This incentive could, in some circumstances, conflict with an MM's duty to obtain best execution of transactions in your account. However, an MM (other than CSIM) may execute trades through other broker-dealers when required by applicable law or when an MM reasonably believes that another broker-dealer will provide better execution, net of any additional resulting transaction charges, than would be the case if the transaction were executed through Schwab. With regard to fixed income and bond ladder strategies, most MMs will generally place transactions with other dealers acting as principal. Such dealers will receive a markup or markdown that is not included in the program fee. Because such transactions would be subject to markups and markdowns outside of the program fee if placed through Schwab or another dealer, this conflict does not arise in connection with trades by these MMs.

In addition to cost considerations, an MM may consider various other factors in its best-execution analysis as described in the MM brochure,

including the liquidity of the security and the need for timely execution. Other broker-dealers may provide an MM with brokerage and research services, as disclosed in the MM's brochure. To be eligible to receive a trade from an MM for your account, the other broker-dealer must have an agreement with Schwab under which Schwab will clear and settle transactions executed by that broker-dealer, or the MM must have agreed to use an electronic system to issue settlement instructions to Schwab for trades executed by other broker-dealers. This is described in more detail under the heading "Prime Brokerage, Step-In and Trade-Away Services" in your Schwab account application agreement.

### **Aggregation of Transactions**

Your MM may aggregate or bunch transactions for your account with transactions for other clients for execution purposes under appropriate circumstances. For these purposes, other clients may include clients of the same MM under another Schwab bundled fee program. In addition, if an MM executes trades with another broker-dealer (as described above), other clients may include additional clients of the MM not participating in any Schwab program or service. This practice will not ordinarily affect or otherwise reduce the costs charged to your account for those transactions. The transactions (as well as any expenses incurred in transactions effected through other broker-dealers) will be allocated according to the MM's policies governing aggregation and allocation of transactions. These policies may require your MM to assign to your account the average price resulting from the aggregated trades. Your MM may allocate partial fills of a block security transaction among clients' accounts randomly, pro rata based on the size of the account, or under some other policy adopted by your MM. Your MM's trade allocation policies may result in certain clients paying higher or lower prices for securities than may otherwise have been obtained if the transactions had been executed separately. Additional information about an MM's policies for aggregation and allocation may be contained in the MM's Form ADV brochure ("MM brochure").

Transactions may be executed for your account through Schwab at different times, in different markets and at less advantageous prices than applicable to trades for other clients of your MM with the same strategy. An MM may have policies and procedures that determine when it will send trades in the program to Schwab in relation to sponsors of other separately managed account programs or other broker-dealers selected by the MM. The MM may include disclosure about its policies and procedures in its MM brochure.

Some MMs, such as the overlay manager for a Diversified Portfolio strategy, may manage accounts based on recommendations or a model portfolio received from another money manager (the "model provider"). In such cases, trades for your account may be placed by an MM at different times, and may be executed in different markets and at less advantageous prices, than trades for accounts with the same strategy managed directly by the model provider. These differences may result from the application of the model provider's policies and procedures in addition to the MM's trading policies and procedures.

### **Custody**

Schwab acts as sole custodian for all assets in client program accounts and performs all custodial functions customarily performed for securities brokerage accounts, including crediting of interest and dividends on account assets. You will retain ownership of all cash, securities and other instruments in your account. The program fee compensates Schwab for these services. If you have accounts and assets at Schwab that are not in the programs, any fees you are charged for the maintenance of such accounts, for custody of assets and for other account-related services will be separate from and in addition to your program fee.

### **Reporting**

Schwab will send you a monthly account statement detailing positions and activity in your account during the preceding month. The statement will include a summary of all transactions made on your behalf, all contributions and withdrawals made to or from your account, all fees

and expenses charged to your account, and the value of your account at the beginning and end of the period. The statement may be based upon information obtained from third parties. Schwab believes that the data obtained from these third parties is accurate, but has no independent means of verifying and cannot guarantee such accuracy. You also will receive a separate confirmation of each transaction, unless you elect to receive a quarterly report containing confirmation information for trades occurring during that calendar quarter. Schwab is not responsible for reviewing transactions in, or the value of, your account.

A third party will calculate investment performance for your account. You will receive this performance information quarterly (with exceptions for Windhaven Portfolios® noted immediately below). Schwab believes that the data obtained from the third party is accurate, but does not independently verify and is not responsible for its accuracy.

MMs may provide performance information directly to you; however, that information may not be calculated on a uniform and consistent basis, and Schwab does not review that information and is not responsible for its accuracy.

### **Program Fee**

Schwab charges an asset-based fee for the services provided by Schwab and the MMs. The following table shows the fee schedule expressed as an annual rate; the program fee is charged to your account on a quarterly basis. The program fees are negotiable based on a number of factors that may result in a particular client paying a fee that is less than the standard fees; SRs with accounts in the programs receive a discount. From time to time, Schwab may also reduce or eliminate the program fee for particular clients or groups of clients as a result of promotional offers. The exact fee schedule that will apply to your account is specified in your Schwab account application and any amendments. Schwab may change the fee schedule applicable to your account by notice to you in accordance with your account application and your Schwab account agreement.

Your account is assigned to a fee category based on the asset type(s) of the managed account (e.g., equity, Diversified Portfolios, fixed income [other than bond ladders], bond ladders or Windhaven Portfolios) you have chosen. (Preferred stock strategies are charged according to the same fee category as fixed income strategies.) The program fee is blended for assets in the same category—i.e., as the market value of your accounts in the same category reaches a higher breakpoint, as set forth below, the assets within each breakpoint category are charged a lower rate. Schwab will calculate your quarterly program fee by multiplying the daily value of the assets in your account for each calendar day in the quarter by the applicable daily fee rate (i.e., the annual rate divided by the number of days in that year) and then adding together the fee for each calendar day in the quarter. On the last business day of each quarter, Schwab estimates the value of your account assets by using the asset values of the account on the next-to-last business day of that quarter. Because the program fee is billed to your account quarterly rather than yearly, the fee you pay on an annual basis may be higher than the annual rate due to the effects of compounding.

If you enroll an existing Schwab account in Windhaven Portfolios that Windhaven® was already managing for you outside of the Connection program, your account will be billed differently than described above in the first calendar quarter of your enrollment: (1) the program fee for Windhaven Portfolios—and not the fee you previously paid to Windhaven outside of the Connection program—will apply for the entire quarter even if your account was only enrolled for a portion of that quarter; (2) the program fee will be billed to your account up to two weeks after the end of the first calendar quarter of your enrollment; (3) the program fee will be calculated by applying the annual rate to the asset value of your account on the last business day of that first quarter and then dividing that multiple by four; and (4) you will not be able to group an account previously managed by Windhaven at Schwab outside of the Connection program with other accounts for purposes of achieving fee breakpoints for that first quarter of enrollment. If you make a cash withdrawal from



or contribution to your account during that first quarter of \$50,000 or more, the fee calculation will be adjusted accordingly. After the first quarter of your enrollment in the Connection program, the fee for your Windhaven Portfolios® account will be calculated as described in the prior paragraph.

#### Managed Account Select® and Managed Account Connection™ Program Fees

	Tier Chargeable Assets	Equity Strategy Annual Rate	Diversified Portfolios Annual Rate	Fixed Income Strategy (Non-Ladder) Annual Rate	Municipal Bond Ladder Strategy Annual Rate	Windhaven Portfolios Annual Rate
Tier						
1	Amounts up to \$500,000	1.35%	1.10%	0.65%	0.35%	0.95%
2	Next \$500,000 (over \$500K up to \$1M)	1.33%	1.05%	0.60%		0.90%
3	Next \$1 million (over \$1M up to \$2M)	1.30%	1.00%	0.57%	0.30%	0.80%
4	Next \$3 million (over \$2M up to \$5M)	1.25%	0.95%	0.55%		
5	Next \$5 million (over \$5M up to \$10M)	1.10%	0.90%	0.50%	0.25%	0.70%
6	Assets over \$10 million	1.05%	0.85%	0.45%		

#### Account Grouping

Your program accounts that are subject to the same fee schedule (i.e., equity, Diversified Portfolios, fixed income [other than bond ladders], bond ladders or Windhaven Portfolios) may be grouped together to achieve lower fee breakpoints. This is referred to as an "Account Group." An Account Group may also include program accounts of your (1) spouse; (2) parents, grandparents and great-grandparents; (3) children, grandchildren, great-grandchildren and their spouses; (4) siblings and their spouses; and (5) an individual whose relationship to you, while not listed in the foregoing, is similar to one of the enumerated relationships. Individual Retirement Accounts ("IRAs"), Roth IRAs and Education IRAs, as well as Simplified Employee Pension IRAs ("SEP-IRAs"), Savings Incentive Match Plan for Employees IRAs ("SIMPLE IRAs"), and other personal retirement accounts generally may be aggregated for this purpose. However, other retirement plan accounts subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as well as charitable remainder trusts, may not be included unless they have identical account registrations. The accounts that may be included in an Account Group are subject to negotiation (except ERISA accounts) and Schwab's approval.

If you have elected to combine your managed accounts into an Account Group, Schwab calculates your fee by totaling the market value of your accounts within the Account Group in each asset category (for example, all equity strategy accounts) and charging those accounts according to the applicable fee schedule. The fee is then allocated on a pro rata basis to each account in that asset category. Each account's pro rata amount is calculated by computing the market value of each account as a percentage of the total market value of all accounts within the Account Group under that asset category fee schedule.

#### Account Minimums

If the market value of your account falls significantly below the specified minimum due to your withdrawal of assets from the account, Schwab may require you to deposit additional money or securities to bring the account up to the required minimum, or Schwab reserves the right to close the account.

#### MM's Compensation

Under Schwab's agreements with the MMs in both programs, Schwab pays each MM for the discretionary investment advisory services it provides. The fees paid by Schwab to MMs range between 0.35% and 0.50% of assets under management for equity investment strategies, between 0.40% and 0.45% for Diversified Portfolios, between 0.20% and 0.40% for fixed income investment strategies (other than bond ladders), 0.15% for bond ladder investment strategies, and 0.35% for Windhaven Portfolios. The MM's fee rate will generally become lower as total program assets managed by the MM reach certain levels, although some MMs may be paid on a fee schedule that does not include breakpoints. MMs may pay Schwab to participate in seminars organized by Schwab and attended by Schwab Representatives, clients or investment advisors doing business with Schwab Advisor Services (which serves independent investment advisors and includes the custody, trading and support services of Schwab). MM participation in these seminars is not required by Schwab.

Under a separate agreement between Schwab and CSIM, CSIM pays Schwab an annual fee of \$250,000 to obtain the Schwab Equity Ratings® from SCFR.

#### Services Covered by the Program Fee

The program fee covers the MM's asset management services, as well as the following services provided by Schwab: (1) execution of transactions in equity securities, ETFs, exchange-traded notes ("ETNs") and agency transactions in fixed income securities; (2) custody of account assets; (3) program administration; (4) monthly account statements; (5) quarterly performance reports; and (6) the services of an SR relating to program accounts.

The program fee covers trade executions for transactions in equity securities executed through Schwab as agent (Schwab does not execute equity transactions as principal for either program). The program fee does not include (i) execution of transactions in fixed income securities by Schwab as principal or (ii) execution of transactions in securities by other broker-dealers. CSIM will not use broker-dealers other than Schwab for equity or ETF trades.

#### Other Charges and Compensation

Trades in fixed income securities executed by Schwab as principal and trades executed with other broker-dealers will involve transaction charges in addition to the program fee. When Schwab or another broker-dealer executes a trade as principal, Schwab or the other dealer will realize the customary dealer profits or losses on the trade. If the other broker-dealer is acting as principal, that broker-dealer may include a markup or markdown in the price at which the transaction is effected. Schwab also will charge a markup or markdown on transactions executed as principal in fixed income securities for Select accounts. When a trade is executed by your MM with another broker-dealer, you may pay additional compensation to that broker-dealer, which may include markups, markdowns, commissions and dealer profits. Any dealer profit, commission, markup or markdown on principal trades will be separate from and in addition to, and will not reduce or otherwise offset, the program fee for your account.

The program fee does not cover certain costs or charges imposed by third parties, including odd-lot differentials, American Depositary Receipt fees, exchange fees and transfer taxes mandated by law. Schwab also may impose additional charges for special services elected by you or an MM, including periodic distribution fees, electronic funds and wire transfer fees, certificate delivery fees, and reorganization fees.

Schwab and CSCorp also may receive indirect economic benefits, in addition to the program fee, if assets in your accounts are held as cash balances earning Schwab One® taxable interest or if trades are executed by a market center in which CSCorp owns an interest.

If you choose a strategy that invests in closed-end funds, mutual funds, ETFs or ETNs (collectively, “Funds”), you may in effect be paying two fees for asset management or investment services. You will pay your pro rata share of a Fund’s fees. Funds pay investment advisory, administrative, distribution, transfer agent, custodial, legal, audit, and other customary fees and expenses. The Fund bears these fees, but you ultimately bear your share of these fees as a Fund shareholder. Mutual fund fees are disclosed in the Fund’s annual and semiannual report or other materials, which may be available on the Fund’s website or through your investment advisor. You also will pay the program fee on assets invested in Funds. Mutual funds available through one of the strategies in the programs may also be available directly from the mutual funds pursuant to the terms of their prospectuses and without paying the program fee (although most funds are designed specifically for use with the MM’s managed account strategy and are generally not available otherwise), and closed-end funds and ETFs are available outside of the programs without paying the program fee, subject to applicable commissions and/or transaction charges.

MMs that have Affiliated Funds in their strategies may have a conflict of interest in deciding whether to purchase and hold shares of those Funds in client accounts, because MMs or their affiliates may earn fees from those Funds. MM Affiliated Funds may pay the MM and/or their affiliates for investment advisory, administrative and transfer agency services, as well as shareholder and other Fund services (collectively, “Fund Services”). Certain MM Affiliated Funds developed for use with an MM’s separate account strategies may have arrangements whereby they do not pay any advisory or administrative fees to the Fund manager or sponsor. Please refer to the Fund’s prospectus and statement of additional information for more information on fees.

It is possible that MM strategies that use Funds may buy, hold or sell shares of Schwab Affiliated Funds, which may include mutual funds or ETFs that are affiliated with Schwab. (CSIM and Windhaven® will not buy ETFs affiliated with Schwab [“Schwab ETFs”] for retirement accounts.) Schwab or its affiliates may receive fees and other compensation from Schwab Affiliated Funds for Fund Services. In addition, mutual funds that are available in the Schwab Mutual Fund Marketplace® (or their affiliates) pay Schwab fees for recordkeeping, shareholder services and/or other administrative services.

Even if you don’t choose a closed-end fund or ETF strategy, it is possible that your MM may decide to buy an ETF for your account with cash that is awaiting investment. This might occur with a subsequent contribution by you to your account after account opening or during the 30-day wash sale period with respect to sale proceeds resulting from a tax-harvesting request. Please see “Investment in Affiliated and Other Funds.”

### **Payment of Program Fees and Other Charges**

The program fees will be deducted from your account on the last business day of the quarter. Other charges are deducted from your account when they are incurred. The program fees and other charges are payable from free credit balances, if any, in your account. If there are no free credit balances in your account, Schwab may redeem money market fund shares in your account to cover the charges or notify you to deposit additional funds into your account. Schwab reserves the right to liquidate at any time a portion of the other assets in your account to cover the program fee or other charges. Liquidation may affect the relative balance of your account and also may have tax consequences. Schwab may withhold any tax to the extent required by law, and may remit the tax to the appropriate governmental authority.

### **Valuation**

For purposes of calculating the program fees, Schwab will value a security listed on a national securities exchange or NASDAQ as of the valuation date at the closing or last sale price on the principal market where

the security is traded. Schwab will value any other securities or investments in your account in a manner determined in good faith to reflect fair value. The actual prices at which you could buy or sell the securities may be different from the prices used to calculate the fee. Any such valuation is not a guarantee of the value of the assets in your account. In computing the value of securities in your account, Schwab may use a pricing service or other independent evaluator, as well as other independent sources. While Schwab believes these sources to be reliable, Schwab does not verify them or guarantee their accuracy.

### **Amount of Fees**

The fees for the Select and Connection programs may be more or less than you would pay if you purchased separately the types of services included in the programs. You may be able to obtain some or all of the types of services available through the programs on a stand-alone basis through Schwab or other firms. For example, you could separately purchase execution services from Schwab, and you could choose to either pay a commission for each transaction or pay an asset-based fee that would cover all transactions. Similarly, you could separately contract with an MM (other than CSIM—see below) to manage your assets, although the MM’s minimum account size for accounts outside the Select and Connection programs may be higher than the minimum for program accounts, and the MM might charge a different fee.

Depending upon the circumstances, the total of any separately paid charges may be higher or lower than the fees for the programs. Factors that bear upon the cost of each of the programs in relation to the cost of the same services purchased separately include, among other things, the type and size of your account (and other accounts that you may be able to combine to determine fee breakpoints), the historical and expected size or number of trades for your account, and the number and range of supplementary advisory and other services provided to your account. The fees for the programs also may be higher or lower than the fees charged by other firms for comparable services. An investment strategy available through the programs may be similar to a mutual fund managed by the same MM, and the operating expenses of such a mutual fund may be lower or higher than the program fee. The Windhaven Portfolios® available through the Connection program are similar to strategies available in programs maintained by other brokerage firms in which Windhaven participates.

The CSIM investment strategies available in the Connection program are not currently offered by CSIM to individual clients outside of Schwab bundled fee programs. CSIM does, however, manage certain mutual funds utilizing Schwab Equity Ratings®. The total operating expenses for those funds will generally be less for an investor than the Connection program fee, but you would not receive the additional services in the Connection program. Schwab Equity Ratings are made available to Schwab clients primarily via the Schwab.com client website.

Because CSIM, Windhaven and Schwab are affiliates, Schwab and its affiliates taken together generate more combined revenue if you open a Connection account with CSIM or Windhaven as the MM than if you open a Select account. The MMs in Select are not affiliated with Schwab. CSIM and Windhaven, as affiliates of Schwab, are not eligible to participate in the Select program.

### **Compensation of SRs**

If you are an independent investor, the SR who serves you may be referred to as a Financial Consultant (“FC”), Local Market Financial Consultant (“LMFC”) or, if you have been notified of an assignment to a Schwab Independent Branch, an Independent Branch Leader (“IBL”) or Independent Branch Services Financial Consultant (“IBS-FC”). If you are enrolled in SPC, you may have both an FC, LMFC, IBL or IBS-FC and/or a Portfolio Consultant (“PC”) acting as your SRs, the last of these being an employee of SPCIA. The compensation of FCs, LMFCs, PCs, Investment Consultants, IBLs and IBS-FCs is described below.

**Financial Consultants.** FCs’ compensation includes the following components: Service Component, Sales Component, Circle of Excellence, and Client Promoter Score.

**Service Component.** The Service Component pays the FC an amount, subject to a minimum, designed to reflect the approximate annual revenue to Schwab attributed to clients in their “Practice”—i.e., clients for whom they are the primary point of contact with Schwab. FCs generally receive more compensation depending on whether a client accepts certain recommendations made by the FC, including the recommendation to enroll in Select or Connection<sup>1</sup> as opposed to maintaining a purely commission-based brokerage relationship or enrolling in a different fee-based service. A Financial Consultant also earns additional compensation for serving clients enrolled in SPC, which reflects the additional time the Financial Consultant spends with those clients.

<sup>1</sup> For SEP-IRAs, SIMPLE IRAs, Company Retirement Accounts, Qualified Retirement Plan accounts, and Schwab Personal Choice Retirement Accounts (collectively, “ERISA-Type Accounts”), plan participants are only eligible to enroll in Windhaven Portfolios® from among the managed accounts included in the program. SRs may not recommend Windhaven Portfolios to account holders of ERISA-Type Accounts, but may provide investment education and factual information regarding the terms and features of Windhaven Portfolios and other eligible wrap fee programs. Schwab may restrict payment of Service Component and Sales Component compensation on assets held in Schwab Personal Choice Retirement Accounts.

#### Service Component Compensation

	Services	Compensation
<b>Non-Fee-Based Services</b>	Stocks Options Bonds Certificates of deposit Exchange-traded funds High Yield Investor Checking High Yield Investor Savings	0.0028% of assets
	All mutual funds All money market funds All other cash Fixed and variable deferred annuities <sup>2</sup> Margin balances <sup>3</sup>	0.0350% of assets
<b>Fee-Based Services</b>	Assets in accounts enrolled in SPC or Schwab Advisor Network® where FC does not provide ongoing service	0.0350% of assets
	Assets in accounts enrolled in Windhaven Portfolios, Schwab Managed Portfolios, Select or Connection <sup>4</sup>	0.0595% of assets
	Assets enrolled in SPC where FC provides ongoing service	0.0770% of assets

<sup>2</sup> Applicable to insurance-licensed FCs only.

<sup>3</sup> Margin compensation applies only to margin balances greater than \$5,000, but not greater than 10% of a client's margin buying power.

<sup>4</sup> If an account enrolled in Select or Connection is grouped with accounts enrolled in SPC, those assets will be measured for compensation purposes at the SPC compensation rate shown in the table above (except for assets enrolled in Diversified Portfolio accounts, which will be measured at the standard Select/Connection rate).

As a result of the Service Component described above, FCs may have a financial incentive to recommend Select and Connection to you over other products and services, including Schwab Advisor Network.

**Sales Component.** FCs generally also receive Sales Component compensation when clients—both within and outside their Practices—bring net new assets to Schwab, enroll in fee-based services like Select and Connection or purchase certain securities or other products. For example, an FC's Sales Component compensation for a Select or Connection enrollment ranges from 0.09% to 0.21% of the assets enrolled, depending on the FC's payout rate. In contrast, an FC receives only from

0.0375% to 0.0875% of net mutual fund purchases (excluding money market funds), again depending on payout rate. Schwab may cap the amount of Sales Component compensation that an FC earns from any one client.

#### Sales Component Compensation

Service or Product	FC's Compensation (depending on the FC's payout rate)
Mutual Funds	0.0375% to 0.0875% of net mutual fund purchases—excludes money market funds
Referrals to SPC, Schwab Advisor Network, Schwab Managed Portfolios, Select or Connection	0.09% to 0.21% of net enrollments
Referrals to Schwab Managed Portfolios or Windhaven Portfolios	\$38 to \$88 for clients who are new to Schwab Managed Portfolios or Windhaven Portfolios; limited to one credit per client
Financial Planning Service	\$135 to \$315 for converted referrals to Personal Financial Plans or Equity Compensation Consultations \$68 to \$158 for converted referrals to Retirement Consultations

**Circle of Excellence.** FCs can earn additional compensation through the Circle of Excellence program by ranking in the top 50% among their peers in terms of sales credits and asset consolidation. FCs who demonstrate exceptional performance during the year may also be eligible to earn an annual trip through the Chairman's Club program.

As a result of the above, FCs may have a financial incentive to recommend Select or Connection to you over another Schwab service or product. For more information on the types of compensation paid to FCs (and updates on the information described above), please visit [http://www.schwab.com/public/schwab/nn/compensation\\_advice/disclosures/representatives\\_compensation](http://www.schwab.com/public/schwab/nn/compensation_advice/disclosures/representatives_compensation) or ask us for a hard copy.

**LMFCs.** LMFCs are Schwab employees who manage and work in Schwab branches in places where Schwab has recently decided to expand its branch presence. The assets in accounts assigned to LMFC Practices are divided into two categories: (1) “Advised Assets,” meaning assets in accounts enrolled in SPC or in a discretionary wrap fee program or accounts managed by an independent third-party investment advisor to whom the client was referred through the Schwab Advisor Network® service; and (2) “Non-Advised Assets,” consisting of assets not in the Advised Asset category, which include stocks, bonds, mutual funds, and ETFs, as well as payment for providing cash management services.

Each month, Schwab calculates and applies an Advised Asset revenue rate and a Non-Advised Asset revenue rate to the assets in accounts assigned to the LMFC's Practice. The two revenue rates are calculated by looking at 12-month trailing assets and revenue from all accounts assigned to all LMFC Practices. This is done by dividing the adjusted revenue amount for each asset category by the associated assets and excluding certain revenues not earned at an individual account level. Schwab then applies these revenue rates to the daily average assets in each category in accounts assigned to the LMFC, yielding an adjusted revenue figure for each asset category. The revenue rates change monthly, but the Advised Asset revenue rate is higher because Schwab generally generates more revenue on Advised Assets. This is due to the asset-based fees paid for advisory services and other revenue generated by the underlying assets in the enrolled accounts, such as shareholder servicing fees paid to Schwab by certain mutual funds. An LMFC, therefore, earns more money by successfully recommending that clients enroll or open an account in one of the programs or another product in the Advised Asset category.

**Portfolio Consultants.** PCs are not employed by Schwab, but instead by SPCIA, an affiliated investment advisor that is primarily in the business of providing non-discretionary investment advice to clients of the SPC



non-discretionary wrap fee program. PCs provide investment portfolio advice to clients who are enrolled in SPC. They do not receive differential compensation based on the securities that they recommend to enrolled clients. PCs assess their clients' financial needs, analyze clients' portfolios, deliver portfolio advice, and provide periodic portfolio review to clients enrolled in SPC. In addition to a base salary, PCs are eligible to earn a bonus that is funded based on Schwab's performance and determined based on manager discretion, which may include consideration of the quality of the representative's interactions with clients, retaining appropriate clients in advised offers, client satisfaction, teamwork, training, professional development, accuracy, and net new assets.

**Investment Consultants.** You may also elect to open a program account through your interaction with an Investment Consultant. These representatives provide clients who are not currently assigned to an FC with a complimentary portfolio analysis or retirement assessment. They conduct a one-time, needs-based portfolio assessment and make recommendations from the full array of service solutions offered by Schwab. In addition to a base salary and certain performance-related incentives, these representatives earn additional monthly compensation based on the criteria listed below. This compensation may be modified, from 85% to 120%, based on client satisfaction scores.

- Providing clients with a high-quality consultation and a client-focused portfolio solution
- \$20 per portfolio consultation or retirement assessment
- \$10 to \$2,360 for new assets that clients consolidate to the firm
- \$100 per account for enrolling clients in Schwab Managed Portfolios™ and referring clients to fee-based services such as Select, Connection, SPC, and Schwab Advisor Network®
- \$185 to \$1,210 for referring a client to Schwab Bank who subsequently takes out a mortgage; the amount of compensation varies based on the size of the loan
- \$50 to \$135 for referring a client to Schwab Bank who subsequently takes out a home equity loan; the amount of compensation varies based on the size of the loan
- \$100 per referral leading to a one-time, fee-based Retirement Consultation, Equity Compensation Consultation, or Personal Financial Plan
- \$30 for life insurance referrals and \$60 for variable and fixed annuity referrals

**IBLs and IBS-FCs.** IBLs are independent contractors who operate, with their employees, Schwab Independent Branches pursuant to a franchise agreement with Schwab. IBLs are not paid on commission for particular sales, nor does Schwab pay them a salary or the incentive compensation earned by SRs who are employed by Schwab. Instead, they earn revenue from their business based on the overall revenue Schwab earns from clients whose accounts are assigned to their Independent Branch.

The assets in accounts assigned to IBLs are divided into two categories: (1) "Advised Assets," meaning assets in accounts enrolled in the program or in another fee-based investment advisory program like SPC or Schwab Managed Portfolios, or accounts managed by an independent third-party investment advisor to whom the client was referred through the Schwab Advisor Network service; and (2) "Non-Advised Assets," consisting of assets not in the Advised Asset category, which include stocks, bonds, mutual funds, and ETFs, as well as payment for providing cash management services.

Each month Schwab calculates and applies an Advised Asset revenue rate and a Non-Advised Asset revenue rate to the assets in accounts assigned to all Schwab Independent Branches. The two revenue rates are calculated by looking at 12-month trailing assets and revenue from all Schwab Independent Branch accounts. This is done by dividing the adjusted revenue amount for each asset category by the associated assets, subtracting certain product-level expenses and excluding certain revenues not earned at the individual account level. Schwab then

applies these revenue rates to the daily average assets in each category in accounts assigned to *individual* Schwab Independent Branches, yielding an adjusted revenue figure for each asset category. The revenue rates change monthly, but the Advised Asset revenue rate is higher because Schwab generally generates more revenue on Advised Assets. This is due to the asset-based fees paid for advisory services and other revenue generated by the underlying assets in the enrolled accounts, such as shareholder servicing fees paid to Schwab by certain mutual funds. An IBL, therefore, earns more money by successfully recommending that a client enroll or open an account in one of the programs or another product in the Advised Asset category.

After adding together the adjusted revenue figures for Advised and Non-Advised Assets, Schwab then applies a multiplier based on the tenure of the IBL. Finally, Schwab deducts certain monthly fees and expenses from the total adjusted revenue amount that the IBL owes to Schwab under the franchise agreement. This results in a Net Payout for the month.

IBS-FCs receive a salary paid by the IBL and, as determined by the IBL as their employer, may be eligible for a bonus based on a percentage of either their salary or the IBL's Net Payout.

The criteria used by the IBL to determine the amount of the bonus may include such factors as net new assets, net new clients acquired through the efforts of an IBS-FC, or the portion of the Net Payout attributable to clients serviced by an IBS-FC.

### Investment in Affiliated and Other Funds

At your option, cash in your account may be invested in a money market fund sponsored by Schwab or CSIM (an "Affiliated Fund") if the amount of cash to be invested satisfies the Affiliated Fund's minimum investment requirement. CSIM or another affiliate of Schwab serving as investment advisor to an Affiliated Fund will receive advisory fees from the Affiliated Fund as set forth in the Affiliated Fund's prospectus. CSIM and other affiliates also may receive other compensation from the Affiliated Fund for shareholder servicing, accounting, recordkeeping, expense management and other administrative services (see the prospectus and statement of additional information for the Affiliated Fund for more information).

If you have a retirement account in the Connection program managed by CSIM, Schwab will reduce the Connection program fee by 75 basis points for any cash in your retirement account and for any assets in your retirement account that are invested in an Affiliated Fund. The amount of the reduction is at least equal to the amount of fees received by Schwab, CSIM and their affiliates from the Affiliated Fund that is attributable to assets held in your Connection retirement account.

If you have an account in the Connection program managed by Windhaven® Schwab will not charge the Connection program fee for any cash or money market fund assets in that account.

Your MM may decide to invest cash in your account that is awaiting investment in an ETF. This might occur with a subsequent contribution by you to your account after account opening or during the 30-day wash sale period with respect to sale proceeds resulting from a tax harvesting request. If your account is managed by Windhaven, Windhaven will invest primarily in ETFs. To the extent assets in your account are invested in an ETF or money market fund, you will in effect be paying for asset management or investment services at two levels—through the fees charged to the ETF or money market fund by the fund manager or sponsor and through the program fee charged to your account. In this case, your MM will be receiving compensation for managing your assets where some part of the assets is invested in an investment fund. It is possible that an ETF may be affiliated with Schwab, in which case certain fund fees and expenses may be payable to Schwab or its affiliates for providing services to the fund. CSIM and Windhaven will not buy ETFs affiliated with Schwab for retirement accounts. If an MM for an equity or fixed income strategy does buy an ETF for your account, it is possible that the ETF may hold a position in a security which you have restricted from your account.

Certain MMs with fixed income strategies may invest in mutual funds that have been developed for use with the MMs' separate account strategies. These mutual funds are affiliated with the MMs and generally have arrangements whereby the funds do not pay any advisory or administrative fees to the fund manager or sponsor; however, as an investor in such a fund, you may be subject to fund fees and expenses that are in addition to the program fee, and certain of such fees and expenses may be payable to the MM or its affiliates for providing services to the fund. Any investment restrictions imposed by you on the MM's management of your account will not apply with respect to investments made by any mutual fund or ETF held in your account. Upon termination of your participation in a strategy that uses a mutual fund, you may no longer be eligible to hold shares of the mutual fund. Please refer to the mutual fund's prospectus and statement of additional information for more information on fees and related matters.

### **Funds Awaiting Investment or Pending Distribution**

Schwab earns interest, generally at money market rates, on aggregate cash balances held in Schwab's bank accounts, which include assets in accounts enrolled in Select or Connection that are awaiting investment or pending distribution. Funds awaiting investment include both cash that you have deposited into your account and uninvested amounts held in your account as a result of an authorized transaction. Schwab may earn interest on such amounts through the beginning of the second business day following the deposit or transaction in question. Schwab may earn interest on assets pending distribution from your account beginning on the day the assets are debited from your account and continuing until the distribution check is presented for payment, the timing of which is beyond Schwab's control.

### **Negative Yield for Cash and Cash Investments**

Please note that any cash or cash investments in your account will result in a negative yield to the extent the program fee exceeds the rates of return for Schwab One® interest or for an Affiliated Fund chosen as a cash sweep vehicle for your account. Please ask your SR about current rates on cash and cash investments for your account.

### **Compensation for Services Outside the Programs**

Schwab and its affiliates and their employees and agents benefit from the compensation you pay to Schwab under the programs. To the extent that you use other products or services Schwab offers, Schwab benefits from this additional compensation. MMs may have other business relationships with Schwab, separate from the programs, in connection with which the MM compensates Schwab for services. For example, an MM may receive (on behalf of clients or otherwise) research, execution, custodial, referral, pricing and other services offered by Schwab or an affiliate in the normal course of its financial services business. Schwab does not charge MMs a fee to participate in the programs, but Schwab reserves the right to charge MMs fees in the future.

If you do not select a Schwab Money Market Fund™ as the cash sweep feature for your account or do not meet the fund's minimum investment (see "Investment in Affiliated and Other Funds"), cash in your account will be held as a free credit balance with Schwab, and you will receive Schwab One taxable interest (a Schwab Money Market Fund is the only cash sweep feature available to retirement accounts). As a registered broker-dealer, Schwab may benefit from the possession or use of any free credit balances in your account, subject to restrictions imposed by law.

Schwab may have business relationships with certain MMs and their affiliates outside of the programs in which Schwab receives direct or indirect compensation. Mutual funds that are affiliated with an MM may participate in Schwab's Mutual Fund OneSource® program, in which Schwab receives remuneration from the mutual funds (or their advisors) for shareholder servicing and other administrative services with respect to shares in those funds held at Schwab. Certain MMs or their affiliates may also have business relationships with Schwab Advisor Services (which serves independent investment advisors and includes the cus-

tody, trading and support services of Schwab) in which these firms manage client assets outside of the programs; these relationships generate trading, margin and other revenue for Schwab in the normal course of its business as a broker-dealer.

### **Risk and Taxes**

All investments involve the risk (the amount of which may vary significantly) that investment performance can never be predicted or guaranteed and that the value of your portfolio will fluctuate due to market conditions and other factors—see "Certain Risks" below. You should also understand that all or a portion of your securities may be sold either at the initiation of or during the course of the management of your account under the programs. You are responsible for all tax liabilities arising from such transactions, and you are encouraged to seek the advice of a qualified tax professional. Program accounts, especially accounts with Diversified Portfolios, will have a large number of positions, and trading in those accounts by the MM can result in a fairly large number of transactions to report for tax purposes, which also may require the assistance of a tax professional.

You may choose the cost basis method for calculating gains and losses on securities transactions in your account for tax purposes. If you do not choose the method, Schwab will calculate your gains and losses using the FIFO (First In, First Out) cost basis method for all securities except mutual funds, which means the first shares acquired of a particular security are the first shares that will be sold. The average cost method will be used for mutual funds, but even if it is applied, lots are sold in a FIFO manner. When an MM sells a security, the cost basis method used to calculate your gains and losses cannot be changed after your trade settles. Your MM's trading authorization includes the ability to select the tax lots they sell in your account. This is known as "versus purchase trading." When an MM places a trade and does not select a lot, the cost basis method listed on your account will be used to calculate your gain or loss.

### **Termination of Participation in the Programs**

You may terminate your participation in a program at any time upon written notice to Schwab without penalty, subject to the payment of any fees incurred and allowing at least two business days for Schwab to process your termination instruction. If you terminate the designated MM on your managed account and do not simultaneously appoint a new MM, your account will no longer be a managed account subject to the applicable program fee. Unless Schwab notifies you otherwise, your account will (i) no longer be enrolled in a program and (ii) become subject to the commissions and fees outlined in the *Charles Schwab Pricing Guide for Individual Investors* and your Schwab account agreement. You will then be responsible for the management of your account.

If you terminate the MM for a managed account with a fixed income strategy that holds shares in a mutual fund developed for use with that strategy (such as Fixed Income Shares in the PIMCO Total Return Strategy), your shares in that mutual fund will be liquidated by the MM. You will not have the option of retaining those shares.

Depending on current market conditions, if you terminate an MM for a fixed income strategy and direct the sale of the bonds in your account, the MM may need additional time to sell your bonds (particularly municipal bonds) at a desirable price. In this situation, your SR will inform you and give you the option of (i) allowing the MM to have additional time to sell your bonds, and the program fee will continue to apply to assets that remain in your account during this process; or (ii) holding the bond in an account that is not managed by the MM and waiting until the bond matures or directing the sale of it yourself at some later date (without the MM's execution capabilities). There can be no assurance as to how long it might take to obtain a desirable price for your bonds or whether a desirable price can be obtained.

Depending on the size of your account, some bonds may be purchased for your account by fixed income MMs in positions that are smaller than marketable round lots (sometimes called "odd lots"). If you have an

odd-lot bond, it may be more difficult to sell than a round lot, and the sale price may be substantially lower than the price which you paid or the price at which the position previously was valued. If you decide to terminate your participation in a program and do not plan to hold the odd lot until maturity, it may be advisable for you to direct the sale of the odd lot when you terminate your program participation, as the MM may be able to obtain a better price for it than Schwab or another broker-dealer.

### **Funding and Adding Securities to Your Account**

You may fund your account with cash, certain mutual fund shares, stocks or bonds, provided that Schwab reserves the right to decline to accept particular securities or to require you to wait a specific period before depositing certain securities. You cannot fund your account with certain securities, including foreign securities (other than American Depositary Receipts), restricted securities and, in the case of Connection accounts managed by CSIM and Windhaven®, fixed income securities. In addition, Windhaven will not accept warrants, rights and units. PIMCO will accept only investment-grade municipal bonds for its municipal bond ladder strategies, and PIMCO has five business days to decide whether to reject even those securities if they are illiquid, subject to federal alternative minimum tax or otherwise inconsistent with relevant guidelines. When funding your account with securities or depositing securities to your account, you should bear in mind that the MM you designate may decide to sell all or a substantial portion of such securities and that you will be responsible for any tax liabilities resulting from such transactions.

## **Account Requirements and Types of Clients**

### **Types of Clients**

The programs are intended for clients seeking discretionary management of their account for a bundled fee. Clients of the programs may include individuals, trusts, charitable organizations, pension and profit-sharing plans, investment clubs, corporations and other business organizations. ERISA-Type Accounts are only eligible for Windhaven Portfolios®, and certain ERISA-Type Accounts may, at Schwab's discretion, not be eligible for the program.

### **Account Minimums**

Minimum account sizes apply to each investment strategy in the program and generally start at \$100,000 for equity strategies and Windhaven Portfolios; the minimum account sizes for fixed income investment strategies (including bond ladder strategies) and for Diversified Portfolios are generally \$250,000 and \$350,000, respectively. The minimum account size for ERISA-Type Accounts enrolling in Windhaven Portfolios is generally \$25,000. From time to time, Schwab may reduce the minimum account size for groups of clients, including SRs with accounts in certain programs. Additional contributions to accounts managed by certain MMs may be subject to minimum amount requirements so that additional contributions of less than the minimum requirement will be held as cash or cash investments and earn interest or be invested in a money market fund as specified by you in your account application.

If the market value of your account falls significantly below the specified minimum due to your withdrawal of assets from the account, Schwab may require you to deposit additional money or securities to bring the account up to the required minimum, or Schwab reserves the right to close the account.

### **Retirement Accounts**

Schwab does not and will not render advice on a regular basis pursuant to an arrangement or understanding that such advice shall serve as a primary basis for investment decisions with respect to any retirement account. Schwab, its employees and agents (i) are not fiduciaries as defined under ERISA or under the Internal Revenue Code; (ii) have no

investment or other discretion with respect to assets covered by the program; (iii) will perform no discretionary acts with respect to such assets; (iv) will effect only such transactions as you instruct each MM you have selected; and (v) will exercise no discretion and provide no advice as to the voting of proxies. The MM is the sole fiduciary, as defined under ERISA, in performing investment management services and exercising discretion over the assets managed in your retirement account, subject to such reasonable restrictions you may impose.

## **Portfolio Manager Selection and Evaluation**

### **Select Services**

From the inception of the Select program in 2001 until the end of 2007, MM evaluation and research services were provided by Callan Associates Inc. ("Callan"), a consulting firm that is not affiliated with Schwab. Effective January 1, 2008, SCFR assumed responsibility for these functions, and effective January 1, 2010, CSIA assumed responsibility for these functions (on that date, the SCFR analysts performing these functions became part of CSIA). For purposes of this discussion, Callan, SCFR and CSIA are each referred to as the "Research Provider."

Before an MM is selected to participate in the Select program, Schwab, with the Research Provider's assistance, performs a comprehensive review of the MM and its investment strategy. Schwab's review may include, among other things, assessing information about the MM and its investment strategy collected from third-party sources and information received directly from the MM. Schwab is not responsible for the performance of any MM under the Select program or any MM's compliance with applicable laws or regulations or other matters within the MM's control.

Schwab, with the Research Provider's assistance, determines which MM investment strategies to include or keep in the Select program by engaging in searches and periodic reviews, which are more fully described below. To be included in Select, an MM must meet the program's business criteria, which include the program's MM fee structure, the program's account minimums, utilization by the MM of the program's portfolio management system, execution by the MM of Schwab's standard MM service agreement, and other factors. Schwab's Advice Policy Committee (the "Committee") makes the final decision whether or not to include or keep an MM and its investment strategy in the Select program, based on the Research Provider's recommendation. The Committee consists of Schwab management personnel and is also responsible for the selection of recommendable mutual funds in various lists maintained by Schwab.

In determining whether to recommend to the Committee that an MM and its investment strategy be included in or terminated from Select, CSIA evaluates information from both quantitative and qualitative analyses. CSIA's review includes assessing information about the MM and its investment strategy collected from third-party sources and information received directly from the MM.

For its quantitative analysis, CSIA uses a proprietary scoring system that combines multiple characteristics into a single score which represents the expected future relative performance rank of the MM's investment strategy within its style category. The characteristics considered include (i) past performance adjusted for risk and style effects and measured over multiple, non-overlapping time horizons; (ii) assets under management; (iii) cash inflows; and (iv) a returns-based measure of active share, which is a measure of dissimilarity to a benchmark index. In its qualitative analysis, CSIA considers a variety of investment criteria, including:

- Historical style consistency
- Appropriateness of the strategy for the style category
- The MM's investment strategy and adherence to it
- Diversity of investment approach versus that of other strategies in Select



- Stability of management and ownership structure
- Governance program of the management company
- Quality of composite return information

CSIA evaluates each MM's investment strategy no less than quarterly based on the factors described above. Changes within an MM's organization or operations that, in CSIA's judgment, warrant review before the regular quarterly review will be reviewed at that time by CSIA. As a result of these reviews, an MM's investment strategy may be terminated from Select or put on a watchlist. If an MM's investment strategy is put on a watchlist, it will still be available for new accounts but may ultimately be removed from the program if no improvement occurs. Schwab reserves the right to terminate an MM's investment strategy from Select at any time for any reason.

If Schwab removes an MM's investment strategy from the Select program or the agreement between an MM and Schwab is terminated, that MM will not be available to manage accounts in the Select program with that investment strategy. If you have chosen an investment strategy or MM that is being removed from the Select program (or the MM is otherwise withdrawing its strategy or participation in the program), Schwab will inform you and your SR as soon as practicable. Your SR will advise you on whether to select a new investment strategy or MM that is available through the Select or Connection program or take other action.

### Diversified Portfolios

The Select program includes Diversified Portfolios, which are also known as multi-strategy portfolios. A Diversified Portfolio strategy includes several component investment strategies ("Strategies"), such as large-cap equity, small-cap equity and fixed income Strategies. You can have a Diversified Portfolio Strategy in a single account, with a minimum account size (generally \$350,000, but may be as low as \$250,000 and as high as \$650,000) that is typically less than if you opened a separate account for each Strategy. The Diversified Portfolios have several different asset allocations comprised of varying percentage allocations of the available Strategies ("Asset Allocations"). Some of the Asset Allocations have bond holdings that are tax-exempt, and some have bond holdings that are taxable. SCFR developed these Asset Allocations to accommodate clients with different risk profiles, time horizons and tax status. Your SR will help you decide whether a Diversified Portfolio Strategy is appropriate for you, and, if so, will help you choose which Asset Allocation is appropriate for you.

A Diversified Portfolio structure typically involves an MM acting as "overlay manager," as well as other MMs who provide model investment portfolios or research for the Strategies to the overlay manager ("Sub-MMs"). (The Sub-MMs may or may not be available on a stand-alone basis in Select.) The functions of an overlay manager will vary depending on the Diversified Portfolio Strategy. Sometimes the overlay manager may have all the trading responsibility for all the Strategies; sometimes the Sub-MMs may have all the trading responsibility (which is often the case with fixed income Strategies), and sometimes the overlay manager and the Sub-MMs may allocate trading responsibility among themselves depending on the type of trading activity. Examples of the different trading activities which may be allocated among the overlay manager and the Sub-MMs include: initial implementation of your portfolio, subsequent changes to your portfolio based on changes to the Sub-MMs' model portfolios, rebalancing your portfolio to bring it within the guidelines of the Asset Allocation, trading caused by cash withdrawals initiated by you, tax harvesting requests initiated by you, and liquidations requested by you.

The overlay manager is authorized to make adjustments if one or more Strategies in your account becomes over- or underweighted from the Asset Allocation as a result of market appreciation or depreciation. Such adjustments will generally be made by the overlay manager when the proportion of equity securities to fixed income securities varies by five or more percentage points from the Asset Allocation or when the proportion of one Strategy varies by more than 10 percentage points from

the Asset Allocation. As a result of the possibility of allocation adjustments, the performance of a Strategy in a Diversified Portfolio account may differ from the performance of that Strategy in a separate account.

The overlay manager may also monitor your Diversified Portfolio account to make sure your investment restrictions are implemented across all Strategies. For taxable accounts, the overlay manager will generally monitor and avoid wash sales.

The following overlay managers—Nuveen Investment Advisers Inc. ("Nuveen") and Parametric Portfolio Associates ("Parametric")—and the Sub-MMs for their Diversified Portfolio Strategies were selected by Schwab for the Select program based on a number of factors, including the following: (i) the reputation, historical performance and organizational stability of the overlay managers and the Sub-MMs; (ii) the overall performance of the Diversified Portfolio Strategies based on the combined performance of the Strategies (calculated on a hypothetical basis); (iii) the fact that most of the Sub-MMs are affiliates of the overlay manager and have pre-existing working relationships with the overlay manager in other multi-strategy portfolios; (iv) most of the Sub-MMs for the Diversified Portfolio Strategies were already in the Select program on a stand-alone basis and have already gone through the selection and review process described above under "Select Services"; and (v) the sub-MMs and overlay managers met Schwab's business criteria for multi-strategy portfolios in the Select program, including the MM fee structure, account minimums, utilization of the program's portfolio management system and execution of Schwab's service agreement. If Schwab (with the Research Provider's assistance) had conducted a wider search for the Sub-MMs and Strategies that comprise the Diversified Portfolio Strategies, it is possible that other Sub-MMs or Strategies may have been selected which would have been ranked higher by the Research Provider than those selected. The Research Provider has evaluated each Sub-MM for investment performance, style adherence, and organizational stability, among other factors, and will continue to evaluate the Sub-MMs on a quarterly basis.

A Sub-MM may be terminated and replaced by the overlay manager and Schwab without your approval. Similarly, Schwab and the overlay manager may also agree to change the percentages of the Asset Allocation without your approval. If you have a Diversified Portfolio Strategy in which a Sub-MM is terminated and replaced, or if the percentages of the Asset Allocation are changed, you will be notified by Schwab as soon as reasonably practicable.

### About Callan

Callan provided MM research and performance evaluation services for the Select program until the end of 2007, at which time SCFR (now CSIA) began performing those services. Many of the MMs and investment strategies in the Select program were initially included in the program based on Callan's recommendation.

Callan received compensation from Schwab for Callan's services relative to the Select program based on the amount of assets in the program. MMs in the Select program may have paid Callan for strategic, communication and product consulting services; investment product analysis; research reports and software programs from Callan's Institutional Consulting Group; or educational services from the Callan Investments Institute and Center for Investment Training. These payments may have given rise to potential conflicts of interest in Callan's recommendations of MMs for inclusion in the Select program and subsequent monitoring of those MMs. According to Callan, Callan managed these conflicts of interest with certain policies and a Code of Ethics designed to help maintain its independence, and its personnel that performed MM searches and evaluations were in a separate division from the areas in the firm that provided services to MMs.

### About CSIA

CSIA is an affiliate of Schwab that provides research and decision-making tools to Schwab for use by Schwab clients, including the *Mutual Fund OneSource Select List*®. CSIA personnel also act as portfolio man-



agers for Schwab Managed Portfolios™ which is a bundled fee program sponsored by Schwab that invests in mutual funds and ETFs. CSIA personnel were formerly part of SCFR. SCFR is still a division of Schwab that provides services such as Schwab Equity Ratings® and recommended asset allocations for investors within different risk categories.

### Connection Services

The MMs eligible to participate in Connection are Schwab affiliates and other third-party firms with professional portfolio management experience at the firm level that Schwab may select to participate on a case-by-case basis. The MMs currently available in Connection include CSIM, Windhaven® and PIMCO. The MM investment strategies in Connection are not subjected to the evaluation and ongoing due diligence process used by Schwab and CSIA for the Select program, although CSIA does assist Schwab in performing limited due diligence regarding PIMCO's municipal bond ladder strategies.

Since the MM investment strategies in the Connection program are not subject to the same evaluation process as MM investment strategies in the Select program, there can be no assurance that any MM investment strategy in the Connection program would be selected for the Select program if that MM investment strategy was subjected to the same process and was otherwise eligible. (Schwab affiliates are not eligible to participate in the Select program.)

CSIM manages equity strategies in Connection using Schwab Equity Ratings and specialized software to construct the portfolio and manage overall risk. Schwab Equity Ratings are made available to CSIM by SCFR for purposes of managing equity strategies in the Connection program, as well as for utilization by CSIM in its management of certain mutual funds. MM Profiles for CSIM strategies are available from your SR.

Windhaven manages Windhaven Portfolios®, which primarily use ETFs to diversify broadly across global asset classes. Windhaven Portfolios may include ETFs that invest in U.S., international and emerging-market stocks, bonds, real estate, precious metals, commodities and various currencies. Windhaven employs an active asset management style that shifts asset allocations within and between asset classes based on a proprietary model of the global capital markets.

The Connection program also includes municipal bond ladder strategies managed by PIMCO. In these strategies, PIMCO buys municipal bonds maturing over a designated period of years that are intended to be held until maturity. Retirement accounts are not permitted in these strategies.

PIMCO will only accept cash or investment-grade municipal bonds to fund bond ladder strategies. When contributing investment-grade municipal bonds, you should be aware that PIMCO may, within five business days following notification of the securities to be contributed, determine to reject any security that is not consistent with the guidelines for the relevant ladder (e.g., because the bond is illiquid or subject to the federal alternative minimum tax). If PIMCO rejects a security, PIMCO may, at its option, either (i) liquidate the security and use the proceeds to fund purchases consistent with the strategy, in which case you may bear additional costs and consequences such as risk of adverse price movement, transaction costs and potential adverse tax consequences or (ii) inform Schwab that it will not accept the security, in which case Schwab will notify you to determine whether to liquidate the holding or to substitute cash or acceptable securities. If a rejection causes your account to fall below the minimum investment requirement, you may need to fund the account with cash or other investment-grade municipal bonds in order to enroll or stay enrolled in the strategy.

There are no criteria for MMs to participate in the Connection program other than prior portfolio management experience at the firm level. However, Schwab reserves the right to remove an MM or its investment strategy from the Connection program at any time for any reason.

If you have chosen an investment strategy or MM that is being removed from the Connection program (or the MM is otherwise withdrawing its

strategy or participation in the program), Schwab will inform you and your SR as soon as practicable. Your SR will advise you on whether to select a new investment strategy or MM that is available through the Connection or Select programs or take any other action.

### Information About MMs

Each MM brochure provides information about that MM. For each of your accounts, you will receive the brochure of the MM you designate to manage that account before the MM begins managing it. The MM has discretion to accept or reject the management of your account.

Additional information about an MM and its investment strategy is available in its MM Profile for that strategy. CSIA provides the MM Profiles for the MMs in the Select program based on information obtained from the MMs and third-party sources. CSIM, Windhaven and PIMCO provide their own MM Profiles. The MM Profile describes the MM, its investment strategy and past performance information. Certain MM Profiles may only be available by meeting with an SR. The accuracy and completeness of the MM data contained in the MM Profile are the responsibility of the MM. CSIA will update select MM Profiles quarterly based on information obtained from the MMs and third-party sources. While Schwab believes that the information contained in the MM Profiles for the MMs is accurate, Schwab does not independently verify or guarantee the accuracy or completeness of the information. Any past performance information supplied by an MM and/or contained in the MM's Profile is not verified or audited by Schwab. There can be no assurance that the performance information is calculated on a uniform or consistent basis. Past MM performance is no guarantee of future results.

### Non-Exclusive Relationship

Schwab and its affiliates may perform, among other things, research, brokerage, asset management and similar services for other clients and receive asset-based fees for such services. In particular, CSIM utilizes the Schwab Equity Ratings in managing certain mutual funds, including a mutual fund that sells short certain stocks with low Schwab Equity Ratings. Schwab and its affiliates and their respective employees and agents may give advice to and take actions for a particular client that differ from the advice given or the timing and nature of action taken with respect to those mutual funds and other clients' accounts. Transactions in a specific security may not be accomplished for all clients' accounts at the same time or at the same price.

The model portfolio for CSIM equity accounts will not be adjusted as frequently as the mutual funds' portfolios and, therefore, the time and market price at which the mutual funds buy or sell a specific security may vary from the time and price at which CSIM buys or sells the same security for a Connection account. Further, the price at which CSIM buys or sells the security for an account in Connection may reflect market activity resulting from purchases and sales by the mutual funds and Schwab clients who acted on changes to the Schwab Equity Ratings before CSIM acted for accounts in Connection.

In managing your account, an MM may purchase or sell securities in which the MM, Schwab or their officers, directors, employees or representatives, directly or indirectly, have or may acquire a position or interest. In addition, it is possible (although unlikely) that a mutual fund managed by CSIM could have a short position in a stock owned by clients in the Connection program, meaning that the CSIM mutual fund portfolio manager expects that the price of the stock held short will go down, even though the CSIM portfolio manager for the Connection strategy has caused Connection client accounts to buy that stock.

The MMs, Schwab or their affiliates may, in the course of business, obtain material nonpublic or other confidential information that, if disclosed, might affect an investor's decision to buy, sell or hold a security. The MMs, Schwab and their affiliates are restricted from disclosing or using this information under applicable law, and are under no obligation to disclose the information to any client or use it for any client's benefit.

## Client Information Provided to Portfolio Managers

By signing the Schwab account application, you authorize Schwab to provide trading and other information about your account to the MM managing your account and third parties designated by the MM. In addition, your FC will communicate such information as necessary to the MM managing your account. Examples of information communicated by your FC to your MM may include investment restrictions, tax harvesting instructions and updates to the information you provide in your account application.

## Additional Information

### Disciplinary Information

The SEC and other regulatory agencies and organizations have, in the past, taken certain disciplinary actions against Schwab for violations of investment-related statutes, regulations and rules. The matters have been settled, and Schwab has paid fines with respect to certain violations.

1. Schwab entered into a consent order with the State of Nevada on November 2, 2011, in which Schwab was fined \$10,000 for failing to detect the lack of Nevada state registration of a non-employee investment advisor. Schwab was found to have violated its own procedures and Nevada Administrative Code Section 90.321 for failing to determine that the non-employee was acting as a professional investment advisor at the time the accounts were set up or during the course of his management of the accounts at issue.
2. A disciplinary action initiated by the Financial Industry Regulatory Authority ("FINRA") asserted that Schwab violated Municipal Securities Rulemaking Board Rule G-14 by: (1) failing to report required information about certain municipal securities transactions to the Real-Time Transaction Reporting System ("RTRS") within 15 minutes of trade time; and (2) failing to report the correct trade execution time to the RTRS for some of these transactions. Without admitting or denying these assertions, Schwab consented to a censure and a fine of \$12,500 on June 17, 2011.
3. Schwab and CSIM have reached agreements with the SEC, FINRA, the Illinois Secretary of State, Securities Department ("Illinois"), and the Connecticut Department of Banking, Securities and Business Investments Division ("Connecticut") to settle matters related to the Schwab YieldPlus Fund® (the "Fund"). For purposes of this discussion of matters related to the Fund, Schwab and CSIM are collectively referred to as "Schwab."

As part of the SEC settlement, the SEC found that Schwab violated certain investment-related laws and regulations related to the offer, sale and management of the Fund from 2005 through 2008. In particular, the SEC found that Schwab: (1) deviated from the Fund's concentration policy with respect to investments in non-agency mortgage-backed securities, without shareholder approval; (2) made materially misleading statements and omissions about the Fund and its associated risks before and during the decline of its net asset value ("NAV"); (3) materially understated the Fund weighted average maturity ("WAM") in certain instances; (4) willfully aided and abetted misstatements and omissions appearing in Fund sales materials and other documents; and (5) lacked policies and procedures reasonably designed to prevent the misuse of material nonpublic information about the Fund. Without admitting or denying these allegations, Schwab agreed to pay a total of approximately \$118,944,922 in disgorgement of fees, penalties and compensation to investors. As part of the settlement with the SEC, Schwab will also take a number of actions to improve procedures and reinforce Schwab's commitment to its clients. These actions include retaining an independent consultant to conduct a comprehensive review of Schwab's policies, practices and procedures designed to prevent the misuse of material, nonpublic information by or related to Schwab's mutual funds. The SEC settlement was approved by the United States District Court for the Northern District of California on February 16, 2011. Additionally, the SEC has brought related complaints against two former employees of Schwab.

The amount to be paid by Schwab pursuant to the SEC settlement includes approximately \$18,000,000 to be paid by Schwab in settlement of the FINRA matter in which FINRA made related factual allegations against Schwab and found that Schwab's conduct violated FINRA's just and equitable principles of trade and its rules pertaining to communications with the public and supervision.

Schwab has also agreed to pay approximately \$8,567,364 in settlement of the Illinois matter in which Illinois made related factual allegations against Schwab and found that Schwab's conduct violated Illinois Securities Law provisions relating to supervision of securities and advisory activity by employees and to maintenance of written procedures reasonably designed to comply with securities laws and regulations.

Schwab has also agreed to pay an amount not to exceed \$2,800,000 in settlement of the Connecticut matter in which Connecticut made related factual allegations against Schwab and found that Schwab violated applicable Connecticut laws and regulations by failing to reasonably supervise its employees.

Schwab and certain affiliated entities and individuals (the "Schwab Parties") were named as defendants in a number of Fund-related class action lawsuits filed in the United States District Court for the Northern District of California in 2008. These lawsuits were consolidated into a single class action complaint that alleged violations of state law and federal securities law similar to those described above. On March 30, 2010, the court granted plaintiffs' motion for summary judgment holding defendants liable for plaintiffs' state law claim regarding changes to the investment policy of the Fund, which plaintiffs alleged were made without shareholder approval in violation of the Investment Company Act of 1940. Although the judgment was subject to a potential appeal and further proceedings on damages, the Schwab Parties entered into a settlement agreement to settle the plaintiffs' federal securities law claims for approximately \$202,700,000 and the plaintiffs' California law claims for approximately \$35,000,000. On April 19, 2011, the court entered an order granting plaintiffs' and defendants' motions for final approval of the settlement agreements.

4. A disciplinary action initiated by the New York Stock Exchange ("NYSE") asserted that Schwab: (a) submitted inaccurate electronic blue sheets in violation of NYSE Rules 410A and 401; and (b) failed to properly supervise the preparation of its electronic blue sheets in violation of NYSE Rule 342. Effective January 5, 2006, the NYSE approved a stipulation of facts and consent to penalty ("Stipulation") between Schwab and the NYSE Division of Enforcement. Without admitting or denying guilt, Schwab consented to the Stipulation that it violated the foregoing rules and regulations. As part of the Stipulation, Schwab consented to a censure and a fine of \$300,000. Schwab also agreed to conduct a validation of all required blue sheet data elements and notify the NYSE in writing that it has completed the validation.

5. A disciplinary action initiated by the NYSE asserted that Schwab: (a) violated NYSE Rules 342(a) and (b) in that Schwab failed to establish and maintain appropriate procedures for supervision and control, including a separate system of follow-up and review, with respect to certain business activities relating to protection of customer assets in accounts managed by non-employee investment advisors and carried by Schwab; and (b) violated Section 17(A) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 17A-4(b)(4) and 17A-4(f) thereunder and NYSE Rule 440 by failing to preserve and maintain certain electronic communications in the required format and for the required retention periods. Effective October 17, 2005, the NYSE approved a stipulation of facts and consent to penalty ("2005 Stipulation") between Schwab and the NYSE Division of Enforcement. Without admitting or denying guilt, Schwab consented to the 2005 Stipulation that it violated the foregoing rules and regulations. As part of the Stipulation, Schwab consented to a censure and a fine of \$1,000,000. Schwab also undertook: (a) to retain an outside consultant to conduct a review of its policies and procedures with respect to the disbursement of funds from accounts managed by investment advisors; (b) to have the consultant provide a report to the NYSE's Division of Enforcement within 120 days of the date the decision becomes final; and (c) to submit to the NYSE a written representa-

tion setting forth the implementation of the recommendations contained in the consultant's report within 60 days of the report's issuance.

6. On September 14, 2004, the SEC issued an order instituting public administrative and cease-and-desist proceedings pursuant to Sections 15(b) and 21B of the Exchange Act and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act"), making findings, imposing remedial sanctions and issuing a cease-and-desist order as to Schwab ("Order"). Schwab consented to entry of the order without admitting or denying the SEC's findings made in the Order. The SEC found that from at least January 2001 through October 2003, Schwab engaged in a practice that enabled certain mutual fund shareholders to place mutual fund orders after the time the funds calculated their net asset values ("NAV") for that day. Specifically, Schwab allowed clients of investment advisors to place substitute mutual fund orders after 4:00 p.m. Eastern Time ("ET"), the time as of which those funds calculated their NAV. The order substitutions were permitted when one of these client's original pre-4:00 p.m. ET mutual fund orders was rejected by Schwab's computer system because it could not be processed as submitted. The SEC found that this practice violated Rule 22c-1(a) under the Investment Company Act and Schwab's own internal policy requiring any orders Schwab received after 4:00 p.m. ET to get the next day's fund price. These substitute orders were not made pursuant to any improper agreements between Schwab personnel and the investment advisor or the investment advisor's clients. The SEC imposed on Schwab the following sanctions: (1) that Schwab cease and desist from committing or causing any violations and any future violations of Rule 22c-1(a) under the Investment Company Act; (2) censure of Schwab; and (3) a civil money penalty payable by Schwab in the amount of \$350,000.

7. A disciplinary action initiated by the NYSE asserted that during the time period between approximately February 1997 and September 2003, Schwab: (a) violated NYSE Rule 346(f) by having persons associated with it (without permission of the NYSE) that Schwab knew, or through the exercise of reasonable care should have known, were subject to statutory disqualification; (b) violated NYSE Rule 351(a)(5) by failing to promptly report to the NYSE certain arrests, arraignments, indictments, convictions, guilty pleas and/or no contest pleas to criminal offenses, other than minor traffic violations of employees; (c) violated NYSE Rule 342 by failing to reasonably supervise its business in order to ensure compliance with federal securities laws and NYSE rules relating to associations with statutorily disqualified individuals and reporting to the NYSE of events related to employee criminal matters. Effective July 8, 2004, the NYSE approved a stipulation of facts and consent to penalty between Schwab and the NYSE Division of Enforcement. Without admitting to or denying guilt, Schwab consented to the stipulation that it violated NYSE rules. As part of the stipulation, Schwab agreed to censure and a fine of \$250,000. Schwab also agreed (a) to retain an outside consultant within 30 days of the decision to perform a review and prepare a report; (b) have the consultant provide a report to the NYSE's Division of Enforcement and Schwab's Board of Directors within 120 days from the date the decision becomes final; and (c) submit to the NYSE a written representation setting forth the implementation of the recommendations contained in the report within 60 days of the report's issuance.

8. A disciplinary action initiated by the National Association of Securities Dealers ("NASD") asserted that: (a) during the period August 14, 2002, through March 25, 2003, Schwab violated Municipal Securities Rule Making Board Rules G-17 and G-30(a) when it relied solely on the bids provided by a broker's broker to determine the fair market value in the liquidation of six municipal security positions for customers; (b) the prices paid to the customers and received by Schwab were below the fair market value for the security in amounts ranging from 6.57% to 38.57%; and (c) Schwab failed to ensure that the transactions were executed at aggregate prices that were fair and reasonable. Effective June 28, 2004, the NASD approved a letter of acceptance, waiver and consent ("AWC") from Schwab. Without admit-

ting or denying guilt, Schwab agreed to censure and a fine of \$30,000 and was required to pay \$30,869.25 plus interest in restitution to the customers. Schwab agreed to provide a copy of its updated written supervisory procedures as they relate to the determination of the fair market value of municipal securities being bought or sold from a public customer to the NASD within 90 days of the acceptance of the AWC.

### Other Financial Industry Activities and Affiliations

Schwab is primarily engaged in business as a broker-dealer and spends most of its time on that business. Schwab is registered as a broker-dealer under the Securities Exchange Act of 1934 and is a member of FINRA. We provide brokerage services to clients located throughout the United States and, in some circumstances, outside the United States. Incidental to our broker-dealer business, we offer our clients a variety of investment information services and products, including seminars, periodicals, reports, guides, planning tools, brochures and other publications about securities and investment techniques. We also provide certain online data and financial reporting services.

Schwab is also registered as an investment advisor under the Investment Advisers Act of 1940. As sponsor of the Select and Connection programs, Schwab is acting as both a registered investment advisor and broker-dealer. Schwab provides investment advisory services outside of the context of the Select and Connection programs. With Schwab Advisor Network®, Schwab makes referrals of investment advisors to investors who are looking for assistance in managing their assets and/or other financial planning activities. Advisors participating in Schwab Advisor Network are independent and not affiliated with Schwab. Investment advisors pay a fee to participate in the Schwab Advisor Network program.

Schwab also acts as a registered investment advisor for other programs, including Schwab Managed Portfolios™ (a mutual fund and ETF wrap program), and Schwab Private Client™ (investment advisory and brokerage services), and when we provide financial planning services through the Schwab Personal Financial Plan™ Schwab Retirement Consultation, and Schwab Equity Compensation Consultation.

Schwab does not trade futures and is not a Futures Commission Merchant. However, for our customers that have a desire to trade futures, we have a referral relationship with a company not affiliated with Schwab. Per the terms of the referral relationship, Schwab receives a portion of the commissions that Schwab clients pay to that company.

### Schwab Affiliates

Schwab is a wholly owned subsidiary of CSCorp, a Delaware corporation that is publicly traded and listed on the NYSE (symbol: SCHW).

Other wholly owned subsidiaries of CSCorp are engaged in investment advisory, brokerage, trust, custody or banking services. CSIM—one of the MMs in the Connection program—serves as an MM in another Schwab managed account program and also provides advisory and administrative services to certain proprietary mutual funds marketed under the Schwab Funds® name and under the Laudus® name. Windhaven®—another one of the MMs in the Connection program—also serves as an MM in another Schwab managed account program and provides discretionary investment advisory services to institutional clients outside of Schwab's wrap fee programs and to clients in programs maintained by other brokerage firms.

CSIA is an affiliate of Schwab that is described above under the heading "About CSIA."

In addition, Schwab has several affiliates and/or units engaged in various aspects of the retirement plan business. The Charles Schwab Trust Company ("CSTC"), a California-chartered trust company, provides custodial and other trust services to Schwab customers and affiliates in relation to retirement plans, including but not limited to 401(k) plans. The Schwab Corporate & Retirement Services division provides custo-



dial services and administrative and recordkeeping support to Schwab corporate customers and their employees in connection with retirement and stock option plans and the monitoring of trading in employee accounts.

Charles Schwab Bank ("Schwab Bank") is a subsidiary of CSCorp that offers deposit accounts, mortgage and home equity line of credit lending products, and credit card products to both Schwab brokerage clients and other clients who have no relationship with Schwab.

## **Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**

### **Code of Ethics**

Schwab has various ethical standards, including a code of ethics adopted pursuant to SEC Rule 204A-1 under the Investment Advisers Act of 1940 (the "Code"). The Code is intended to reflect fiduciary principles that govern the conduct of Schwab and its supervised persons in those situations where Schwab acts as an investment advisor as defined under the Investment Advisers Act of 1940 in providing investment advice to clients. As a general matter, the Code requires that Schwab's covered persons (including SRs) comply with applicable federal securities laws, report violations of the Code, and (for those persons who are deemed "access persons" by virtue of their involvement in providing investment advice or access to certain related information) report their personal transactions and holdings in certain securities periodically and get pre-clearance before buying certain securities, including an initial public offering or private offering. The Code prohibits access persons from disclosing portfolio transactions or any other nonpublic information to anyone outside of Schwab, except as required to effect securities transactions for clients, or from using the information for personal profit or to cause others to profit. Access persons are also prohibited from engaging in deceptive conduct in connection with the purchase or sale of securities for client accounts. The Code is subject to change as necessary to remain current with regulatory requirements and internal business policies and procedures. A copy of Schwab's Code is available on request.

Schwab has imposed policy restrictions on all personnel with respect to transactions for their own accounts and accounts over which they have control or a beneficial interest. These include restrictions on SR purchases of stocks on the "Restricted List," which includes securities for which Schwab is engaged in certain activities involving public offerings. SR trading restrictions also prohibit unacceptable trading practices such as front running, crossing trades with customers, and insider trading.

### **Addressing Potential Conflicts**

The compensation of SRs described above creates a potential conflict of interest when an SR recommends to you or discusses with you one of these programs, MMs or investment strategies available through the programs. Schwab addresses these conflicts in a variety of ways, including monitoring for compliance with the Code and establishing advice policies and guidelines that SRs must follow when making recommendations. SRs are supervised by their direct managers and by a Central Supervision Team for compliance with Schwab's advice policies and guidelines. In order to address potential conflicts under ERISA and the parallel provisions of the Internal Revenue Code, Schwab prohibits SRs from recommending Windhaven Portfolios® to account holders of ERISA-Type Accounts.

Supervisors who oversee SRs review a variety of factors at least once per year, including but not limited to client suitability information, asset allocation data and internal notes to verify that both the program and investment strategy recommendations made within the program are suitable. Daily supervisory functions, including review of trading activity, portfolio construction, verbal, written and electronic client correspondence, money movement, product sales and referrals, and new account enrollments are conducted by a Central Supervision Team. Centralized Supervisors do not participate in or influence the compensation programs outlined above, and they monitor daily SR overall activity to identify and address any actions that may not be in the best interest of the client.

### **Personal Trading**

Schwab monitors the personal securities holdings and trading of SRs. Schwab reviews SR accounts custodied at Schwab and applicable accounts custodied at other firms. The surveillance program monitors holdings and trades against the Code, Schwab's Compliance Manual, and other applicable policies. Additionally, SRs must disclose all securities accounts they own or control after their hire date and review and confirm the accuracy of those accounts on an annual basis during their employment.

### **Review of Accounts**

An SR will meet with you approximately once per year to review your program accounts. It is during, and in preparation for, this meeting that your SR reviews the performance of your program accounts in light of your financial goals and situation. If at any time you experience a material, life-changing event that may impact your immediate or long-term strategy (e.g., the birth of a child, early retirement, or receiving an inheritance), your SR is available to review your situation and discuss the impact these events may have on your program accounts. The SR may also consult with you about whether you may want to add or change investment strategies or MMs because of a change in your situation, the MM or its strategy (such as the departure of a portfolio manager).

MMs monitor and review their clients' accounts pursuant to the MMs' own compliance and supervisory systems of account review. Schwab does not participate in and is not responsible for such review.

### **Schwab's Participation or Interest in Client Transactions**

Consistent with applicable law and regulations, Schwab may execute trades for fixed income securities as principal. Schwab does not act as principal for equity trades in either program. Schwab will execute fixed income principal transactions only when an MM believes you will receive at least as favorable an execution as would be the case were the transaction executed through another dealer. When Schwab executes orders in fixed income securities as principal, Schwab may receive compensation in connection with such transactions in the form of a dealer markup or markdown. Such compensation is separate from and in addition to, and will not reduce or otherwise offset, the program fee for your account. Please refer to "Schwab's Execution Services" under "Services, Fees and Compensation" above for more information.

Schwab may also effect agency cross trades (except with respect to accounts managed by CSIM or Windhaven®) to the extent permitted by applicable law and regulations and Schwab's internal policies. "Agency cross trades" are transactions in which Schwab acts as advisor to one side of the transaction (in Schwab's role as program sponsor) and broker for the parties on both sides of the transaction. Schwab may receive compensation from the client on the other side of the transaction (the amount of which may vary). Thus, Schwab may have a potentially conflicting division of loyalties and responsibilities. If Schwab effects an agency cross transaction for your account, the confirmation for the transaction will disclose that Schwab or its affiliate acted as agent for both buyer and seller in the transaction. The compensation received by Schwab from the other client is in addition to the program fees. While such compensation, in theory, could create a potentially conflicting division of loyalties and responsibilities, all transactions in the programs are directed by the MM, and Schwab will be acting solely as a broker-dealer in connection with such trades.

If your MM buys new issue bonds through Schwab acting as a dealer, Schwab receives a customary selling concession for providing distribution and operational services, which ranges from less than 0.01% to 2% of the par value, or face amount, of the bond, depending on the product. The percentage rate of the selling concession may differ not only between different new issue offerings, but also between different series and bond maturities within a single offering.

Schwab has entered into a fixed income dealer agreement with J.P. Morgan Securities Inc. ("J.P. Morgan") to purchase from J.P. Morgan,



and sell to our clients (with Schwab acting as principal), certain new issue fixed income securities from offerings in which J.P. Morgan acts as an underwriter or a selling group member. Pursuant to this agreement, Schwab receives a portion—and, in some cases, all—of the relevant selling concession. The percentage of the selling concession received by Schwab depends upon the type of offering, the type of security, and the underwriting syndicate's arrangement with the issuer. Although Schwab's aggregate compensation for a particular offering increases with the number of securities in the offering that Schwab sells to its clients, the portion of the selling concession Schwab receives in an offering does not vary based upon the number of securities sold to its clients.

### Certain Risks

Investments in securities, both generally and in the context of the investment strategies available through the Select and Connection programs, involve various risks, including those summarized below. In addition, each MM may have its own investment style, which may involve risks different from or in addition to those summarized below. The profile for each MM includes several measures of volatility and other risk factors for that MM based on the MM's past management of accounts; these may not necessarily be indicative of future risks. Please review the brochure and MM Profile for each MM that you are considering, which may include additional relevant disclosures.

### Equity Risks

**General.** The prices of equity securities rise and fall daily. These price movements may result from factors affecting individual companies, industries or the securities market as a whole. Individual companies may report poor results or be negatively affected by industry and/or economic trends and developments. The prices of securities issued by such companies may suffer a decline in response. In addition, the equity market tends to move in cycles that may cause stock prices to fall over short or extended periods of time.

**Large-Cap and Mid-Cap Risk.** Investment strategies that focus on large- and/or mid-cap segments of the stock market involve the risk that these types of stocks tend to go in and out of favor based on market and economic conditions. However, stocks of mid-cap companies tend to be more volatile than those of large-cap companies because mid-cap companies tend to be more susceptible to adverse business or economic events than larger, more established companies. During a period when large- and mid-cap U.S. stocks fall behind other types of investments—bonds or small-cap stocks, for instance—the performance of investment strategies focused on large- and/or mid-cap stocks will lag behind the performance of investments in bonds or small-cap stocks.

**Small-Cap and International Risk.** Historically, small-cap and international stocks have been riskier than large- and mid-cap stocks. Stock prices of smaller companies may be based in substantial part on future expectations rather than current achievements and may move sharply, especially during market upturns and downturns. Small-cap companies themselves may be more vulnerable to adverse business or economic events than larger, more established companies, and international companies may be more vulnerable to geopolitical factors than U.S. companies. During a period when small-cap and/or international stocks fall behind other types of investments—bonds or large-cap stocks, for instance—the performance of investment strategies focused on small-cap or international stocks will lag behind the performance of bonds or large-cap stocks.

**Management Risk.** MMs generally make investment decisions for particular investment strategies using historical information. There is no guarantee that a strategy based on historical information will produce the desired results in the future. In addition, if market dynamics change, the effectiveness of that kind of strategy may be limited. Either of these risks may cause the investment strategy of a particular MM to underperform its benchmark or similar investment strategies managed by different MMs.

**Dividend Equity Strategy Risk.** The CSIM Dividend Equity Strategy primarily invests in dividend-paying stocks. As a result, performance for this strategy will correlate directly with the performance of the dividend-paying stock segment of the stock market. This may cause this investment strategy to underperform investment strategies that do not limit their investments to dividend-paying stocks. In addition, if stocks held in your portfolio reduce dividends or stop paying dividends, your portfolio's ability to generate income may be adversely affected.

**Schwab Equity Ratings®** CSIM strategies using Schwab Equity Ratings have limitations arising from the use of that stock selection discipline. Given that systematic stock selection approaches cannot capture all the dynamics that affect individual stock returns, Schwab Equity Ratings may not capture more subjective, qualitative influences on return and risk such as management changes and pending lawsuits. Furthermore, the ratings may not reflect the possible impact of late-breaking news. The quality of the ratings depends on the accuracy of financial data provided by third parties, including the companies rated through the approach.

### Fixed Income Risks

**General.** Bond prices rise and fall daily, and fixed income investments are subject to various risks, including changes in interest rates. As with any investment whose performance is tied to these markets, the value of a managed account fixed income portfolio will fluctuate, which means that you could lose money.

**Interest Rate Risk.** When interest rates rise, bond prices usually fall, and with them the value of your portfolio. A fall in interest rates could hurt your portfolio by lowering its yield.

**State and Regional Factors.** To the extent that your fixed income portfolio is invested in securities from a given state or geographic region, its value and performance could be affected by local, state and regional factors, including erosion of the tax base and changes in the economic climate. National governmental actions, such as the elimination of tax-exempt status, also could affect performance. In addition, your portfolio may be more sensitive to adverse economic, business or political developments if a substantial portion of it is invested in municipal securities that are financing similar projects. Your portfolio may also have more exposure to the risks of a given issuer than a diversified bond fund.

**Credit Risk.** A decline in the credit quality of a fixed income investment could cause the value of your fixed income portfolio to fall. Your portfolio could lose money if the issuer or guarantor of a portfolio investment fails to make timely principal or interest payments or otherwise honor its obligations. The emphasis of a fixed income strategy on quality and preservation of capital also could cause your portfolio to underperform certain other types of bond investments, particularly those that take greater maturity and credit risks. Municipal securities may have greater risks than taxable bonds.

**Maturity Risk.** The MM's duration and maturity decisions will affect the value of your fixed income portfolio. To the extent that the MM anticipates interest rate trends imprecisely, your portfolio could miss yield opportunities or its value could fall.

**Tax Risk.** If tax-exempt securities purchased in your portfolio are later deemed to be taxable, a portion of your portfolio's income could be taxable. Any defensive investments in taxable securities could generate taxable income. Also, some types of municipal securities produce income that is subject to the federal alternative minimum tax ("AMT"). You should consult your tax advisor about the potential effects of the AMT on your tax situation.

**Liquidity Risk.** Some bonds, particularly municipal bonds, may be difficult to sell, and the last quoted price for a bond may be based on the last price at which the bond was traded, which may not accurately reflect the current market price. If you are enrolled in a fixed income strategy and are terminating your account, withdrawing funds from your

account, or otherwise taking action that may require the sale of one or more bonds in your account, the MM may need additional time to sell your bonds, especially if you own a small amount of bonds from one or more issuers. There can be no assurance as to how long it might take to sell your bonds, and the sale price may be substantially lower than the price which you paid or the price at which the bond was previously traded.

**Default Risk.** A bond issuer may be unable to make interest or principal payments, thereby resulting in a default. If this happens, the bond may have little or no value.

#### **Municipal Bond Ladder Strategy Risks**

Municipal bond ladder strategies are generally subject to the same risks as listed under “Fixed Income Risks” above. In addition, depending on the types and amounts of securities within your ladder, a municipal bond ladder strategy may not ensure adequate diversification of your investment portfolio. If you include callable bonds within your ladder, these bonds may be called prior to maturity and you may be unable to reinvest the principal in a similar bond issue. A called bond may alter the schedule of principal and interest payments within your ladder. You and your investment advisor must evaluate whether a municipal bond ladder and the securities held within it are consistent with your investment objectives, risk tolerance, and financial circumstances.

#### **ETF Strategy Risks**

Shares of ETFs trade on the secondary market, and cannot be directly purchased from or redeemed by the Fund. Shares of ETFs may trade above or below their NAV. The per-share NAV of an ETF is generally calculated at the end of each business day, and will generally fluctuate with changes in the market value of the ETF’s holdings. The market prices of shares of ETFs, however, will generally fluctuate continuously throughout the trading day in accordance with the relative supply of, and demand for, the shares on the exchange on which such shares are listed, which may not correlate with NAV. The trading price of shares of an ETF may deviate significantly from the ETF’s per-share NAV during periods of market volatility. Price differences may be due to the fact that supply and demand forces at work in the secondary trading market for shares of an ETF are closely related to, but not identical to, the

same forces influencing the prices of the securities held by the ETF. ETFs are subject to secondary market trading risks. Shares of an ETF will be listed for trading on an exchange; however, there can be no assurance that an active or liquid trading market for them will develop or be maintained. There can be no assurance that the requirements of the exchange necessary to maintain the listing of the ETF shares will continue to be met or will remain unchanged.

Generally, ETFs are created using direct exposure to the securities in the index (e.g., stocks, bonds, etc.). However, some ETFs provide market exposure through indirect means, such as futures, options or structured products. In the case of a structured product, there may be counterparty risk associated with the issuers of the product.

#### **Windhaven Portfolios® Risks**

**Global Capital Markets Risk.** Windhaven Portfolios are invested in the global capital markets and are exposed to these markets. This exposure includes a large number of asset classes with varying risk profiles. Windhaven® applies a systematic risk management discipline based on the application of the Windhaven Global Asset Allocation Model to construct investment portfolios that provide the balance between risk and return appropriate to three categories of risk tolerance. However, the individual securities in accounts managed by Windhaven are subject to the market risk associated with the asset class they represent. In addition, since Windhaven Portfolios use exchange-traded products (“ETPs”) for exposure to the asset classes, it is possible that an ETP would fail to track the underlying index properly.

**Model Risk.** The Windhaven Global Asset Allocation Model is a key component of the risk management discipline described above. The model will determine which asset classes are overweight in the portfolios. Since no model is a perfect predictor of future market behavior, it is possible that the overweight positions may fail to add value to or may increase losses in a portfolio for a period of time.

**Counterparty Risk.** Windhaven uses either ETFs or, on occasion, ETNs. ETFs are subject to the same risks described under “ETF Strategy Risks” above. To the extent that Windhaven uses an ETN, accounts managed by Windhaven are exposed to the credit risk of the issuer.