SCHWAB CHARLES CORP
Form 10-Q
November 08, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2010

Commission File Number: 1-9700

THE CHARLES SCHWAB CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-3025021**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

211 Main Street, San Francisco, CA 94105

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (415) 667-7000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

1,194,827,651 shares of $.01 par value Common Stock

Outstanding on October 22, 2010

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THE CHARLES SCHWAB CORPORATION

Quarterly Report on Form 10-Q

For the Quarter Ended September 30, 2010

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Part I FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Income

(In millions, except per share amounts)

(Unaudited)

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net Revenues				
Asset management and administration fees	$ 468	$ 451	$ 1,325	$ 1,439
Interest revenue	442	356	1,261	1,063
Interest expense	(58)	(62)	(169)	(161)
Net interest revenue	384	294	1,092	902
Trading revenue	182	241	624	772
Other	32	36	99	132
Net impairment losses on securities [(1)]	(3)	(11)	(19)	(38)
Total net revenues	1,063	1,011	3,121	3,207
Expenses Excluding Interest				
Compensation and benefits	381	371	1,176	1,173
Professional services	85	70	249	194
Occupancy and equipment	66	67	202	245
Advertising and market development	34	34	139	141
Communications	49	48	154	155
Depreciation and amortization	35	38	108	121
Class action litigation reserve			196	
Money market mutual fund charges	132		132	
Other	82	63	215	168
Total expenses excluding interest	864	691	2,571	2,197
Income before taxes on income	199	320	550	1,010
Taxes on income	(75)	(120)	(215)	(387)
Net Income	$ 124	$ 200	$ 335	$ 623
Weighted-Average Common Shares Outstanding Diluted	1,194	1,163	1,192	1,160
Earnings Per Share Basic	$ .10	$ .17	$ .28	$ .54

Earnings Per Share Diluted	$	.10	$	.17	$	.28	$	.54

(1) Net impairment losses on securities include total other-than-temporary impairment losses of $0 million and $52 million, net of $(3) million and $41 million recognized in other comprehensive income, for the three months ended September 30, 2010 and 2009, respectively, and total other-than-temporary impairment losses of $41 million and $239 million, net of $22 million and $201 million recognized in other comprehensive income, for the nine months ended September 30, 2010 and 2009, respectively.

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Balance Sheets

(In millions, except share and per share amounts)

(Unaudited)

	September 30, 2010	December 31, 2009
Assets		
Cash and cash equivalents	$ 5,701	$ 8,241
Cash and investments segregated and on deposit for regulatory purposes (including resale agreements of $11,642 at September 30, 2010 and $8,346 at December 31, 2009)	20,066	18,373
Receivables from brokers, dealers, and clearing organizations	510	560
Receivables from brokerage clients net	9,842	8,627
Other securities owned at fair value	341	916
Securities available for sale	26,017	22,120
Securities held to maturity (fair value $14,826 at September 30, 2010 and $6,880 at December 31, 2009)	14,390	6,839
Loans to banking clients net	8,178	7,348
Loans held for sale	121	104
Equipment, office facilities, and property net	610	641
Goodwill	528	528
Other assets	994	1,134
Total assets	$ 87,298	$ 75,431
Liabilities and Stockholders Equity		
Deposits from banking clients	$ 48,836	$ 38,820
Payables to brokers, dealers, and clearing organizations	1,483	2,373
Payables to brokerage clients	27,676	26,246
Accrued expenses and other liabilities	1,260	1,407
Long-term debt	2,008	1,512
Total liabilities	81,263	70,358
Stockholders equity:		
Preferred stock 9,940,000 shares authorized; $.01 par value per share; none issued		
Common stock 3 billion shares authorized; $.01 par value per share; 1,421,761,844 shares issued at September 30, 2010 and 1,392,091,544 shares issued at December 31, 2009	14	14
Additional paid-in capital	2,912	2,298
Retained earnings	7,363	7,243
Treasury stock, at cost 227,014,531 shares at September 30, 2010 and 229,983,936 shares at December 31, 2009	(4,257)	(4,291)
Accumulated other comprehensive income (loss)	3	(191)
Total stockholders equity	6,035	5,073
Total liabilities and stockholders equity	$ 87,298	$ 75,431

See Notes to Condensed Consolidated Financial Statements.

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THE CHARLES SCHWAB CORPORATION

Condensed Consolidated Statements of Cash Flows

(In millions)

(Unaudited)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Cash Flows from Operating Activities		
Net income	$ 335	$ 623
Adjustments to reconcile net income to net cash provided by operating activities:		
Net impairment losses on securities	19	38
Stock-based compensation	64	54
Depreciation and amortization	108	121
Other	12	(26)
Originations of loans held for sale	(1,277)	(2,279)
Proceeds from sales of loans held for sale	1,267	2,264
Net change in:		
Cash and investments segregated and on deposit for regulatory purposes	(1,693)	(2,754)
Receivables from brokers, dealers, and clearing organizations	51	189
Receivables from brokerage clients	(1,218)	(751)
Other securities owned	577	(39)
Other assets	57	11
Payables to brokers, dealers, and clearing organizations	377	195
Payables to brokerage clients	1,701	3,187
Accrued expenses and other liabilities	62	(133)
Net cash provided by operating activities	442	700
Cash Flows from Investing Activities		
Purchases of securities available for sale	(13,791)	(11,144)
Proceeds from sales of securities available for sale	220	107
Principal payments on securities available for sale	9,979	4,613
Purchases of securities held to maturity	(10,149)	(2,808)
Principal payments on securities held to maturity	1,314	73
Net increase in loans to banking clients	(897)	(921)
Purchase of equipment, office facilities, and property	(82)	(108)
Other investing activities	4	
Net cash used for investing activities	(13,402)	(10,188)
Cash Flows from Financing Activities		
Net change in deposits from banking clients	9,574	11,659
Issuance of long-term debt	701	747
Repayment of long-term debt	(204)	(79)
Net proceeds from common stock offering	543	
Dividends paid	(215)	(209)
Proceeds from stock options exercised and other	23	46
Other financing activities	(2)	(2)

Net cash provided by financing activities	10,420	12,162
(Decrease) Increase in Cash and Cash Equivalents	(2,540)	2,674
Cash and Cash Equivalents at Beginning of Period	8,241	5,442
Cash and Cash Equivalents at End of Period	$ 5,701	$ 8,116
Supplemental Cash Flow Information		
Cash paid during the period for:		
Interest	$ 131	$ 111
Income taxes	$ 281	$ 350

See Notes to Condensed Consolidated Financial Statements.

THE CHARLES SCHWAB CORPORATION

Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

1. Introduction and Basis of Presentation

The Charles Schwab Corporation (CSC) is a savings and loan holding company engaged, through its subsidiaries, in securities brokerage, banking, and related financial services. Charles Schwab & Co., Inc. (Schwab) is a securities broker-dealer with 302 domestic branch offices in 45 states, as well as a branch in each of the Commonwealth of Puerto Rico and London, U.K. In addition, Schwab serves clients in Hong Kong through one of CSC s subsidiaries. Other subsidiaries include Charles Schwab Bank (Schwab Bank), a federal savings bank, and Charles Schwab Investment Management, Inc. (CSIM), the investment advisor for Schwab s proprietary mutual funds, which are referred to as the Schwab Funds®.

The accompanying unaudited condensed consolidated financial statements include CSC and its majority-owned subsidiaries (collectively referred to as the Company). All material intercompany balances and transactions have been eliminated. These condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States, which require management to make certain estimates and assumptions that affect the reported amounts in the accompanying financial statements. Certain estimates include other-than-temporary impairment of securities available for sale and securities held to maturity, the valuation of goodwill, the allowance for credit losses, and legal reserves. Actual results could differ from those estimates. These condensed consolidated financial statements reflect all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the periods presented. These adjustments are of a normal recurring nature. Certain prior-year amounts have been reclassified to conform to the 2010 presentation. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The Company s results for any interim period are not necessarily indicative of results for a full year or any other interim period.

2. New Accounting Standards

Adoption of New Accounting Standards

Transfers of Financial Assets: On January 1, 2010, the Company adopted new guidance on accounting for transfers of financial assets for transfers occurring after January 1, 2010. This new guidance removes the concept of a qualifying special-purpose entity and amends the requirements for a transfer of a portion of a financial asset to be accounted for as a sale and related disclosures. There were no transfers of financial assets during the first nine months of 2010 for which this guidance was applicable.

Consolidation of Variable Interest Entities: On January 1, 2010, the Company adopted new guidance on consolidation of variable interest entities (VIEs). This new guidance amends the consolidation guidance applicable to VIEs, including changing the approach to determining a VIE s primary beneficiary (the reporting entity that must consolidate the VIE) and the frequency of reassessment. The adoption of this new guidance did not have a material impact on the Company s financial position, results of operations, earnings per share (EPS), or cash flows.

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Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

3. Securities Available for Sale and Securities Held to Maturity

The amortized cost, gross unrealized gains and losses, and fair value of securities available for sale and securities held to maturity are as follows:

September 30, 2010	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
U.S. agency residential mortgage-backed securities	$ 13,421	$ 249	$ 1	$ 13,669
Non-agency residential mortgage-backed securities	1,943	4	297	1,650
Corporate debt securities	2,795	8		2,803
Certificates of deposit	2,799	3		2,802
U.S. agency notes	2,757	28		2,785
Asset-backed securities	2,197	11		2,208
Commercial paper	100			100
Total securities available for sale	$ 26,012	$ 303	$ 298	$ 26,017
Securities held to maturity:				
U.S. agency residential mortgage-backed securities	$ 13,074	$ 416	$	$ 13,490
Asset-backed securities	978	13		991
Corporate debt securities	338	7		345
Total securities held to maturity	$ 14,390	$ 436	$	$ 14,826

December 31, 2009	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
U.S. agency residential mortgage-backed securities	$ 11,601	$ 199	$ 21	$ 11,779
Non-agency residential mortgage-backed securities	2,460		519	1,941
Corporate debt securities	2,368	13	1	2,380
Certificates of deposit	1,950	3		1,953
U.S. agency notes	2,975	4	1	2,978
Asset-backed securities	1,077	12		1,089
Total securities available for sale	$ 22,431	$ 231	$ 542	$ 22,120
Securities held to maturity:				
U.S. agency residential mortgage-backed securities	$ 5,105	$ 36	$ 27	$ 5,114
Asset-backed securities	1,389	25		1,414

Corporate debt securities	345	7		352
Total securities held to maturity	$ 6,839	$ 68	$ 27	$ 6,880

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Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

A summary of securities with unrealized losses, aggregated by category and period of continuous unrealized loss, is as follows:

	Less than 12 months		12 months or longer		Total	
September 30, 2010	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
Securities available for sale:						
U.S. agency residential mortgage-backed securities	$ 495	$ 1	$	$	$ 495	$ 1
Non-agency residential mortgage-backed securities	8	1	1,364	296	1,372	297
Total securities with unrealized losses [(1)]	$ 503	$ 2	$ 1,364	$ 296	$ 1,867	$ 298

[(1)] The number of investment positions with unrealized losses totaled 173.

	Less than 12 months		12 months or longer		Total	
December 31, 2009	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
Securities available for sale:						
U.S. agency residential mortgage-backed securities	$ 3,801	$ 11	$ 1,994	$ 10	$ 5,795	$ 21
Non-agency residential mortgage-backed securities	171	10	1,770	509	1,941	519
Corporate debt securities	374	1			374	1
U.S. agency notes	864	1			864	1
Total	$ 5,210	$ 23	$ 3,764	$ 519	$ 8,974	$ 542
Securities held to maturity:						
U.S. agency residential mortgage-backed securities	$ 1,885	$ 27	$	$	$ 1,885	$ 27
Total	$ 1,885	$ 27	$	$	$ 1,885	$ 27
Total securities with unrealized losses [(1)]	$ 7,095	$ 50	$ 3,764	$ 519	$ 10,859	$ 569

(1) The number of investment positions with unrealized losses totaled 333 for securities available for sale and 30 for securities held to maturity.

Unrealized losses in securities available for sale of $298 million as of September 30, 2010, were concentrated in non-agency residential mortgage-backed securities. Included in non-agency residential mortgage-backed securities are securities collateralized by loans that are considered to be Prime (defined as loans to borrowers with a Fair Isaac & Company credit score of 620 or higher at origination), and Alt-A (defined as Prime loans with reduced documentation at origination). At September 30, 2010, the amortized cost and fair value of Alt-A residential mortgage-backed securities were $536 million and $374 million, respectively.

Assessment of Other-Than-Temporary Impairment

Management evaluates whether securities available for sale and securities held to maturity are other-than-temporarily impaired (OTTI) on a quarterly basis. Debt securities with unrealized losses are considered OTTI if the Company intends to sell the security or if it is more likely than not that the Company will be required to sell such security prior to any anticipated recovery. If management determines that a security is OTTI under these circumstances, the impairment recognized in earnings is measured as the entire difference between the amortized cost and then-current fair value.

A security is also OTTI if management does not expect to recover the amortized cost of the security. In this circumstance, management utilizes cash flow models to estimate the expected future cash flow from the securities and to estimate the credit loss. The impairment recognized in earnings is measured by the difference between the present value of expected cash flows and the amortized cost of the security. Expected cash flows are discounted using the security s effective interest rate.

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(Unaudited)

The evaluation of whether the Company expects to recover the amortized cost of a security is inherently judgmental. The evaluation includes the assessment of several bond performance indicators including: the portion of the underlying loans that are delinquent (30 days, 60 days, 90+ days), in bankruptcy, in foreclosure or converted to real estate owned; the actual amount of loss incurred on the underlying loans in which the property has been foreclosed and sold; the amount of credit support provided by the structure of the security available to absorb credit losses on the underlying loans; the current credit ratings issued by either Standard & Poor s, Fitch Ratings, or Moody s; the current price and magnitude of the unrealized loss; and whether the Company has received all scheduled principal and interest payments. Management uses cash flow models to further assess the likelihood of other-than-temporary impairment for the Company s non-agency residential mortgage-backed securities. To develop the cash flow models, the Company uses forecasted loss severity, prepayment speeds (i.e. the rate at which the principal on underlying loans are paid down), and default rates over the securities expected remaining maturities.

Certain Alt-A and Prime residential mortgage-backed securities experienced deteriorating credit characteristics in the first nine months of 2010, including increased payment delinquencies and increased losses on foreclosures of underlying mortgages as a result of housing price declines. Additionally, the securities have experienced a decrease in prepayment rates due to the slowing of general economic activity and heightened levels of unemployment. Forecasted home price fluctuations are an important variable in forecasting the expected loss severity and default rates. Based on the Company s cash flow projections, management determined that it does not expect to recover all of the amortized cost of these securities and therefore determined that these securities were OTTI. The Company does not intend to sell the securities available for sale and it will not be required to sell these securities before anticipated recovery. The Company employs a buy and hold strategy relative to its mortgage-related securities. Further, the Company has an adequate liquidity position at September 30, 2010, with cash and cash equivalents totaling $5.7 billion, a loan-to-deposit ratio of 17%, adequate access to short-term borrowing facilities and regulatory capital ratios in excess of well capitalized levels. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities, the Company recognized an impairment charge equal to the securities expected credit losses of $3 million and $19 million during the third quarter and first nine months of 2010, respectively. The expected credit losses were measured as the difference between the present value of expected cash flows and the amortized cost of the securities. Impairment charges recognized in earnings are included in net impairment losses on securities. Further deterioration in the performance of the underlying loans in the Company s residential mortgage-backed securities portfolio could result in the recognition of additional impairment charges.

Actual credit losses on the Company s residential mortgage-backed securities were not material during the third quarter or first nine months of 2010.

The following table is a rollforward of the amount of credit losses recognized in earnings for OTTI securities held by the Company during the period for which a portion of the impairment was recognized in other comprehensive income:

	Three Months Ended September 30,		**Nine Months Ended September 30,**	
	2010	**2009**	**2010**	**2009**
Balance at beginning of period	$ 76	$ 27	$ 60	$
Credit losses recognized into current period earnings on debt securities for which an other-than-temporary impairment was not previously recognized		6	4	38
Credit losses recognized into current period earnings on debt securities for which an other-than-temporary impairment was previously recognized	3	5	15	
Balance at end of period	$ 79	$ 38	$ 79	$ 38

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(Unaudited)

The maturities of securities available for sale and securities held to maturity at September 30, 2010, are as follows:

	Within 1 year	After 1 year through 5 years	After 5 years through 10 years	After 10 years	Total
Securities available for sale:					
U.S. agency residential mortgage-backed securities [1]	$	$	$ 106	$ 13,563	$ 13,669
Non-agency residential mortgage-backed securities [1]			24	1,626	1,650
Corporate debt securities	1,547	1,256			2,803
Certificates of deposit	2,277	525			2,802
U.S. agency notes		2,785			2,785
Asset-backed securities		701	362	1,145	2,208
Commercial paper	100				100
Total fair value	$ 3,924	$ 5,267	$ 492	$ 16,334	$ 26,017
Total amortized cost	$ 3,919	$ 5,227	$ 485	$ 16,381	$ 26,012
Securities held to maturity:					
U.S. agency residential mortgage-backed securities [1]	$	$	$ 393	$ 13,097	$ 13,490
Asset-backed securities		898	93		991
Corporate debt securities	174	171			345
Total fair value	$ 174	$ 1,069	$ 486	$ 13,097	$ 14,826
Total amortized cost	$ 172	$ 1,052	$ 484	$ 12,682	$ 14,390

(1) Residential mortgage-backed securities have been allocated over maturity groupings based on final contractual maturities. Actual maturities will differ from final contractual maturities because a certain portion of loans underlying these securities require scheduled principal payments and borrowers have the right to prepay obligations.

Proceeds and gross realized gains (losses) from sales of securities available for sale are as follows:

	Three Months Ended September 30,	Nine Months Ended September 30,

	2010	2009	2010	2009
Proceeds	$ 95	$ 22	$ 220	$ 107
Gross realized gains	$	$	$	$ 1
Gross realized losses	$	$ (3)	$	$ (4)

Realized gains and losses from sales of securities available for sale are included in other revenue.

4. Loans to Banking Clients and Related Allowance for Credit Losses

The composition of the loan portfolio is as follows:

	September 30, 2010	December 31, 2009
Residential real estate mortgages	$ 4,219	$ 3,710
Home equity lines of credit	3,480	3,304
Personal loans secured by securities	510	366
Other	19	13
Total loans to banking clients	8,228	7,393
Allowance for credit losses	(50)	(45)
Total loans to banking clients net	$ 8,178	$ 7,348

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Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

Included in the loan portfolio are nonaccrual loans totaling $48 million and $34 million at September 30, 2010, and December 31, 2009, respectively. Nonperforming assets, which include nonaccrual loans and other real estate owned, totaled $52 million and $37 million at September 30, 2010, and December 31, 2009, respectively. There were no loans accruing interest that were contractually 90 days or more past due at September 30, 2010, or December 31, 2009. The amount of interest revenue that would have been earned on nonaccrual loans, versus interest revenue recognized on these loans, was not material to the Company s results of operations for the first nine months of 2010 or 2009.

Changes in the allowance for credit losses were as follows:

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Balance at beginning of period	$ 51	$ 41	$ 45	$ 20
Charge-offs	(4)	(4)	(14)	(9)
Recoveries			1	
Provision for credit losses	3	7	18	33
Balance at end of period	$ 50	$ 44	$ 50	$ 44

5. Long-term Debt

Long-term debt net of unamortized debt discounts and premiums, where applicable, consists of the following:

	September 30, 2010	December 31, 2009
Senior Notes	$ 1,449	$ 747
Senior Medium-Term Notes, Series A	250	450
Junior Subordinated Notes	202	202
Finance lease obligation	107	111
Fair value adjustment		2
Total long-term debt	$ 2,008	$ 1,512

CSC has a universal automatic shelf registration statement on file with the Securities and Exchange Commission (SEC), which enables CSC to issue debt, equity and other securities. In the third quarter of 2010, the Company issued $700 million of Senior Notes that mature in 2020 under this registration statement. The Senior Notes have a fixed interest rate of 4.45% with interest payable semi-annually.

6. Commitments and Contingent Liabilities

The Company has clients that sell (i.e., write) listed option contracts that are cleared by various clearing houses. The clearing houses establish margin requirements on these transactions. The Company satisfies the margin requirements by arranging unsecured standby letter of credit agreements (LOCs), in favor of the clearing houses, which are issued by multiple banks. At September 30, 2010, the aggregate face amount of these LOCs totaled $445 million. In connection with its securities lending activities, Schwab is required to provide collateral to certain brokerage clients. Schwab satisfies the collateral requirements by arranging LOCs, in favor of these brokerage clients, which are issued by multiple banks. At September 30, 2010, the aggregate face amount of these LOCs totaled $14 million. There were no funds drawn under any of these LOCs at September 30, 2010.

The Company also provides guarantees to securities clearing houses and exchanges under their standard membership agreement, which requires members to guarantee the performance of other members. Under the agreement, if another member becomes unable to satisfy its obligations to the clearing houses and exchanges, other members would be required to meet shortfalls. The Company s liability under these arrangements is not quantifiable and may exceed the cash and securities

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Notes to Condensed Consolidated Financial Statements

(Tabular Amounts in Millions, Except Per Share Data, Ratios, or as Noted)

(Unaudited)

it has posted as collateral. However, the potential requirement for the Company to make payments under these arrangements is remote. Accordingly, no liability has been recognized for these guarantees.

Legal contingencies: The Company is subject to claims and lawsuits in the ordinary course of business, including arbitrations, class actions and other litigation, some of which include claims for substantial or unspecified damages. The Company is also the subject of inquiries, investigations, and proceedings by regulatory and other governmental agencies. In addition, the Company is responding to certain litigation claims brought against former subsidiaries pursuant to indemnities it has provided to purchasers of those entities. Certain of these matters are described below.

The Company believes it has strong defenses in all significant matters currently pending and is contesting liability and the damages claimed. Nevertheless, some of these matters may result in adverse judgments or awards, including penalties, injunctions, or other relief, and the Company may also determine to settle a matter because of the uncertainty and risks of litigation. Except as otherwise noted below, based on current information and consultation with counsel, management believes that the resolution of matters currently pending will not have a material impact on the financial condition or cash flows of the Company, but could be material to the Company s operating results for a particular future period, depending on results for that period. However, predicting the outcome of a matter is inherently difficult, particularly where claims are brought on behalf of various classes of claimants, claimants seek substantial or unspecified damages, or when investigations or legal proceedings are at an early stage, and in many cases, including certain matters described below, it is not possible to determine whether a loss will be incurred or to estimate the range of that loss until the matter is closer to resolution.

Auction Rate Securities Regulatory Inquiries: Schwab has been responding to industry wide inquiries from federal and state regulators regarding sales of auction rate securities to clients who were unable to sell their holdings when the normal auction process for those securities froze unexpectedly in February 2008. On August 17, 2009, a civil complaint was filed against Schwab in New York state court by the Attorney General of the State of New York (NYAG) alleging material misrepresentations and omissions by Schwab regarding the risks of auction rate securities, and seeking restitution, disgorgement, penalties and other relief, including repurchase of securities held in client accounts. As reflected in a statement issued August 17, 2009, Schwab has responded that the allegations are without merit and that Schwab intends to contest any charges. On March 15, 2010, Schwab filed a motion to dismiss the case and various claims in the civil complaint.

Separately, on November 19, 2009, Schwab received a Wells notice from the Financial Industry Regulatory Authority (FINRA) regarding a preliminary determination to recommend disciplinary action against Schwab for possible rule violations regarding sales of auction rate securities through the Company. On February 9, 2010, Schwab received a second letter from FINRA regarding additional disciplinary charges. A Wells notice provides recipients an opportunity to respond to issues raised in an investigation prior to any decision on an enforcement proceeding, and is neither a formal allegation nor a finding of wrongdoing. The Company has responded to FINRA to explain why it believes enforcement charges are unwarranted.

YieldPlus Fund Litigation and Regulatory Inquiries: The Company is the subject of consolidated class action litigation, regulatory investigations and individual investor arbitration claims relating to the Schwab YieldPlus Fund®, an ultra-short bond fund (Bond Fund). The Bond Fund was designed to invest in a variety of fixed income instruments, including corporate bonds, asset-backed securities, mortgage-backed securities and other fixed income investments. The credit crisis that began in mid-2007 led to a decline in the value of a majority of fixed income investments market wide. As a result, certain Schwab clients who chose to invest in the Bond Fund experienced a decline in their investments, leading to the litigation.

Nine class action lawsuits were filed between March and May 2008 on behalf of investors in the Bond Fund alleging violations of state law and federal securities law in connection with the fund s investment policy, disclosures and marketing. These cases were consolidated in a single action on July 3, 2008, in the U.S. District Court for the Northern District of California. Specific allegations include changes to the investment policy of the fund regarding limits on positions in mortgage-backed securities without obtaining a shareholder vote; inadequate disclosure of the risks associated with fund investments in mortgage-backed securities and fund risk management; inaccurate reporting of the fund s weighted-average duration; and failure to disclose redemptions of positions in YieldPlus by other Schwab investment funds. The lawsuit seeks unspecified compensatory and rescission damages, unspecified equitable and injunctive relief, and costs and attorneys fees. Defendants named in the lawsuit include the Company, Schwab, CSIM, the fund itself, Schwab Investments (registrant and

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issuer of the fund s shares), Charles R. Schwab, Randall W. Merk (current president of the fund), and current and former trustees and officers of the fund and/or Schwab. On February 4, 2009, the court denied defendants motion to dismiss plaintiffs federal law claims and dismissed all but one state law claim. On August 21, 2009, the court certified two classes of plaintiffs for purposes of the federal law claims and a single class of plaintiffs for purposes of the remaining state law claim.

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 Bond Fund, which plaintiffs alleged were made without shareholder approval in violation of Section 13(a) of the Investment Company Act of 1940. On April 5, 2010, defendants filed a motion for interlocutory appeal of this ruling, which the court denied at a hearing on April 26, 2010. On April 8, 2010, the court issued an order denying defendants motion for summary judgment on plaintiffs federal law claims. On April 23, 2010, the Company entered into a settlement agreement with plaintiffs in which the Company, without admitting liability, agreed to a total of $200 million to resolve plaintiffs federal law claims. On May 14, 2010, the Company entered into a settlement agreement with plaintiffs in which the Company, without admitting liability, agreed to resolve plaintiffs state law claim for $35 million. Pursuant to a joint motion by plaintiffs and defendants in support of the proposed settlements, the settlement agreements were preliminarily approved by the court on May 26, 2010, and have been awaiting final court approval. On October 14, 2010, the court issued an opinion interpreting the proposed settlement terms and holding that federal securities law class members resident outside of California would not be precluded under the proposed settlement agreements from bringing further claims under California law against the defendants. In light of the court s opinion, the Company is evaluating its litigation options, including whether to seek termination of the proposed federal and state settlements.

For the nine months ended September 30, 2010, the Company has accrued a reserve of $196 million in connection with the lawsuit, reflecting the preliminary settlements, net of insurance proceeds of $39 million under applicable policies. The Company will continue to evaluate the reserve pending final resolution of the litigation; actual liability could be higher or lower than the amount reserved.

Separately, the Company has been responding to investigations by federal and state regulators regarding these matters. On October 14, 2009, the Company received a Wells notice from the staff of the Securities and Exchange Commission (SEC) regarding the staff s preliminary determination to recommend the filing of a civil enforcement action against Schwab Investments, CSIM, Schwab, and the president of the Bond Fund for possible violations of the securities laws with respect to the fund. On October 27, 2009, the Company also received a Wells notice from FINRA regarding a preliminary determination to recommend disciplinary action against Schwab for possible violation of securities laws and FINRA rules with respect to the fund. The Company has responded to the notices to explain why it believes enforcement charges are unwarranted, and has been in discussions with the SEC and FINRA staff and state regulators regarding potential settlement of civil regulatory charges. Given the status of those discussions, the Company is unable to predict whether a settlement with the SEC or other regulators can be reached, or to estimate the range of any potential liability, and therefore has not established a reserve in connection therewith. Although the Company believes it has strong defenses if enforcement proceedings were instituted, any adverse judgment could result in the imposition of disgorgement, penalties, and other monetary and injunctive relief against the Company.

In addition to the above matters, as of September 30, 2010, the Company remained the subject of 68 individual arbitration claims seeking $17 million in damages relating to investments in the Bond Fund, for which the Company has been accruing reserves.

Total Bond Market Fund Litigation: On August 28, 2008, a class action lawsuit was filed in the U.S. District Court for the Northern District of California on behalf of investors in the Schwab Total Bond Market Fund . The lawsuit, which alleges violations of state law and federal securities law in connection with the fund s investment policy, names Schwab Investments (registrant and issuer of the fund s shares) and CSIM as defendants. Allegations include that the fund improperly deviated from its stated investment objectives by investing in collateralized mortgage obligations (CMOs) and investing more than 25% of fund assets in CMOs and mortgage-backed securities without obtaining a shareholder vote. Plaintiffs seek unspecified compensatory and rescission damages, unspecified equitable and injunctive relief, and costs and attorneys fees. On February 19, 2009, the court denied defendants motion to dismiss plaintiffs federal securities law claim, and dismissed certain state law claims with leave to amend. On April 27, 2009, the court issued a stay of proceedings while defendants

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appealed the court s February 19, 2009 decision refusing to dismiss plaintiffs federal securities law claim. On August 12, 2010, the Ninth Circuit Court of Appeals ruled in favor of the defendants and dismissed plaintiffs federal securities law claim. On September 28, 2010, plaintiffs filed a second amended class action complaint dropping the federal securities law claim and certain of its state law claims. On September 3, 2010, a second class action lawsuit by a different law firm was filed in the U.S. District Court for the Northern District of California on behalf of investors in the fund. The new lawsuit, which also names Schwab Investments and CSIM as defendants, alleges violations of state law in connection with the fund s deviation from the performance of its benchmark index and concentration in mortgage-backed securities, and seeks restitution and disgorgement of management or other fees. On October 11, 2010, defendants filed a motion to consolidate the two class actions.

The SEC Wells notice received by the Company on October 14, 2009, concerning the Bond Fund, also provided notice of the SEC staff s intention to recommend the inclusion of additional charges against Schwab Investments and CSIM for possible violations of the securities laws with respect to the Total Bond Market Fund. The Company has responded to the SEC Wells notice to explain why the proposed charges regarding the Total Bond Market Fund are unwarranted, and has also addressed the proposed charges in the discussions with SEC staff described above concerning the Bond Fund.

7. Fair Values of Assets and Liabilities

Fair value is defined as the price that would be received to sell an asset or the price paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurement accounting guidance describes the fair value hierarchy for disclosing assets and liabilities measured at fair value based on the inputs used to value them. The fair value hierarchy maximizes the use of observable inputs and minimizes the use of unobservable inputs. Observable inputs are based on market pricing data obtained from sources independent of the Company. A quoted price in an active market provides the most reliable evidence of fair value and is generally used to measure fair value whenever available. Unobservable inputs reflect management s judgment about the assumptions market participants would use in pricing the asset or liability. Where inputs used to measure fair value of an asset or liability are from different levels of the hierarchy, the asset or liability is categorized based on the lowest level input that is significant to the fair value measurement in its entirety. Assessing the significance of a particular input requires judgment. The fair value hierarchy includes three levels based on the objectivity of the inputs as follows:

Level 1 inputs are quoted prices in active markets as of the measurement date for identical assets or liabilities that the Company has the ability to access. This category includes active exchange-traded money market funds, mutual funds, and equity securities. The Company did not transfer any assets or liabilities between Level 1 and Level 2 as of September 30, 2010, or December 31, 2009.

Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates, benchmark yields, issuer spreads, new issue data, and collateral performance. This category includes residential mortgage-backed securities, asset-backed securities, corporate debt securities, certificates of deposit, commercial paper, U.S. agency and municipal debt securities, and U.S. Treasury securities.

Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. The Company did not have any financial assets or liabilities utilizing Level 3 inputs as of September 30, 2010, or December 31, 2009.

Assets and Liabilities Recorded at Fair Value

The Company s assets recorded at fair value include certain cash equivalents, investments segregated and on deposit for regulatory purposes, other securities owned, and securities available for sale. The Company uses prices obtained from an independent third-party pricing service to measure the fair value of investment securities categorized as Level 2. The Company validates prices received from the pricing service using various methods including comparison to prices received from additional pricing services, comparison to quoted market prices, where available, comparison to internal valuation

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models, and review of other relevant market data. The Company does not adjust the prices received from the independent third-party pricing service unless such prices are inconsistent with the definition of fair value and result in a material difference in the recorded amounts. At September 30, 2010, and December 31, 2009, the Company did not adjust prices received from the independent third-party pricing service. Liabilities recorded at fair value are not material, and therefore are not included in the following tables.

The following tables present the fair value hierarchy for assets measured at fair value:

September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at Fair Value
Cash equivalents:				
Money market funds	$ 1,656	$	$	$ 1,656
Certificates of deposit		250		250
Commercial paper		525		525
Total cash equivalents	1,656	775		2,431
Investments segregated and on deposit for regulatory purposes:				
U.S. Government securities		1,086		