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# Charles Schwab Investment Advisory, Inc. Schwab Managed Portfolios™ Disclosure Brochure

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This brochure provides information about the qualifications and business practices of Charles Schwab Investment Advisory, Inc. ("CSIA") as an advisor in the Schwab Managed Portfolios program. If you have any questions about the contents of this brochure, please contact us at the phone number above. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority. CSIA's description of itself in this brochure as a registered investment advisor does not imply a certain level of skill or training on the part of CSIA or its representatives.

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

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## Advisory Business

Charles Schwab Investment Advisory, Inc. ("CSIA") is a wholly owned subsidiary of The Charles Schwab Corporation ("CSCorp."), a Delaware corporation that is publicly traded and listed on the New York Stock Exchange (symbol: SCHW). CSIA has been registered as an investment advisor since November 5, 2009.

CSIA provides portfolio management services for the Schwab Managed Portfolios™ wrap-fee program ("SMP," the "SMP Program," or the "Program") that is sponsored by its affiliate Charles Schwab & Co., Inc. ("Schwab") and also, as of January 2015, for the Schwab Intelligent Portfolios™ wrap-fee program ("SIP" or the "SIP Program") that is sponsored by another affiliate, Schwab Wealth Investment Advisory, Inc. ("SWIA"). The SMP Program consists of various investment strategies, selected by clients, and consists of either mutual funds ("SMP-MF") or exchange-traded funds, also known as ETFs ("SMP-ETF"), bought and sold for clients on a discretionary basis, as well as a cash investment. The SIP Program consists of various investment strategies, selected by clients, and consists of ETFs and a cash allocation; for more information on SIP, please refer to SWIA's disclosure brochure, available at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). The investment strategies employed in each program account are also governed by the client's agreement with Schwab or SWIA and by any reasonable restriction(s) on the management of the account that may be requested by a client and accepted by CSIA.

As of December 31, 2014, CSIA managed approximately \$21,573,000,000 in assets in the Program. CSIA does not manage any assets on a non-discretionary basis. More information about the SMP Program is available in the Schwab Managed Portfolios Disclosure Brochure provided to Program clients.

## Fees and Compensation

Pursuant to an agreement between CSIA and Schwab, Schwab pays all costs and expenses incurred by CSIA in connection with the SMP Program and other services provided by CSIA to Schwab. Also, pursuant to an agreement, SWIA pays CSIA a fixed annual fee in connection with the SIP Program. Schwab also provides CSIA with human resources, legal, compliance, and other administrative and technological support services. The portion of the costs and expenses paid by Schwab for the work done by CSIA in connection with the Program is expected to range from \$2.5 million to \$3.0 million per year and may be adjusted by Schwab and CSIA from time to time as more or fewer resources are required to support the Program. CSIA does not enter into agreements directly with Program clients and accordingly does not receive direct compensation from or negotiate fees with them.

## Performance-Based Fees and Side-by-Side Management

CSIA does not receive performance-based fees in connection with either the SIP Program or the SMP Program.

## Types of Clients

Clients of the SMP Program may include individuals, trusts, charitable organizations, investment clubs, corporations, and other business organizations. Government entities and certain accounts subject to the Employee Retirement Income Security Act of 1974 ("ERISA") are not eligible for this Program.

The minimum investment required to open an account in SMP-MF and SMP-ETF is \$25,000 for all account types. If the market value

of your account falls below this 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, and CSIA reserves the right to discontinue management of the account.

## Methods of Analysis, Investment Strategies, and Risk of Loss

Using strategic asset allocations and fund selection parameters approved by Schwab, CSIA creates diversified portfolios of mutual funds or ETFs combined with a cash investment in a single account for the SMP Program. Each portfolio is designed so that the strategic asset allocation is consistent with a certain combination of investment objectives and risk tolerance. Within SMP-ETF, CSIA may implement limited, generally short-term deviations from the strategic allocation ("tactical allocations"). Within both SMP-MF and SMP-ETF, certain portfolios are intended for taxable accounts and others for tax-deferred accounts. Certain portfolios are intended for clients who are looking for some level of income generation. Each SMP-MF portfolio consists of approximately 7–30 mutual funds. Each SMP-ETF portfolio consists of approximately 7–25 ETFs.

CSIA also creates diversified portfolios of ETFs combined with a cash allocation in a single account for the SIP Program. The parameters for asset allocation and ETF selection for SIP accounts are established by SWIA and differ from the SMP Program parameters.

There may be times when SIP clients and SMP-ETF clients are investing in the same ETF; however, each Program has a separate portfolio management team making trading and investing decisions.

CSIA may use written reports prepared by recognized analysts who are specialists in the industry and may use computer-based models to assist in portfolio management. CSIA may also use statistical and other information published by third-party data providers, industry and government, information gathered at meetings of professionals within the industry, and its own research of investment trends.

## General Risks

### Management Risks

CSIA applies its investment techniques and risk analyses in making investment decisions or recommendations for its clients, but there can be no guarantee that they will produce the desired results. In addition, there is no guarantee that a strategy based on historical information will produce the desired results in the future and, if market dynamics change, the effectiveness of the strategy may be limited. Each strategy runs the risk that CSIA's investment techniques will fail to produce the desired results. There also can be no assurance that all of CSIA's key personnel will continue to be associated with CSIA for any length of time.

### Investment Risks

Investments in securities, including mutual funds and ETFs and the securities that they in turn invest in, involve various risks, including those summarized below. In addition, each mutual fund and ETF has its own investment style, which may involve risks different from those described below. Clients and prospective clients should be aware that investing in securities involves risk of loss that clients should be prepared to bear.

### Model Risks

CSIA may use quantitative analyses and/or models. Any imperfections, limitations, or inaccuracies in its analyses and/or models

could affect its ability to implement strategies. By necessity, these tools make simplifying assumptions that may limit their effectiveness. Models that appear to explain prior market data can fail to predict future market events. Further, the data used in models may be inaccurate and/or it may not include the most current information available.

### **ETF General Risks**

ETFs in which the strategy may invest involve certain inherent risks generally associated with investments in a portfolio of securities, including the risk that the general level of security prices may decline, thereby adversely affecting the value of each unit of the ETF. Moreover, an ETF may not fully replicate the performance of its benchmark index because of the temporary unavailability of certain index securities in the secondary market or discrepancies between the ETF and the index with respect to the weighting of securities or the number of securities held. ETFs in which the strategies invest have their own fees and expenses as set forth in the ETF prospectuses.

ETFs may have exposure to derivative instruments, such as futures contracts, forward contracts, options, and swaps. There is a risk that a derivative may not perform as expected. The main risk of derivatives is that some types can amplify a gain or loss, potentially earning or losing substantially more money than the actual cost of the derivative, or that the counterparty may fail to honor its contract terms, causing a loss for the ETF. Use of these instruments may also involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk, and the risk that an ETF could not close out a position when it would be most advantageous to do so.

### **Schwab ETFs™ Risks**

The ETFs managed by CSIA's affiliate Charles Schwab Investment Management, Inc. ("CSIM") and included in the Program were launched beginning in November 2009, and some of them even more recently. Accordingly, there is limited data available for CSIA to rely upon when assessing investment risk associated with some of these ETFs. As a result, one or more of the following may occur: (1) poor liquidity in or limited availability of the ETFs, or (2) lack of market depth, causing the ETFs to trade at excessive premiums or discounts.

### **Mutual Fund Risks**

Mutual fund managers may base investment decisions for funds on 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 fund to underperform its benchmark or similar funds. Mutual funds in which the strategies invest have their own fees and expenses as set forth in the fund prospectuses.

Mutual funds may have exposure to derivative instruments, such as futures contracts, forward contracts, options, and swaps. There is a risk that a derivative may not perform as expected. The main risk of derivatives is that some types of derivatives can amplify a gain or loss, potentially earning or losing substantially more money than the actual cost of the derivative, or that the counterparty may fail to honor its contract terms, causing a loss for the fund. Use of these instruments may also involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk, and the risk that a fund could not close out a position when it would be most advantageous to do so.

### **Affiliated Mutual Funds Risks**

The value of mutual funds can be impacted by the movement of large positions in and out of a particular fund. Because of the limited universe of mutual funds available, Program clients may also collectively account for a large portion of the assets in certain Schwab-affiliated mutual funds. A decision by CSIA to buy or sell some or all of a particular Schwab-affiliated fund where Program clients hold a significant portion of that fund may negatively impact the value of that fund.

### **Schwab Equity Ratings® Risks**

Some of the Schwab affiliate mutual funds in SMP-MF accounts use Schwab Equity Ratings as a principal means of selecting individual equities. Schwab Equity Ratings is Schwab's proprietary stock evaluation system and evaluates securities on the basis of four primary factors: fundamentals, valuation, momentum, and risk.

Certain Schwab-affiliate equity mutual funds have limitations arising from their use of the Schwab Equity Ratings. Given that systematic stock evaluation 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.

### **Market/Systemic Risks**

Equity and fixed income markets rise and fall daily. The performance of a client's investments is, to varying degrees, tied to these markets. When markets fall, the value of a client's investments will fluctuate, which means a client could lose money.

### **Asset Allocation/Strategy/Diversification Risks**

The asset classes in which the strategy seeks investment exposure can perform differently at any given time (as well as over the long term), so the strategy will be affected by its allocation among the various asset classes. The asset allocation decisions can result in more portfolio concentration in a certain asset class or classes, which could reduce overall return if the concentrated assets underperform CSIA expectations. The more aggressive the strategy selected, the more likely the portfolio will contain larger weights in riskier asset classes, such as equities. Depending on market conditions, there may be times where diversified portfolios perform worse than less-diversified portfolios.

### **Investment Strategy Risks**

There are risks associated with the long-term core strategic holdings for each of the strategies. The more aggressive the strategy selected, the more likely the portfolio will contain larger weights in riskier asset classes, such as equities.

### **Trading/Liquidity Risks**

A particular investment may be difficult to purchase or sell, or may become difficult to sell after being purchased for a client account. CSIA may be unable to sell securities on behalf of a client at an advantageous time and/or price due to then-existing trading market conditions.

### **Large Investment Risks**

Program clients may collectively account for a large portion of the assets in certain ETFs or mutual funds. A decision by CSIA to buy

or sell some or all of a particular ETF or mutual fund where Program clients hold a significant portion of that ETF or mutual fund may negatively impact the value of that ETF or mutual fund.

## **Underlying Securities Risks**

### **Equity-Related Risks**

#### **General Risks**

The prices of equity securities, and thus the value of funds or ETFs that invest in them, will rise and fall. 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, which may cause stock prices to fall over short or extended periods of time.

#### **Large- and Mid-Cap Risks**

Mutual funds and ETFs that focus on large- and/or mid-cap segments of the stock market bear 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 the performance of these other investments.

#### **Small-Cap and International Risks**

Historically, small-cap and international stocks have been riskier than large- and mid-cap U.S. stocks (see the Foreign Investment–Related Risks section below for additional information). During a period when small-cap and/or international stocks fall behind other types of investments—U.S. large- and mid-cap stocks, for instance—the performance of investment strategies focused on small-cap or international stocks may lag the performance of these other investments.

### **Fixed Income–Related Risks**

#### **General Risks**

Bond markets rise and fall daily, and fixed income investments, which generally also include instruments with variable or floating rates, are subject to various risks. As with any investment whose performance is tied to bond markets, the value of a fixed income mutual fund or ETF will fluctuate, which means that you could lose money.

#### **Interest Rate Risks**

When interest rates rise, bond prices usually fall, and with them the value of a mutual fund or ETF holding the bonds. A decline in interest rates generally raises bond prices, and with them potentially the value of a bond fund, but could also hurt the performance of a mutual fund or ETF by lowering its yield. The longer the duration of the investments held by an ETF or fund, the more sensitive to interest rate movements its value is likely to be.

#### **Credit Risks**

A decline in the credit quality of a fixed income investment could cause the value of a fixed income mutual fund or ETF to fall. The

mutual fund or ETF could lose value 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 a mutual fund or ETF to underperform certain other types of bond investments, particularly those that take greater maturity and credit risks.

#### **High-Yield Risks**

High-yield securities and unrated securities of similar credit quality (sometimes called junk bonds) are subject to greater levels of credit and liquidity risks. High-yield securities and the ETFs or mutual funds that invest in them may be considered speculative.

#### **Government Securities Risks**

Many U.S. government securities are not backed by the full faith and credit of the United States government, which means they are neither issued nor guaranteed by the U.S. Treasury. Certain issuers of securities, such as the Federal Home Loan Banks (FHLB), maintain limited lines of credit with the U.S. Treasury. Securities issued by other issuers, such as the Federal Farm Credit Banks Funding Corporation (FFCB), are supported solely by the credit of the issuer. There can be no assurance that the U.S. government will provide financial support to securities of its agencies and instrumentalities if it is not obligated to do so under law.

#### **State and Regional Risks**

To the extent that a mutual fund or ETF 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, a mutual fund or ETF 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.

#### **Foreign Risks**

Investments in securities of foreign issuers or securities with credit or liquidity enhancements provided by foreign entities may involve certain risks such as adverse changes in foreign economic, political, regulatory, and other conditions; differing accounting, auditing, financial reporting, and legal standards and practices; differing securities market structures; and higher transaction costs. In addition, sovereign risk, or the risk that a government may become unwilling or unable to meet its loan obligations or guarantees, could increase the credit risk of financial institutions connected to that particular country.

### **Foreign Investment–Related Risks**

#### **General Risks**

Investments in securities of foreign issuers may involve certain risks that are greater than those associated with investments in securities of U.S. issuers. These include risks of adverse changes in foreign economic, political, regulatory, and other conditions; changes in currency exchange rates or exchange control regulations (including limitations on currency movements and exchanges); differing accounting, auditing, financial reporting, taxes, and legal standards and practices; differing securities market structures; and higher transaction costs.



### Emerging Markets Risks

These and other risks (e.g., nationalization, expropriation, or other confiscation of assets of foreign issuers) are greater for those ETFs or mutual funds investing in companies tied economically to emerging countries, the economies of which tend to be more volatile than the economies of developed countries.

### Frontier Markets Risks

The risks associated with investing in foreign or emerging markets generally are magnified in frontier markets, also known as “next emerging” markets. Some frontier markets may operate in politically unstable regions of the world and may be subject to additional geopolitical/disruption-of-markets risks.

### Geopolitical/Disruption-of-Markets Risks

Geopolitical events may adversely affect global economies and markets and thereby decrease the value of and/or the ease of trading the ETFs or mutual funds invested in those affected markets. Those events as well as other changes in foreign and domestic economic and political conditions could adversely affect the value of the strategy's investments.

### Currency Risks

Fluctuations in exchange rates may adversely affect the value of a strategy's foreign currency holdings and investments denominated in foreign currencies.

## Risks Related to Other Asset Classes

### Commodities Risks

Commodities involve unique risks that may be distinct from those that affect stocks and bonds, including worldwide supply and demand factors, weather conditions, currency movements, and international government policies regarding commodity reserves and choice of currency for commodity pricing.

### Hard Asset Risks

The production and marketing of hard assets, such as precious metals, oil and gas, real estate and/or agricultural commodities may be affected by geopolitical and environmental factors and are cyclical in nature. During periods of economic or financial instability, hard asset securities and other instruments may be subject to broad price fluctuations, reflecting volatility of energy and basic materials prices and possible instability of supply of various hard assets. Hard asset securities, hard asset companies, and other instruments may also experience greater price fluctuations than the relevant hard asset. In periods of rising hard asset prices, such securities or instruments may rise at a faster rate and, conversely, in time of falling hard asset prices, such securities may suffer a greater price decline.

### Real Estate Risks

Real estate-related investments may be adversely affected by factors affecting the real estate industry, which may include changes in interest rates and social and economic trends. Real Estate Investment Trusts (“REITs”) may also be subject to the risk of fluctuations in income from underlying real estate assets, poor performance by the REITs' manager, prepayments and defaults by borrowers, adverse changes in tax laws, and, with respect to U.S. REITs, their failure to qualify for the special tax treatment granted to REITs under the Internal Revenue Code of 1986 and/or to maintain exempt status under the Investment Company Act.

## Limitations of Disclosure

The foregoing list of risks does not purport to be a complete enumeration or explanation of the risks involved in CSIA's investment strategies. As CSIA's investment strategies develop and change over time, clients and investors may be subject to additional and different risk factors. No assurance can be made that profits will be achieved or that substantial losses will not be incurred.

## Disciplinary Information

CSIA has no legal or disciplinary events that it is required to report.

## Other Financial Industry Activities and Affiliations

In its role as sponsor of the Program, CSIA's affiliate, Schwab, sets the target asset allocations for each Program portfolio and creates the parameters that determine mutual fund and ETF eligibility for the Program. Although CSIA does not favor any Schwab-affiliate mutual fund or ETF, or disfavor any third-party mutual fund or ETF, in its selection of investments or allocation among investments for Program portfolios, the parameters and eligibility criteria created by Schwab are designed, in part, to favor certain Schwab affiliate mutual funds and ETFs and to disfavor certain third-party mutual funds and ETFs. This results in higher overall compensation to Schwab, CSIM, and the ultimate parent entity, The Charles Schwab Corporation, though not directly to CSIA.

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

### Code of Ethics

CSIA has a code of ethics adopted pursuant to SEC Rule 204A-1 under the Investment Advisers Act of 1940 (the “Code”). The Code reflects the fiduciary principles that govern the conduct of CSIA and its employees when acting as investment advisor. The Code requires that CSIA's covered employees comply with applicable federal securities laws and report violations of the Code. Covered employees who are deemed “access persons” by virtue of providing investment advice or having access to certain related information must report their personal transactions and holdings in, and obtain clearance before buying, ETFs used in SMP and SIP Program portfolios. The Code prohibits access persons from disclosing SMP and SIP Program transactions or any other non-public information to anyone except certain designated employees of CSIA and Schwab. The Code also prohibits access persons from using the information for personal profit or the profit of others. Access persons may not engage 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.

You can get a copy of the Code by asking your Schwab representative or calling Schwab at 1-877-316-6400.

### Participation or Interest in Client Transactions

CSIA's affiliate, Schwab, sponsors the Program and receives compensation from ETFs and mutual funds held in Program accounts. This compensation is in addition to the explicit asset-based fee that Program clients pay to Schwab. CSIM, another CSIA affiliate, earns compensation from affiliated mutual funds and ETFs held in the Program. Program clients receive detailed disclosures about Schwab's and CSIM's Program-related compensation in the Schwab Managed Portfolios™ Disclosure Brochure.

## Personal Trading

As described above, the Code is designed to detect and prevent conflicts of interest and unlawful practices that may arise in connection with an access person's personal securities transactions. Accordingly, the Code requires access persons to obtain prior approval before placing personal trades for ETFs used in SIP and SMP Program portfolios.

## Brokerage Practices

All brokerage transactions for securities in SMP Program accounts will be routed to Schwab for execution, which may not always obtain as favorable a price as another broker-dealer.

CSIA may aggregate securities sales or purchases (a trade order) among two or more clients, within a single strategy and, where possible and as appropriate, like trades across strategies within SMP or across programs. CSIA will not aggregate trades unless it believes that aggregation is consistent with its duty to seek best execution for affected clients in the aggregate and consistent with the terms of the client's investment advisory agreement. CSIA's trading practices (aggregations of trades, allocation of trades, and use of trade rotation and other processes) are designed so that the practices do not unfairly and systematically favor one client over another and that, over time, client accounts are treated equitably.

CSIA excludes from aggregation those client accounts that have relevant investment restrictions or client activity (e.g., withdrawals pending) and, therefore, should not participate in the aggregated trade. CSIA reserves the right to not aggregate transactions when to do so would be (i) unfair under the circumstances; (ii) impractical; or (iii) otherwise inappropriate. CSIA generally allocates trade orders pro rata among clients who participated in the aggregated trade order. CSIA will review its aggregation procedures at least annually to confirm that they are adequate to prevent any client from being systematically disadvantaged as a result of the aggregated transactions.

Trade orders for different programs (e.g., the SMP Program and the SIP Program) are generated by different investment teams and typically on different trading systems and may utilize one or more trading strategies (e.g., price at the time of order arrival, market closing price, volume weighted average price over some specified period). Certain trading strategies place relatively greater emphasis on timing, others on speed of execution, while others place greater emphasis on reducing market impact cost. As a result, the speed of trade order fulfillment and the prices achieved for the same security may vary in different programs or strategies. Certain trading strategies, which may include accounts in programs with different fee structures, may trade in advance of other trade strategies or may be completed more quickly, and, as a result, may achieve different execution on the same or similar securities. In addition, market, regulatory and/or country limitations (especially in the case of emerging markets) may contribute to differences in security prices.

Clients in the SMP program direct CSIA to use Schwab to effect securities trades for their account. Large share trade orders can occur when there are large daily flows into or out of the program, CSIA reallocates/rebalances clients' accounts, or CSIA replaces an ETF with another ETF across all applicable client accounts. For these large trade orders, Schwab may solicit bids from other broker-dealers that may act as principal in the transaction, meaning that the other broker-dealer executes the trade in an account in which the broker-dealer has a beneficial ownership interest, or may execute a riskless-principal trade where the other broker-dealer buys

(sells) a security from (to) a third party (e.g., another customer or broker-dealer).

In transactions where Schwab uses another broker-dealer acting as principal, the other broker-dealer typically accepts the risk of market price and liquidity fluctuations of executing the transactions. The broker-dealer adds a fee, called a markup or markdown (or "spread"), to compensate for this risk. The spread is not shown separately on a client's trade confirmation or account statement. Schwab does not act as principal for ETF trades in the SMP Program and does not receive the spread. In SMP transactions where Schwab uses another broker-dealer acting as an agent, the other broker-dealer may charge a fee or commission. This fee or commission is not shown separately on a client's trade confirmation or account statements. Schwab does not charge a commission itself or receive the third-party broker-dealer's fee or commission. Schwab may receive remuneration such as liquidity or order flow rebates from a market or firm to which orders are routed, but its trading practices are designed to achieve best execution. There will be no offset of the SMP Program fee by third-party broker-dealer markups and markdowns or other fees. Instead, these markups and markdowns will reduce the overall return of a client's account.

CSIA may use a trade rotation process among client accounts within a single program or across programs (e.g., within the SMP Program or within the SIP Program or across the SMP and SIP Programs) when trades need to be executed over more than one trading day. Trades done on the same day or on different days are not guaranteed to receive the same trading price. CSIA may also use a trade rotation process across programs (SMP and SIP) on a daily basis. CSIA will review its rotation procedures at least annually to confirm that they are adequate to prevent any client from being systematically disadvantaged.

Trading orders that can be only partially filled are generally allocated on a pro rata basis, randomly allocated, or allocated on some other basis consistent with the goal of giving all clients equitable opportunities over time. If a single aggregated trade order is filled at varying prices, client accounts subject to the same trading strategy generally receive an average price for trades placed through the same broker, or other steps are taken so that all similarly situated accounts receive fair consideration over time. In some cases, the trading desk may execute a trading strategy at the same time it is executing a trade order for the same security, with the same or a different broker, to meet account or strategy-specific requirements, in which case the two trades may be treated as distinct trades and may not be subject to pro rata allocation.

When investment opportunities are expected to be in very limited supply (collectively, "limited opportunities"), CSIA will generally consider the needs of clients across programs. When it is not practicable to allocate an opportunity across all eligible accounts, CSIA uses various methods, such as random allocation and sequencing, to give all accounts using the same trading strategy equitable opportunities for allocation over time. This may result in a limited opportunity being allocated to only some of the eligible accounts.

## Review of Accounts

CSIA's portfolio managers review, at least quarterly, the performance of SMP Program investment strategies against their applicable benchmarks. Schwab contacts clients participating in the Program at least annually to determine whether there have been any changes in their financial situation or investment objectives and whether clients wish to impose any reasonable restrictions on the management of their accounts or reasonably modify existing

restrictions. Schwab communicates the information obtained from clients to CSIA as necessary for the management of the account.

## **Client Referrals and Other Compensation**

As explained in “Fees and Compensation” beginning on page 1, Schwab compensates CSIA for providing portfolio management services in the Program. CSIA does not make payments to its representatives for referring clients to the SMP Program. Schwab makes payments to its representatives for referring clients to the SMP Program as described in a separate Schwab Managed Portfolios™ Disclosure Brochure.

## **Custody**

Schwab has custody of client assets in SMP Program accounts and, at least quarterly, sends SMP Program clients account statements detailing account positions and activities during the preceding period. Account statements include a summary of all transactions made on behalf of the account, all deposits and withdrawals made to or from the account, all fees and expenses charged to the account, and the value of the account at the beginning and end of the period. You should review these statements carefully.

## **Investment Discretion**

CSIA has discretionary authority to manage accounts enrolled in the Program, subject to the reasonable restrictions requested by SMP Program clients and accepted by CSIA. Clients invested in SMP-MF may restrict up to three mutual funds in each Program account. Clients invested in SMP-ETF may restrict up to three ETFs in each Program account. Mutual funds and ETFs designated for restriction by clients will be replaced with alternatives selected by CSIA. Clients who enrolled in SMP-MF prior to July 23, 2010, may also restrict third-party mutual fund families, but not mutual fund families affiliated with CSIA.

## **Voting Client Securities**

CSIA has adopted written proxy voting policies and procedures (“Procedures”). For proxies voted by CSIA on behalf of each client

who delegates voting authority to CSIA (“Delegating Clients”), procedures may be changed as necessary to comply with regulatory requirements and internal policies and procedures and are designed to maximize the economic benefit to Delegating Clients. CSIA has retained a third-party vendor to manage this process and reviews the vendor’s own written policies no less than annually to determine consistency with the Procedures and with CSIA’s fiduciary duty to Delegating Clients.

For proxy issues deemed by CSIA portfolio management staff to raise significant concerns, CSIA reviews the analysis and recommendation of the vendor. Examples of factors that could cause a matter to raise significant concerns include, but are not limited to, issues whose outcome have the potential to materially affect a company’s industry, or regional or national economy, and matters which involve broad public policy developments which may materially affect the environment in which the company operates. After evaluating all such recommendations, CSIA decides how to vote the shares and will instruct the vendor to vote consistent with its decision.

To address any potential conflicts of interest, CSIA votes proxies of affiliated mutual funds and ETFs in the same proportion as the vote of all other shareholders of the mutual fund or ETF (i.e., “echo vote”), unless otherwise required by law. When required by law, CSIA also “echo votes” proxies of unaffiliated mutual funds and ETFs. When not required to “echo vote,” CSIA delegates to the vendor responsibility for voting proxies of an unaffiliated mutual fund and ETF in accordance with the vendor’s procedures.

Program clients can get a copy of the Procedures and information about how CSIA has voted their securities in a particular proxy vote by asking their Schwab representative or calling CSIA at (415) 667-1910.

## **Financial Information**

CSIA does not require or solicit prepayment of SMP Program fees and is therefore not required to include a balance sheet for its most recent fiscal year. CSIA is not the subject of any financial condition that is reasonably likely to impair its ability to meet its contractual obligations to its clients. CSIA is not the subject of any bankruptcy petition, nor has it been the subject of any bankruptcy petition at any time during the past 10 years.