ADMINISTRATIVE PROCEEDING BEFORE THE
SECURITIES COMMISSIONER OF SOUTH CAROLINA

IN THE MATTER OF:) COMPLAINT

E*Trade Securities, LLC,

)
)
)
)
) File Nos. 09085, 10009

----------------------~R~e~sp~o~n~d~e~n~t·~--)

NOTICE: THE RESPONDENT HAS 30 DAYS TO REQUEST A HEARING.
THE RESPONDENT HAS 30 DAYS TO FILE AN ANSWER.

The Securities Division of the South Carolina Office of the Attorney General ("the
Division") alleges that Respondent E*Trade Securities, LLC (the "Respondent" or "E*Trade") has engaged in acts, practices, and transactions, which constitute violations of the South Carolina Uniform Securities Act, S.C. Code Ann.§ 35-1-101 et seq. (Supp. 2009) (the "Act") as set forth herein.
JURISDICTION

1. The Securities Commissioner of the State of South Carolina (the "Commissioner") has jurisdiction over this matter pursuant to S.C. Code Ann. § 35-1-601(a).
FACTUAL ALLEGATIONS

Tj EMC /Sus2 246.13Sht 9A7.2<diction t021- herein, the Respondent, a limited liability company

of the State of Delaware, was a securities dealer registered with
the Division under the provisions of the Act.

EXPLANATION OF ARS PRODUCTS AND THE AUCTION PROCESS

3. "Auction rate securities" (hereinafter "ARS") are essentially long-term debt or
equity instruments that include municipal auction rate bonds, auction rate preferred shares ("ARPS") of "closed-end" mutual funds, and various asset-backed auction rate bonds. ARS are issued primarily by municipalities, investment companies (mutual funds), and corporations.
4. ARS feature a variable interest rate that resets through a periodic bidding process
known as a "Dutch auction." These auctions occur at preset intervals, typically ranging from seven (7) to forty-two (42) days. These intervals are set by the issuer and described in the prospectus at the time a particular ARS product is first offered.
5. In the typical Dutch auction, a bidder states the amount of ARS the bidder is
willing to purchase and the minimum interest rate the bidder is willing to accept. Bids are then ranked from lowest to highest, according to the minimum interest rate each bidder is willing to accept. The lowest interest rate required to sell all of a particular ARS product available at auction, is known as the "clearing rate." Setting a clearing rate serves two purposes: (a) identifying the successful bidders, and (b) setting the interest rate that will be paid by the issuer of the ARS to the new owners until the next successful auction.
6. Auctions for each ARS product are conducted at the incremental date set at the
issuance of the product. Pre-auction, existing owners of an ARS product have three choices: (a) offer their ARS for sale at the auction; (b) elect to "hold" their existing position in the ARS regardless of the new interest rate determined at the auction; or (c) elect to "hold at rate," meaning they will retain their ARS if the new clearing rate is at least as high as the prior rate. Bids to purchase ARS can be submitted by existing owners or other interested buyers.
2

7. An auction is "successful" when there are sufficient bids to purchase the number
of ARS shares offered for sale at that auction. In a successful auction, the winning bidders become the new owners of the ARS being sold by the selling investors.
8. When there are insufficient bids to purchase all of the ARS offered for sale, a
"failed" auction occurs. When an auction fails, investors are generally unable to sell any of their ARS until a successful auction occurs. Under such circumstances, investors may end up holding illiquid ARS investments until: (a) a successful auction occurs, (b) the issuer redeems the ARS, or (c) the investors decide to sell their ARS to others in the secondary market (often at a price significantly below par value).
9. Beginning in February, 2008, the ARS market experienced widespread and
repeated failed auctions from which the market has not recovered. As a result, in excess of $330 billion of ARS were rendered illiquid.
HISTORY OF ARS MARKET

10. Historically, an ARS product would generally be offered and sold by a registered
securities dealer acting as underwriter. The underwriter of the ARS product then would typically act to manage the auction held on the incremental date specified for the particular ARS. The underwriting securities dealer ordinarily would be compensated for the initial offering and receive additional fees for managing the periodic auctions until the ARS product reached maturity, was redeemed, or was no longer traded publicly.
11. In 1987, the United States Financial Accounting Standards Board ("F ASB")
adopted F ASB 95, outlining the accounting treatment of cash and "cash equivalents." Cash equivalents were defined as those investments that (i) have short terms, (ii) are readily convertible to cash, and (iii) are near maturity. FASB 95 was issued before the ARS market had grown very large.
3

12. Prior to 2005, the primary investors in ARS products were large institutional
investors or large corporations engaged in the temporary investment of cash on hand. Many of the large publicly held or traded entities that invested in ARS treated their ownership of these products as "cash equivalent" for accounting purposes.
13. In 2005, certified public accounting firms in the United States recognized that
F ASB 95 applied to ARS and began advising their clients who filed public financial reports that ARS could not be treated as "cash equivalents" under generally accepted accounting principles and F ASB 95. As the instruments were actually long-term or perpetual debt obligations, accounting firms required clients to move the accounting for ARS holdings on their balance sheets from cash equivalents to long-term debt. The consequence of implementing this change of the accounting classification for ARS was an immediate reduction of "current assets" on ARS investors' balance sheets. Instead of valuing ARS at the investors' cost (the "par" or "face" value of the ARS product), ARS had to be valued by considering the length to time of redemption or, as with ARPS, the lack of any guarantee of redemption. As this accounting position became known in 2005 and early 2006, the institutional and corporate investors who previously comprised over 90% of the investors in ARS began liquidating their holdings.
14. Due to the institutional and corporate investors' reduced demand for the purchase
of new ARS and their 'dramatic increase in orders to sell their existing ARS, underwriters, desiring to prevent failures of the ARS market, began entering "support bids" using their own proprietary trading funds. These underwriters then resold these ARS to retail clients of the firm, to divest themselves of the inventory acquired in supporting ARS auctions. The underwriters were under no legal obligation to place support bids, and could refrain from doing so at any time in their sole discretion.

4

15. By May, 2007, a substantial portion of the entire ARS market in the United
States, as much as 80% by some estimates, had been resold to retail investors.
16. In the latter part of 2007, many ARS underwriters stopped submitting support
bids in some types of ARS auctions. This resulted in a significant number of failed ARS auctions by November, 2007.
17. In February, 2008, the entire market for ARS products m the United States
collapsed when virtually all underwriting securities dealers simultaneously stopped submitting support bids. This is known as the "freeze" of the ARS market. The ARS market continues to experience widespread failures, making many ARS holdings illiquid. Since the February, 2008 freeze, some ARS have been redeemed by their issuers. However, numerous · investors, including certain of Respondent's South Carolina customers, currently hold ARS that they have been unable to sell through the auction process and that have not yet been redeemed by the issuers.
E*TRADE'S INVOLVEMENT IN THE ARS MARKET

18. The Respondent E*Trade has held itself out to its customers as a lower-cost
alternative to the "full service" securities dealers with whom it competes for business.
19. The Respondent solicited South Carolina customers to invest in ARS products.
The Respondent offered and sold ARS products to its South Carolina customers, and was compensated for these sales.
20. Unlike E*Trade's advertised equity trading business model, where customers
process their own orders in a self-directed manner, E*Trade's actual internal policies, procedures and systems required the involvement of an E*Trade Financial Advisor authorized to sell ARS products in order for a customer's purchase of those products to be completed.
5

21. E*Trade Financial Advisors, or "FAs," are E*Trade agents who engaged in the
offering, sale or purchase of securities. F As are persons who are required to be registered with the Division as securities salesmen affiliated with and supervised by the Respondent when dealing with customers in South Carolina or when an FA is present in South Carolina and engaged in the offer, sale, or purchase of securities with a customer no matter where the customer is located.

22. A sale of ARS products to a customer was accomplished by an authorized
E*Trade FA submitting a customer's order to the E*Trade fixed income desk where the order was reviewed and transmitted to the E*Trade ARS distributor for execution.
23. E*Trade's supervisory employees periodically advised FAs to consider
recommending ARS products for clients seeking short-term investing options and categorized ARS products as being comparable with U.S. Treasury Bills, Commercial Paper, and Certificates of Deposit in terms of safety and liquidity.
24. E*Trade's F As regularly recommended ARS products to clients for short-term
investments.

25. The Respondent did not provide F As with substantial training or information
about the liquidity risks of ARS products, or the possibility of failed ARS auctions, prior to the freeze of the ARS auction market in early 2008.
26. The Respondent did not advise F As to disclose the risks of failed auctions or
illiquidity to ARS purchasers prior to the freeze of the ARS auction market in early 2008.
27. The risk of failed auctions for ARS products was rarely, if ever, discussed with
the Respondent's clients prior to the freeze of the ARS auction market in early 2008.
28. The Respondent did not act as an underwriter, manager, or agent for any issuer of
ARS.

6

29. As a distributing or "downstream" broker-dealer, the Respondent did not submit
bids in an effort to support any of the ARS auctions or to prevent them from failing.
30. The Respondent acted as a broker-dealer for E*Trade Customers by submitting
their bids to purchase and orders to sell ARS.
SOUTH CAROLINA INVESTORS Client One
31. Client One was, at all times relevant herein, a resident of South Carolina.
32. Client One contacted the Respondent on October 16, 2006, requesting investment
opportunities for funds then invested in an IRA. He was connected with one of the Respondent's FAs, Brian Fallon ("Fallon"), who recommended an ARS product.
33. In making this recommendation, Fallon described ARS as providing rates of
return competitive with money market rates and stated that the products were highly liquid.
34. When Client One asked during this conversation whether he could hypothetically
liquidate the ARS at the end of the week, Fallon confirmed that this was the case.
35. Client One subsequently invested $75,000 in ARS products recommended by the
Respondent's FA.
36. Client One was not informed of the risk of failed auctions in the October 16,
2006, conversation or in any other conversation prior to the widespread failure of ARS auctions in early 2008. At that time, Client One expressed his desire to liquidate his ARS holdings if possible.
37. As of August I 9, 2010, Client One's ARS holdings remained unsold and
unredeemed in his E*Trade account.

7

Client Two
38. Client Two was, at all times relevant herein, a South Carolina resident.
39. Client Two contacted the Respondent on August 1, 2007, requesting investment
opportunities for funds in his E*Trade account. He was connected with one of the Respondent's FAs, Geoffrey Greenfield ("Greenfield"), who recommended an ARS product to Client Two.
40. In making this recommendation, Greenfield described the ARS product as a very
short-term bond that was "virtually risk-free."
41. Client Two was not informed about the auction process or the possibility of
auction failures in this conversation or any other conversation prior to the widespread failure of ARS auctions in early 2008.
42. Client Two subsequently invested $250,000 in ARS products recommended by
the Respondent's FA.
43. Prior to May 9, 2008, Client Two left a message for Greenfield expressing
concern about the state of the ARS auction market.
44. On May 9, 2008, Client Two had a conversation with Greenfield in which
Greenfield apologized for not presenting the possibility of failed auctions as a risk of the investment he recommended. At that time, Greenfield indicated his "gut feeling" was that the ARS situation would be resolved within a matter of weeks.
45. As of August 19, 2010 despite efforts to liquidate his ARS holdings, Client Two
still held over $100,000 in illiquid ARS.
APPLICABLE LAW AND CAUSES OF ACTION

46. The Commissioner has jurisdiction over this matter pursuant to S.C. Code Ann. §
35-1-601.

8

47. The Respondent E*Trade, is a federal covered broker dealer and is notice filed as
an investment advisor under the Act, and is required to observe various standards of conduct in its dealings with South Carolina customers. These standards are found in the Act, in the rules adopted by the Commissioner pursuant to the Act, in the Securities Exchange Act of 1934, and in rules imposed on the Respondent by the Securities and Exchange Commission (the "SEC") itself and through the authority of the SEC as granted to the National Association of Securities Dealers (the "NASD") and its successor organization, the Financial Industry Regulatory Authority ("FINRA").
48. The Respondent is required to reasonably supervise agents, investment adviser
representatives, and other individuals conducting securities business on its behalf pursuant to S.C. Code Ann. § 35-1-412. Similar standards are also imposed on the Respondent by 15 USC 78o(b)(4)(E) and NASD Rule 3010.
49. Pursuant to S.C. Rules 13-501 and 13-502, the Respondent is obligated to
determine the suitability of any investments recommended to customers based on reasonable inquiry and other relevant information. Similar standards are also imposed on the Respondent by NASD Rule 2310.
50. Pursuant to S.C. Code Ann. § 35-1-501, it is unlawful for a person, in connection
with the offer, sale, or purchase of a security, directly or indirectly: (1) to employ a device, scheme, or artifice to defraud; (2) to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person. Similar standards are also imposed by 15 USC 78o(c)(2)(A), NASD Rule 2210, and FINRA Rules 2010 and 2020.
9

First Cause of Action

51. The Respondent violated S.C. Code Ann. § 35-1-412 insofar as it failed to
adequately train, instruct, and supervise its agents, investment advisor representatives, and other individuals operating on its behalf as to the material disclosures and communications necessary to offer, sell, or recommend ARS products in compliance with the Act.
Second Cause of Action
52. The Respondent violated the suitability requirements of S.C. Rules 13-501 and
13-502 insofar as it failed to honor customers' stated desires for liquid investments by recommending ARS products, which carried the possibility of auction failure and illiquidity.
Third Cause of Action

53. The Respondent violated S.C. Code Ann. § 35-1-501 in the offering of ARS
products to customers by omitting to state material facts regarding the auction process
and the possibility of auction failure and illiquidity. Additionally, the Respondent has
made untrue statements of material fact by comparing ARS products with short-term investments in regards to liquidity.

REQUESTED RELIEF
WHEREAS, the Respondent's failure to supervise its agents, investment adviser representatives, and other employees violates the Act;
WHEREAS, the Respondent's failure to ascertain the suitability of ARS products for its
South Carolina ARS customers violates the Act;
WHEREAS, the Respondent's omission of material facts regarding ARS products during
10

its course of dealing with South Carolina ARS customers violates the Act;
WHEREAS, the Commissioner has the authority, pursuant to S.C. Code Ann. § 35-1-412
to issue an order denying, suspending, or revoking the registration of a broker-dealer or investment adviser;
WHEREAS, an order issued pursuant to S.C. Code Ann.§ 35-1-412 may impose a civil
penalty not to exceed $10,000 for each violation of the Act; and
WHEREAS, it is necessary and appropriate, in the public interest, for the protection of investors, and consistent with the purposes fairly intended by the policy and provisions ofthe Act to suspend the Respondent's registration as a broker-dealer in South Carolina until all of Respondent's South Carolina ARS investors desiring liquidity are made whole for their investments in ARS through the Respondent, and further to impose a civil penalty not to exceed $10,000 per violation of the Act;
NOW THEREFORE, the Division requests that the Commissioner grant the following
relief against the Respondent:
a. Suspend the Respondent's registration as a broker-dealer in South
Carolina until all South Carolina investors who (i) purchased ARS as liquid or
short-term investments from Respondent, (ii) are unable to liquidate the ARS at
par value, and (iii) desire liquidation, have obtained such relief; and
b. Order the Respondent to pay an administrative fine in an amount not
exceeding $10,000.00 dollars for each violation of the Act and each violation of any rule or order promulgated by the Commissioner; and
c. Order any other relief that the Commissioner deems appropriate.

11

NOTICE AND OPPORTUNITY FOR A HEARING

NOTICE is hereby given that the Respondent shall have thirty (30) days from the date of receipt of this Complaint to give written notice requesting a hearing on the matters contained herein to Thresechia Navarro, Securities Division, Post Office Box 11549, Columbia, South Carolina, 29211-1549. In the written Answer, the Respondent, in addition to requesting a hearing, shall admit or deny each factual allegation in this Complaint, shall set forth specific facts on which the Respondent relies, and shall set forth concisely the matters of law and affirmative defenses upon which the Respondent relies. A Respondent without knowledge or information sufficient to form a belief as to the truth of an allegation shall so state.

Upon receipt of a written notice requesting a hearing, this matter will be scheduled for a hearing. The Respondent may then appear, with or without the assistance of an attorney, at the hearing to present testimony, evidence, and argument relating to the matters contained herein. In the event such written notice requesting a hearing is not received within the above-stated thirty
(30) day period of time, an order Suspending Respondent's Registration and Imposing an Administrative Fine may be entered in this proceeding with no further notice.

12

By seeking to issue an order Suspending Respondent's Registration and Imposing an

Administrative Fine, the Division is not waiving any rights it may have to pursue additional

remedies available to it for the above or other violations of the Act committed by the

Respondent.

Executed and entered, this the ~ay of August, 2010.

SOUTH CAROLINA OFFICE OF THE ATTORNEY GENERAL

By:~~ Assistant Attorney General

Securities Division
Post Office Box 11549
Columbia, South Carolina 29211
(803) 734-4 731

13