

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. C040400_62

To: Department of Enforcement
NASD

Re: Scottrade, Inc.
Member (CRD No. 8206)

Pursuant to NASD Procedural Rule 9216, Scottrade, Inc. (Scottrade) submits this Letter of Acceptance, Waiver and Consent (AWC) for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against Scottrade alleging violations based on the same factual findings.

Scottrade understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and the National Adjudicatory Council (NAC) Review Subcommittee or the Office of Disciplinary Affairs (ODA), pursuant to NASD Procedural Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Scottrade; and
3. If accepted:
 - a. This AWC will become part of Scottrade's permanent disciplinary record and may be considered in any future actions brought by NASD or any other regulator against Scottrade;
 - b. This AWC will be made available through NASD's public disclosure program in response to public inquiries about Scottrade's disciplinary record;
 - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Procedural Rule 8310 and IM-8310-2; and
 - d. Scottrade 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 allegation in this AWC or create the impression that the AWC is without factual basis. Nothing in this provision affects Scottrade's testimonial obligations or rights to take legal or factual positions in litigation or other legal proceedings in which NASD is not a party.

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Scottrade also understands that its experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

Scottrade has been a member of NASD since May 1980. Scottrade conducts a general securities business from its main office located in St. Louis, Missouri. Scottrade does not have any relevant disciplinary history.

I. WAIVER OF PROCEDURAL RIGHTS

Scottrade specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against Scottrade;
- 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 NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Furthermore, Scottrade specifically and voluntarily waives any right to claim bias or prejudice 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.

In addition, Scottrade specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of NASD Procedural Rule 9143 or the separation of functions prohibitions of NASD Procedural 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.

II. ACCEPTANCE AND CONSENT

- A. Scottrade hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD 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 NASD:

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A. SUMMARY

1. From at least January 1, 2001 to at least September 28, 2001 (the "relevant period"), Scottrade improperly extended credit by permitting cash account customers to use the proceeds of unsettled sale transactions to fund subsequent purchase transactions in violation of Regulation T, promulgated under Section 7 of the Securities Exchange Act of 1934 (the "Exchange Act").
2. Specifically, Section 220.8 of Regulation T and interpretations thereunder require full cash payment for the purchase of any security in a cash account, prior to the sale of that security.
3. During the relevant period, Scottrade required cash or fully paid for securities to be deposited prior to the customer's first transaction in the account. Thereafter, it permitted a customer to conduct buy/sell transactions using the proceeds of prior unsettled sales to pay for subsequent purchases, without having a good-faith basis for believing that the customer would promptly make full cash payment before selling the security. Such conduct violates Regulation T.
4. During the relevant period, Scottrade permitted over 1,400 cash accounts to effect approximately 27,597 transactions in this manner.

B. REGULATION T AND CASH ACCOUNTS

5. Section 7(c) of the Exchange Act provides, in relevant part, as follows:

It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer - on any security (other than an exempted security) ... in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System ... shall prescribe.
6. Section 220.8(a)(1)-(2) of Regulation T, promulgated by the Board of Governors of the Federal Reserve System provides, in relevant part, as follows:
 - (a) *Permissible Transactions.* In a cash account, a creditor, may:
 - (1) Buy for or sell to any customer any security or other asset if: (i) There are sufficient funds in the account; or (ii) The creditor accepts in good faith the customer's agreement that the customer will promptly make full cash payment for the security or asset before selling it and does not contemplate selling it prior to making such payment.

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- (2) Buy from or sell for any customer any security or other asset if:
 - (i) The security is held in the account; or (ii) The creditor accepts in good faith the customer's statement that the security is owned by the customer or the customer's principal, and that it will be promptly deposited in the account
- 7. Regulation T prohibits the extension of credit to cash account customers. "A broker may buy securities for a cash account only if the customer has sufficient funds in the account to pay for all purchases independent of the sale proceeds to be received from the sale of those securities." See Lewco Securities Corporation, Exch. Act Rel. No. 36334 (October 4, 1995). See also In re John Thomas Gabriel, Exch. Act Rel. No. 34661 (September 13, 1994).
- 8. Under Regulation T, securities may only be purchased in a cash account if the customer has sufficient funds in the account to pay for all purchases, independent of the sale proceeds to be received from the sale of those securities. See Fed. Res. Staff Op., 2 *Federal Reserve Regulatory Services*, Part 5-616.11 (May 27, 1994). In order to comply with Regulation T, a customer must have funds for the purchase in the account or must deliver a check for full payment of the purchase transaction to the broker-dealer by settlement date. See Fed. Res. Staff Op., 2 *Federal Reserve Regulatory Services*, Part 5-615.94 (Sept. 30, 1986 and March 30, 1987). The use of proceeds of the sale of a security to pay for its purchase is prohibited. Id. A customer who sells a security on trade date to pay for another security purchased on that day does not have "sufficient funds in the account" on trade date. See Fed. Res. Staff Op., 2 *Federal Reserve Regulatory Services*, Part 5-616.14 (Feb. 18, 1999). See also Fed. Res. Staff Op., 2 *Federal Reserve Regulatory Services*, 5-616.15 (Jan. 6, 2000) and Fed. Res. Staff Op., 2 *Federal Reserve Regulatory Services*, Part 5-615.971 (Apr. 19, 1991) ("Payment cannot be made if the sale of the security or another security on the date of delivery is expected to provide the funds for payment.").
- 9. In January 2000, the Federal Reserve Staff issued two opinions that address the issue of transactions in cash accounts. In the first Staff opinion, Federal Reserve Staff Opinion 5-616.16,¹ a cash account customer begins the day with \$10,000 in cash. The customer then engages in four transactions that same day: buys stock A for \$10,000, sells stock A for \$10,000, buys stock B for \$10,000, and sells stock B for \$10,000. With respect to the purchase of stock B, the Board staff stated that the purchase must be made pursuant to Section 220.8(a)(1)(ii) (which requires the creditor to accept in good faith the customer's agreement to make full cash payment for the security before selling it), because the funds in the account had already been used for the purchase of stock A. The Board staff then stated:

¹ Fed. Res. Staff Op., 2 *Federal Reserve Regulatory Services*, Part 5-616.16 (Jan. 7, 2000).

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Because the customer is selling the stock of Company B on the same day it is purchased (which is before settlement date for the purchase), the creditor's good-faith acceptance of the customer's agreement required by section 220.8(a)(1)(ii) would be called into question. Although a one-time sale of a security in a cash account before settlement date without full cash payment may not itself be a violation of Regulation T, the creditor must exercise increasing caution in accepting subsequent purchases pursuant to 220.8(a)(1)(ii).

10. In the other Federal Reserve Staff opinion issued in January 2000, Federal Reserve Staff Opinion 5-616.16,² a cash account customer began the day with fully paid-for securities and no cash in the account. That same day, the customer instructs the creditor to sell the securities. Yet later that same day, the customer instructs the creditor to purchase the same securities for the same cost at which they were sold. The Board staff stated that the sale was permissible under section 220.8(a)(2)(i), which permits a creditor to sell fully-paid securities in an account. The purchase was permissible under 220.8(a)(1)(ii), which permits a creditor to sell a security "if the creditor accepts in good faith the customer's agreement that the customer will promptly make full cash payment for the security or asset before selling it and does not contemplate selling it prior to making such payment."
11. In a recently issued Federal Reserve Staff Opinion, 5-616.16,³ the Board staff reiterated that the practice of permitting cash account customers to use the proceeds of unsettled sale transactions to fund subsequent purchase transactions violates Regulation T. Specifically, in May 2003 the Board staff addressed a situation in which a customer sells stock A on Day 1, buys stock B on Day 2, sells stock B on Day 3, and then buys and sells stock C on Day 5. The fact pattern assumed the following: (1) each of the purchases was less than the value of the account; (2) stock A had been fully paid-for; and (3) a three-day settlement process applied. The Board staff stated that Regulation T permits two methods for paying for a securities purchase in a cash account: (1) a customer who has sufficient funds in the account on trade date may purchase securities and sell them at any time; and (2) a customer who does not have sufficient funds in the account on trade date may purchase securities only with the understanding that such securities will not be sold until they are paid in full. However, the Board staff emphasized that sale proceeds that had not yet been received do not constitute "sufficient funds." Consequently, under the facts presented, the Board staff stated that the sale of stock B on Day 3 should have put the creditor on notice that the customer may have engaged in an impermissible transaction, because stock B was purchased with the proceeds of the sale of stock A, and the sale of stock A would not settle until Day 4. In that same regard, the sale of stock C

²Fed. Res. Staff Op., 2 Federal Reserve Regulatory Services, Part 5-616.16 (Jan. 7, 2000).

³Fed. Res. Staff Op., 2 Federal Reserve Regulatory Services, Part 5-616.18 (May 12, 2003).

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on Day 5 was similarly impermissible because it was purchased with unsettled funds from the sale of stock B. The Board reiterated that this interpretation did not set forth a new legal proposition: "For over 50 years, Regulation T has required customers to pay for securities purchased in a cash account before selling them."

C. THE VIOLATIONS

12. From at least January 1, 2001 to at least September 28, 2001, Scottrade permitted customers to purchase and sell securities in a series of trades without requiring full cash payment for each securities purchase. Further, Scottrade did not have any good-faith basis for believing that the customers would promptly make full cash payment before selling the securities. Instead, Scottrade improperly permitted the use of unsettled proceeds of securities sold as payment for subsequent securities purchases, and then allowed the securities purchased to be sold without requiring full cash payment.
13. For example, Scottrade effected for a cash account customer at least five unlawful purchases and at least five unlawful sales, with each set of transactions on the same day, using unsettled funds. During the relevant period, Scottrade similarly effected purchases for a cash account customer on one day, and then effected sell transactions of the same stock the following day, again without the purchase funds being settled. Each of the practices violates Regulation T.
14. In connection with the foregoing trades, totaling 27,597 transactions, Scottrade permitted the improper trading by one of two means: (i) securities were sold without full cash payment having been made by the customer, and/or (ii) proceeds from unsettled sale transactions were applied as payment for subsequent purchases.
15. Scottrade charged cash account customers approximately \$7 for a market order during the relevant time period. Consequently, Scottrade received approximately \$193,170 in revenue due to the foregoing misconduct.
16. The foregoing acts, practices and conduct by Scottrade constitute separate and distinct violations of Section 7, Section 220.8 of Regulation T and NASD Conduct Rule 2110.

SANCTIONS

Scottrade consents to the imposition, at a maximum, to the following sanctions of:

1. A censure; and
2. A fine of \$250,000 to be paid within 10 days of notice of acceptance of this AWC.

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

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III. OTHER MATTERS

- A. Scottrade understands that it may attach a Statement of Corrective Action to this AWC, which is a statement of demonstrable corrective steps taken to prevent future misconduct. Scottrade 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 NASD, nor does it reflect the views of NASD or its staff.
- B. Scottrade agrees to pay any monetary sanctions imposed on it upon notice that this AWC has been accepted and that such payments are due and payable. Scottrade has attached an Election of Payment form showing the method by which it proposes to pay any fine imposed.
- C. Scottrade specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

Scottrade certifies that this AWC has been read and that all provisions of this AWC are understood, and that Scottrade has been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, has been made to induce Scottrade to submit it.

SCOTTRADE, INC.

11/31/04
Date

By: 
Rodger O. Riney, President

Reviewed by:


Counsel for Scottrade, Inc.

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Accepted by NASD:

December 21, 2004

Date

A handwritten signature in black ink, appearing to read "Thomas D. Clough", written over a horizontal line.

Thomas D. Clough, District Director
Signed on behalf of the Director of ODA, by
delegated authority