

JUDGE JONES

08 CIV 10053

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

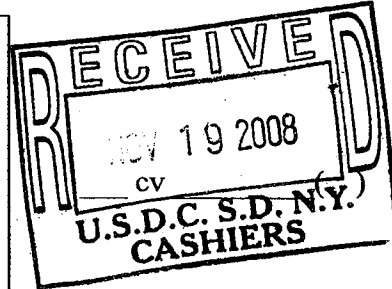
SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

DENNIS K. McNELL,

Defendants.



COMPLAINT

The Securities and Exchange Commission (the "SEC" or "Commission") alleges as follows:

NATURE OF THE ACTION

1. This case arises from the fraudulent conduct of Dennis K. McNell ("McNell") while he was the Chief Executive Officer ("CEO"), Chief Operating Officer ("COO"), and a registered representative of Redwood Trading, LLC ("Redwood"), a now defunct broker-dealer. During the period of October 2003 through September 2004, McNell (i) aided and abetted his customer's fraudulent trading scheme involving the execution of thousands of short sales of securities listed on the New York Stock Exchange ("NYSE") with the intent to artificially depress the price of those shares, and (ii) engaged in a scheme to conceal substantial trading losses that McNell had incurred in a Redwood proprietary trading account during July and August 2004. The trading scheme that was orchestrated by McNell's customer, and aided and abetted by McNell, yielded approximately \$2,400,000 in illicit gains in less than a year. McNell's scheme to

hide trading losses, caused losses to Redwood of approximately \$140,000, which, in turn, caused Redwood to engage in business while undercapitalized.

2. Between October 2003 and September 2004, a Redwood customer carried out a manipulative scheme through several Redwood accounts by repeatedly executing short sales of numerous securities listed on the NYSE with the intent to artificially depress the price of those shares. In furtherance of the scheme, the Redwood customer routinely executed short sales while the price of the security was declining, in violation of SEC Rule 10a-1, which was in effect at that time. The Redwood customer also failed to mark thousands of his orders to sell securities as short sales in order to create the false appearance that the orders were long sales.

3. As the broker for the Redwood customer's accounts, McNell aided and abetted these violations by (i) disabling the function of Redwood's trading software that was programmed to prevent illegal short selling, and (ii) allowing the Redwood customer to engage in the illegal conduct for almost a year. As a result, when the Redwood customer entered his illegal short sale orders, the Redwood trading software did not block the orders, as it was designed to do, and instead, submitted them for execution on the NYSE, where they were routinely executed in violation of SEC Rule 10a-1, which was in effect at that time.

4. During July and August 2004, McNell also fraudulently concealed his substantial trading losses from Redwood's chief compliance officer ("Compliance Officer"). Specifically, McNell surreptitiously caused over ninety unprofitable trades, resulting in approximately \$140,000 of losses, to be transferred into Redwood's error

account from a day trading account over which McNell had exclusive control and trading authority.

5. By incurring these substantial losses, and then concealing them from Redwood's Compliance Officer, McNell also caused Redwood to violate its net capital requirements.

6. By engaging in this conduct, McNell violated Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 thereunder, and aided and abetted violations of Sections 9(a)(2), 10(a)(1), 10(b), 15(c)(3) and 17(a)(1) of the Exchange Act [15 U.S.C. §§ 78i(a)(2), 78j(a)(1), 78j(b), 78o(c)(3), and 78q(a)(1)], Exchange Act Rules 10b-5, 15c3-1, 17a-3, 17a-4(j) [17 C.F.R. §§ 240.10b-5, 240.15c3-1, 240.17a-3 and 240.17a-4(j)] and former Exchange Act Rule 10a-1 [17 C.F.R. § 240.10a-1]. Unless enjoined, defendant will likely engage in such conduct and commit such violations (except for violations of former Rule 10a-1, which has been rescinded) in the future. Accordingly, the defendant should be enjoined from violating these provisions and rules, except former Rule 10a-1, and ordered to pay appropriate civil money penalties.

JURISDICTION AND VENUE

7. This Court has jurisdiction over this action pursuant to Sections 21(d), 21(e), and 27 of the Exchange Act [15 U.S.C. §§ 78u(d) and (e), and 78aa].

8. Venue is proper in this district pursuant to Section 27 of the Exchange Act [15 U.S.C. § 78aa] because certain acts and transactions constituting the violations occurred in this district.

9. McNell, directly or indirectly, made use of the means or instrumentalities of interstate commerce, or of the mails, or the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged in the complaint.

DEFENDANT

10. Defendant McNell is 42 years old and currently resides in Northern California. He was a former principal of Redwood and also served as the CEO, COO, and a registered representative at the firm. McNell has not been associated with a securities broker or dealer since December 2006.

RELEVANT ENTITY

11. During the relevant period, Redwood had its headquarters in San Francisco, California and was registered with the Commission as a broker-dealer. Redwood ceased operations on December 31, 2004. In January 2005, Redwood filed a Form BDW to withdraw its registration as a broker-dealer. In March 2005, the SEC terminated Redwood's registration as a broker-dealer.

FACTUAL ALLEGATIONS

Background

12. During the relevant period, Section 10(a)(1) of the Exchange Act and former Rule 10a-1 thereunder provided that, subject to narrow exemptions, none of which were applicable to the short sales alleged herein, a listed security could not be sold short on "minus-ticks" or "zero-minus-ticks." A "minus-tick" refers to a price below the immediately preceding sale price for that security. A "zero-minus-tick" refers to a price which is the same as the immediately preceding sale price for that security, but which is

less than the most immediate different preceding sale price. In this Complaint the terms, “minus tick” and “zero-minus-tick” will be collectively referred to as a “down-tick.”

Rule 10a-1 was rescinded by the Commission in July 2007.

13. During the relevant period, Exchange Act Rule 3b-3 defined a “short sale” as any sale of a security which the seller does not own, and further states that “a person shall be deemed to own securities only to the extent that he has a net long position in such securities.”

McNell Disabled the Function in Redwood’s Software that was Programmed to Prevent Illegal Short Selling in Redwood Accounts

14. In December 2002, McNell’s customer, Robert Beardsley (“Beardsley”), opened a day-trading account at Redwood in the name of Redstar Capital (“Redstar”), a company he owned and controlled. Subsequently, Beardsley opened additional day-trading accounts at Redwood in the name of several nominees.

15. From December 2002 through September 2004, Beardsley traded stocks in his Redwood accounts, including the Redstar and nominee accounts, from one or more computers in his house, by using trading software that Redwood provided to him and other customers.

16. In late 2003, Beardsley called McNell to complain about the buying power limitations in the Redstar account. In response to Beardsley’s complaint, McNell enabled a back-office software function called “Ignore Buying Power Limits,” which removed certain limits on Beardsley’s buying power in his Redwood accounts. During this call, McNell also told Beardsley about another trading software function called, “Ignore Trading Rules.” Although this function did not relate to Beardsley’s complaint about buying power, Beardsley asked McNell to enable it as well. McNell then enabled the

“Ignore Trading Rules” function. By enabling the Ignore Trading Rules function, McNell disabled the software’s ability to block short selling of stocks on down-ticks.

17. Almost immediately, Beardsley realized that he could execute short sales of stock on down-ticks through his Redstar account, in contravention of the then-existing short sale rules. Beardsley then began to execute illegal short sales through his Redstar account at Redwood.

18. All of the illegal trades in the Redstar account were executed on the NYSE. To ensure that the illegal short sales would be executed by the NYSE, Beardsley failed to mark his orders as short sales, thereby creating the false appearance that his orders were long sales. Consequently, Beardsley’s short sale orders were routinely executed on down-ticks through the NYSE.

19. On or about December 2003, Beardsley asked McNell to open additional accounts at Redwood in the name of two nominees (the “Nominee accounts”).

20. When McNell set up these accounts, he gave the accounts the same capabilities as the Redstar account, including enabling the Ignore Trading Rules function. This allowed short sales on down-ticks to be executed in these accounts as well.

21. Beardsley then invited another trader, George Lindenberg, to trade with him in the Nominee accounts. (The Nominee accounts and the Redstar account will hereinafter be collectively referred to as the “Beardsley accounts.”)

22. All of the trading in the Beardsley accounts was executed pursuant to a short selling scheme designed to drive down the price of a stock by selling shares short on a down-tick, an illegal practice at the time, and then covering the short position at the artificially depressed price.

23. Beardsley successfully employed the short selling scheme with respect to numerous NYSE-listed securities. Although the profit for each of the illegal trading sequences was relatively small, Beardsley executed dozens of such trading sequences in a typical trading day, and thereby obtained illicit trading profits of approximately \$2,400,000 in less than a year.

**McNell Knew that Beardsley Was Perpetrating a Fraudulent Scheme
Through the Beardsley Accounts**

24. During the relevant period, McNell, as the broker for the Beardsley accounts, knew that Beardsley was carrying out an illegal scheme in the Beardsley accounts. By late December 2003 or early January 2004, McNell knew about Beardsley's illegal scheme based on statements made by Beardsley to McNell and McNell's review of Redwood trading records for the Beardsley accounts.

25. For example, in late December 2003 or early January 2004, McNell asked Beardsley whether all of the short selling in the Beardsley accounts was being executed illegally. In response, Beardsley asked McNell if he intended to modify the back-office settings to prevent further illegal short selling. McNell responded that he would "see what happens." In fact, McNell never modified the back office functions to stop the illegal short selling until September 2004, after he became aware of the SEC's investigation.

26. McNell, as the broker for the Beardsley accounts, was required to, and did, review the trading in these accounts. McNell routinely reviewed Redwood account records that inaccurately reflected that the Beardsley accounts had executed long sales of securities that McNell knew had actually been sold short. In the course of reviewing

these records, McNell also learned that Beardsley was not accurately marking the sale orders in the Beardsley accounts as short. Based on this deception, these short sale orders were routinely executed on down-ticks on the NYSE, in violation of SEC Rule 10a-1, which was in effect at that time.

McNell's Fraudulent Scheme to Conceal Proprietary Trading Losses by Transferring Them to Redwood's Error Account

27. From on or about July 28 through August 24, 2004, McNell defrauded Redwood by concealing his losses in a day trading account over which McNell had exclusive control and trading authority (the "McNell proprietary account") by secretly transferring the losses to a Redwood error account. McNell knew that Redwood's error account was only to be used to resolve legitimate trading errors. McNell engaged in this illicit conduct so that he could conceal his substantial trading losses from Redwood's Compliance Officer.

28. In particular, McNell surreptitiously caused over ninety unprofitable trades, resulting in approximately \$140,000 of losses, to be transferred into Redwood's error account from the McNell proprietary account.

29. In order to cause the losing trades to be transferred to the error account, McNell accessed the back-office portion of the trading software and canceled the losing trades in the McNell proprietary account. McNell knew that by canceling these losing trades in the McNell proprietary account after the orders had been executed, they would be transferred to Redwood's error account by Redwood's clearing firm.

30. Because McNell canceled these losing trades during the trading day, the trades were not identified by Redwood's clearing firm as having originated in the McNell proprietary account. Consequently, the clearing firm did not generate order tickets for

those trades, as it would have done in the ordinary course. Moreover, the trade blotters that were generated for the McNell proprietary account were materially inaccurate because they did not reflect that these losing trades had been executed in that account.

31. For example, on or about August 19, 2004, McNell purchased 7,000 shares of Google at a price of approximately \$103.641 per share. On that day, McNell also sold 7,000 shares of Google at a price of \$96.952, resulting in a loss of approximately \$47,000. After McNell executed these losing trades in Google stock, he subsequently canceled them so that they would not appear in the McNell proprietary account. As a result, these Google trades were transferred to Redwood's error account, effectively transferring the \$47,000 in trading losses from the McNell proprietary account to Redwood's error account. Consequently, Redwood's records for the McNell proprietary account for August 19, 2004 falsely reflected that the account had a loss of approximately \$6,000 when, in reality, it had a loss of approximately \$53,000 including the approximately \$47,000 in losses from trading Google stock, which McNell had secretly transferred to the error account.

**McNell Created a False Profit to Further Conceal
the Effect of His Trading Losses**

32. To further conceal the adverse effect of his trading losses on Redwood's net capital and financial condition, McNell fraudulently created a false profit in the McNell proprietary account.

33. To do this, on or about August 24, McNell accessed the back-office function of the trading software and altered the execution price of 1,400 Google shares that he had purchased from the correct execution price of \$104.31 to \$0.31 per share. By doing this, McNell caused Redwood to falsely report to its clearing firm at the end of the

trading day on August 24, that the McNell proprietary account had bought 1,400 shares of Google at \$0.31 per share, instead of the correct price of \$104.31. This created a false profit of approximately \$146,000 in the McNell proprietary account. McNell created this phantom profit to offset the approximately \$140,000 of losses that McNell had transferred to Redwood's error account. On August 25, Redwood's clearing firm detected the mispriced Google shares and corrected the purchase price for those shares.

**Redwood Had a Net Capital Deficiency as a Result of
McNell's Trading Losses**

34. On or about August 24, 2004, Redwood had a net capital deficiency of approximately \$40,000. The net capital deficiency was a direct result of the approximately \$140,000 in trading losses that McNell had incurred in the McNell proprietary account and secretly transferred to Redwood's error account.

35. On or about August 30, 2004, Redwood's Compliance Officer discovered that Redwood was below its minimum net capital requirement. This net capital deficiency was remedied by the close of business on August 31, 2004, when Redwood's majority owner contributed approximately \$75,000 to Redwood.

36. From August 24, 2004 through August 31, 2004, Redwood continued to allow its customers to trade in Redwood accounts even though the firm had a net capital deficiency.

37. During the relevant period, McNell, as the CEO and COO of Redwood, knew that his substantial trading losses were having a significant adverse impact on the firm's net capital.

McNell Failed to Produce Redwood's Records to the SEC

38. During the relevant period, McNell was obligated to, and did, maintain custody and control of Redwood's books and records.

39. On or about March 26, 2006, the SEC issued a subpoena (the "SEC Subpoena") to McNell, requiring the production of certain Redwood books and records that were in McNell's custody and control. These documents included any Redwood documents regarding trading in the McNell proprietary account, any Redwood account statements and trading records concerning the firm's error account, and Redwood communications concerning these and other subject matters. These documents included records that Redwood was required to preserve under Section 17(a)(1) of the Exchange Act, and Rule 17(a)(3) thereunder.

40. Pursuant to Exchange Act Rule 17a-4(j) [17 C.F.R. § 240.17a-4(j)], Redwood was obligated to promptly furnish to the SEC staff, upon the staff's request, copies of those records that it was required to preserve under Section 17(a)(1) of the Exchange Act, but failed to do so.

41. McNell, in his capacity as the custodian of Redwood's books and records, was required to promptly produce the requested documents to the SEC staff, but he repeatedly failed to do so.

FIRST CLAIM FOR RELIEF

McNell Aided and Abetted Beardsley's Violations of Sections 9(a)(2), 10(a)(1), and 10(b) of the Exchange Act [15 U.S.C. §§ 78i(a)(2), 78j(a)(1), and 78j(b)], and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5], and former Exchange Act Rule 10a-1 [17 C.F.R. § 240.10a-1]

42. Paragraphs 1 through 41 are re-alleged and incorporated herein by reference.

43. Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)] provides that any person who knowingly provides substantial assistance to another person in violation of a provision of the Exchange Act, or any rule or regulation issued under the Exchange Act, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

44. By engaging in the above-conduct in the Beardsley accounts, Beardsley, directly or indirectly, knowingly or recklessly, by use of the means or instrumentalities of interstate commerce or of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of a security: (a) employed a device, scheme, or artifice to defraud; (b) made untrue statements of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in acts, practices, or courses of business which operated as a fraud or deceit upon other persons, in violation of Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

45. By engaging in the above-conduct in the Beardsley accounts, Beardsley directly or indirectly effected, alone or with one or more other persons, a series of

transactions in securities registered on a national securities exchange, creating actual or apparent active trading in such securities, or raising or depressing the price of such securities, for the purpose of inducing the purchase or sale of such securities by others, in violation of Section 9(a)(2) [15 U.S.C. § 78i(a)(2)].

46. At the time of the alleged conduct, Section 10(a)(1) of the Exchange Act and Rule 10a-1 thereunder provided that, subject to narrow exemptions, a listed security could not be sold short (i) at a price below the immediately preceding sale price for that security, or (ii) at a price which is the same as the immediately preceding sale price for that security, but which is less than the most immediate different preceding sale price. None of the exemptions that were provided for under the rule were applicable to the short selling executed in the Beardsley accounts during the relevant period, as alleged herein. By engaging in the above-conduct in the Beardsley accounts, Beardsley violated Section 10(a)(1) [15 U.S.C. § 78j(a)(1)] and former Exchange Act Rule 10a-1 [17 C.F.R. § 240.10a-1].

47. By his conduct, described above, McNell knowingly provided substantial assistance to Beardsley's violations of Sections 9(a)(2), 10(a)(1), and 10(b) of the Exchange Act [15 U.S.C. §§ 78i(a)(2), 78j(a)(1), and 78j(b)], and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5], and former Exchange Act Rule 10a-1 [17 C.F.R. § 240.10a-1].

48. By engaging in the foregoing conduct, McNell aided and abetted violations of Sections 9(a)(2) [15 U.S.C § 78i(a)(2)], 10(a)(1) [15 U.S.C. § 78j(a)(1)] and 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5], and former Exchange Act Rule 10a-1 [17 C.F.R. § 240.10a-1].

SECOND CLAIM FOR RELIEF

McNell Violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)], and Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5]

49. Paragraphs 1 through 48 are re-alleged and incorporated herein by reference.

50. By reason of the foregoing conduct relating to McNell's concealment of his trading losses from Redwood, McNell directly or indirectly, knowingly or recklessly, by use of the means or instrumentalities of interstate commerce or of the mails, or of the facilities of a national securities exchange, in connection with the purchase or sale of a security: (a) employed a device, scheme or artifice to defraud; (b) made untrue statements of a material fact or omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in acts, practices, or courses of business which operated as a fraud or deceit upon other persons.

51. By engaging in the foregoing conduct, defendant McNell violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5].

THIRD CLAIM FOR RELIEF

McNell Aided and Abetted Redwood's Violations of Section 15(c)(3) of the Exchange Act [15 U.S.C. § 78o(c)(3)], and Exchange Act Rule 15c3-1 [17 C.F.R. § 240.15c3-1]

52. Paragraphs 1 through 51 are re-alleged and incorporated by reference.

53. Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)] provides that any person who knowingly provides substantial assistance to another person in violation of a provision of the Exchange Act, or any rule or regulation issued under the Exchange Act,

shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

54. Section 15(c)(3) of the Exchange Act [15 U.S.C. § 78o(c)(3)] makes it unlawful for a broker or dealer to engage in any securities business while not in compliance with the net capital rule, Exchange Act Rule 15c3-1 [17 C.F.R. § 240.15c3-1].

55. As described above, McNell knowingly provided substantial assistance to Redwood's violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder, by among other things, causing Redwood to engage in securities business while it was in violation of the net capital rule.

56. By engaging in the foregoing conduct, McNell aided and abetted Redwood's violations of Section 15(c)(3) of the Exchange Act and Rule 15c3-1 thereunder.

FOURTH CLAIM FOR RELIEF

McNell Aided and Abetted of Redwood's Violations of Section 17(a)(1) of the Exchange Act [15 U.S.C. § 78q(a)(1)], and Exchange Act Rules 17a-3 and 17a-4(j) [17 C.F.R. §§ 240.17a-3 and 240.17a-4(j)]

57. Paragraphs 1 through 56 are re-alleged and incorporated by reference.

58. Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)] provides that any person who knowingly provides substantial assistance to another person in violation of a provision of the Exchange Act, or any rule or regulation issued under the Exchange Act, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

59. Section 17(a)(1) [15 U.S.C. § 78q(a)(1)] of the Exchange Act and Rule 17a-3 [17 C.F.R. § 240.17a-3] thereunder require that registered brokers and dealers make and keep current certain specified books and records relating to their business. Such books and records must be accurate.

60. Among the records that brokers and dealers are required to make and keep are: (i) blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities [Rule 17a-3(a)(1)]; and (ii) “[a] memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution” [Rule 17a-3(a)(7)]. Among other things, McNell’s scheme to conceal his trading losses caused Redwood to (i) not create order tickets for his trading in the McNell proprietary account, and (ii) create inaccurate trade blotters for the trading in the McNell proprietary account.

61. Rule 17a-4(j) of the Exchange Act provides that: “Every member, broker and dealer subject to this section shall furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records . . . that are required to be preserved under this section, or any other records . . . subject to examination under section 17(b) of the Exchange Act [15 U.S.C. 78q(b)] that are requested by the representative of the Commission.” As alleged above, McNell caused Redwood to not produce documents that were requested by the SEC staff.

62. As described above, McNell knowingly provided substantial assistance to Redwood’s violations of Section 17(a)(1) and Rules 17a-3 and 17a-4(j) thereunder.

63. By engaging in the foregoing conduct, McNell aided and abetted Redwood’s violations of Section 17(a)(1) and Rules 17a-3 and 17a-4(j) thereunder.

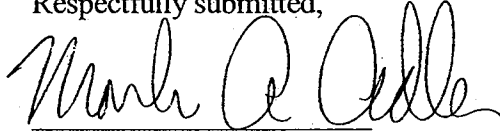
PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that the Court enter a judgment:

- (a) permanently enjoining McNell from violating Sections 9(a)(2), 10(a)(1), 10(b) of the Exchange Act and Rule 10b-5 thereunder;
- (b) permanently enjoining McNell from aiding and abetting violations of Sections 15(c)(3) and 17(a)(1) of the Exchange Act and Rules 15c3-1, 17a-3 and 17a-4(j) thereunder;
- (c) ordering defendant McNell to pay a civil penalty pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)]; and
- (d) providing such other relief as may be appropriate.

Dated: 1/19/08

Respectfully submitted,



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