

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO: 2006004297301**

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: E*Trade Securities, LLC (CRD No. 29106) and
E*Trade Clearing, LLC (CRD No. 25025)

Pursuant to Rule 9216 of FINRA's Code of Procedure, Respondents E*Trade Securities, LLC and E*Trade Clearing, LLC (collectively "E*Trade," "Firm," or "Respondent") submit this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against E*Trade alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Respondent E*Trade Securities, LLC has been a registered broker-dealer and a member of FINRA (f/k/a National Association of Securities Dealers or NASD) since February 19, 1992. E*Trade Securities' principal place of business is New York, New York. The Firm's business primarily consists of providing an on-line, Internet-based platform for customers trading in stocks and options.

E*Trade Clearing, LLC has been a registered broker-dealer and a member of FINRA since April 2002. E*Trade Clearing's principal place of business is also New York, New York. The activities of E*Trade Clearing, as reflected by its name, are primarily related to clearing and are not sales related.

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REGISTRATION & DISCLOSURE

OVERVIEW

During most of the period of January 1, 2003 through May 31, 2007 (the "review period"), E*Trade primarily utilized an automated proprietary system (the "System") to review accounts for potentially suspicious activity. The System employed five filters which queued transactions and accounts for further review by a group of analysts within the Firm's AML/Risk Department. The Firm developed these filters by identifying patterns of abnormal activity in brokerage accounts surrounding money movement. Consequently, E*Trade's AML filter-based System triggered a review of potentially suspicious trading activity primarily when accompanied by money movement activity. Because the Firm's AML System did not flag and cause the review of accounts for suspicious trading activity unless accompanied by suspicious money movement, it was not reasonably designed to achieve compliance with the Bank Secrecy Act and implementing regulations thereunder, in contravention of NASD Conduct Rule 3011(b), and the Firm's written procedures for detecting and reporting suspicious trading activity did not comply with NASD Conduct Rule 3011(a). Since E*Trade is a registered municipal securities dealer, E*Trade also violated MSRB Rule G-41. E*Trade's violations of NASD Rule 3011 and MSRB Rule G-41 also constitute a violation of NASD Rule 2110.

LEGAL STANDARD AND FACTS

A. FINRA's AML Rule

On July 2, 2002, the Department of Treasury, in implementing the Bank Secrecy Act, issued the regulation requiring suspicious transaction reporting for broker-dealers.¹ In accordance with this regulation, FINRA promulgated Rule 3011, which since 2002 has required broker-dealers to, among other things,

(a) Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) of the Bank Secrecy Act and the implementing regulations thereunder;

(b) Establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder;²

¹ 31 C.F.R. §103.19(a)(1) (2002).

² NASD Conduct Rule 3011; see also Special NASD Notice to Members 02-21, *Anti-Money Laundering*, dated April 2002, at 5.

A firm's AML procedures must address a number of areas including monitoring of account activities, including but not limited to, *trading* and the flow of money into and out of accounts.³ Firms are required to file with Treasury's Financial Crimes Enforcement Network ("FinCEN") "a report of any suspicious transaction relevant to a possible violation of law or regulation."⁴ With respect to the monitoring of trading, FinCEN's SAR-SF identifies 20 types of suspicious activity that must be reported including "market manipulation," "pre-arranged or other non-competitive trading," and "wash or other fictitious trading."

A firm's obligation is not a one-size-fits-all requirement and each financial institution should tailor its AML program to fit its business. In this regard, each broker/dealer, in developing an appropriate AML program should consider factors such as its size, location, business activities, the types of accounts it maintains, and the types of transactions in which its customers engage.⁵ One of the factors that members are instructed to consider generally when tailoring their supervisory procedures and systems to the business conducted is the technological environment in which the firm operates.⁶ On-line firms such as E*Trade have been instructed to "consider conducting computerized surveillance of account activity to detect suspicious transactions and activity."⁷

B. E*Trade's Automated AML System Was Inadequate Because It Focused Primarily on Money Movement

Between January 2003 and May 2007, E*Trade primarily relied upon an automated proprietary filter-based System to review accounts for money laundering activity. That System focused primarily on the review of suspicious money movement. The Firm's System utilized five filters that queued transactions and accounts for further review by analysts. Two of the five filters were designed to flag suspicious patterns of money movement into and out of accounts. Another two of the five filters were designed primarily to flag suspicious patterns of money movement in relation to the number or dollar value of trades executed. Only the fifth filter was focused primarily on potentially

³ Special NASD Notice to Members 02-21 at 5 (stating, in relevant part, that firms must determine the manner in which AML procedures that address, among other things, "monitoring of account activities including but not limited to, trading and the flow of money into and out of the account," will apply to various accounts).

⁴ 31 C.F.R. §103.19(a)(1) (2002).

⁵ Special NASD Notice to Members 02-21 at 4.

⁶ NASD Notice to Members 99-45, *NASD Provides Guidance On Supervisory Responsibilities*, at 2.

⁷ Special NASD Notice to Members 02-21 at 7.

suspicious trading activity and that was limited to monitoring the trading activity within E*Trade employees' accounts.

Once a filter was triggered, the transaction or account that resulted in the filter "hit" was electronically placed in the queue, resulting in a "System alert." Analysts then manually accessed a variety of other sources and systems to review the account activity, including any suspicious trading activity. These sources included internal systems, internet resources, FinCEN reports, and OFAC alerts from CDC. During the review period, there were approximately 400 to 800 System alerts each day and E*Trade employed three to six analysts who were responsible for reviewing these alerts. Because the alerts were triggered by money movements, it was unlikely that the System analysts reviewed for suspicious trading activity, such as wash or matched trading, in the absence of money movements. Ordinarily, the System analysts only reviewed for potentially manipulative trading activity when they received such a System alert or a referral from another department in the Firm.

During the review period, E*Trade processed, on average, more than 110,000 customer orders daily with little or no human intervention. During this period, E*Trade did not tailor its suspicious activity monitoring program to its business of facilitating investors' self-directed electronic access to the market. For example, the Firm did not conduct computerized surveillance of customer account activity to monitor for matched or washed trading. Instead, it relied on its System analysts and other employees to manually monitor for and detect suspicious trading activity without providing them with sufficient automated tools necessary to monitor for such activity.

Such an approach to suspicious activity detection was unreasonable given E*Trade's business model. By way of example, for a ten month period between January through October 2006, E*Trade customers executed 85,029 matched transactions with the exact same share amount, price, and execution time. While matched trading is not illegal in and of itself, it is expressly prohibited when effectuated "[f]or purposes of creating a false or misleading appearance of active trading in any security[.]"⁸ Consequently, a matched trade could be an indication of suspicious activity requiring further review.

E*Trade, however, had no automated systems specifically designed to detect manipulative matched or wash trading. On-line trading firms, such as E*Trade, are required to design and implement systems reasonably designed to detect trading activity in customer accounts that may be manipulative and thus reportable. Based upon the foregoing, E*Trade violated NASD Conduct Rule 3011(b).

C. E*Trade's AML Policies And Procedures Violated NASD Conduct Rule 3011(a)

⁸ Securities Exchange Act of 1934 § 9(a)(1) (2002).

E*Trade's AML procedures, called upon employees to view transactions in the context of other account activity to determine whether a transaction was suspicious. The AML procedures defined "transactions" to include "deposits, withdrawals, wire transfers, *securities trading*, and investments."⁹ As described above, during the review period the Firm's AML filter-based System triggered review of potentially suspicious trading activity primarily when accompanied by money movement activity. Accordingly, during the review period, because the Firm did not have separate and distinct monitoring procedures for suspicious trading activity in the absence of money movement, E*Trade's AML policies and procedures could not reasonably be expected to detect and cause the reporting of suspicious securities transactions.¹⁰

These failures constitute a violation of NASD Conduct Rule 3011(a).

Conclusion

As set forth above, E*Trade violated NASD Conduct Rules 3011 and 2110, and MSRB Rule G-41 (1) by failing to establish and implement policies and procedures that could reasonably be expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g), and (2) by failing to establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder.

B. Respondent also consents to the imposition, at a maximum, of the following sanctions:

1. A censure; and
2. A fine of \$1 million.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

The sanctions set forth above take into account the Firm's prompt corrective action to remediate its AML system and procedures after the initiation of FINRA's investigation, but without prompting by FINRA, including the implementation of automated monitoring systems specifically designed to detect suspicious trading during the review period and the expansion of staff along with the retention of third party vendors dedicated to the monitoring function.

⁹ E*Trade Financial Corporation Domestic Regulated Brokerage Subsidiaries Anti-Money Laundering Policies And Procedures, *Transactions*, at 6 (emphasis added).

¹⁰ Within the Firm's written supervisory procedures and manuals during the review period, there were a total of seven references to "market manipulation", but these were limited in nature and could not reasonably be expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g).

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against it;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review

Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and
- C. If accepted:
 - 1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;
 - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record;
 - 3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-3; and
 - 4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.
- D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

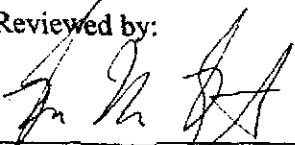
Respondent certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that it has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

12-17-08
Date

E*Trade Securities, LLC
E*Trade Clearing, LLC
Respondent
E*Trade Securities, LLC
E*Trade Clearing, LLC

By: James E. Ballowe, Jr.
General Counsel

Reviewed by:

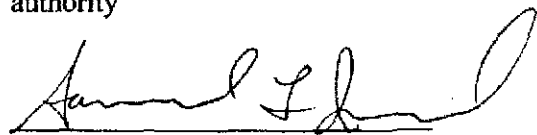


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Washington, D.C. 20006-1101

Accepted by FINRA:

12/31/08
Date

Signed on behalf of the
Director of ODA, by delegated
authority



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