

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 58012 / June 24, 2008**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13081**

**In the Matter of**

**SCOTTRADE, INC.,**

**Respondent.**

**ORDER INSTITUTING**  
**ADMINISTRATIVE AND CEASE-AND-**  
**DESIST PROCEEDINGS PURSUANT TO**  
**SECTIONS 15(b) AND 21C OF THE**  
**SECURITIES EXCHANGE ACT OF 1934,**  
**MAKING FINDINGS, AND IMPOSING A**  
**CEASE-AND-DESIST ORDER**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Scottrade, Inc. (“Scottrade” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (the “Order”), as set forth below.

### III.

On the basis of this Order and Respondent's Offer, the Commission finds that

#### Summary

1. This matter arises from representations Scottrade made to its customers in connection with their Nasdaq pre-open orders from January 1, 2001 through December 31, 2004 (the "relevant time period").<sup>1</sup> First, Scottrade expressly misrepresented in the customer account opening documents and account statements it sent to its customers that one of its policies was to route its customers' orders based on factors that included "liquidity at market opening," among other things, which gave its customers the opportunity to receive executions "that may be superior to the national best bid offer ('NBBO') in any one market center."<sup>2</sup> During the relevant time period, Scottrade had no written policies and procedures to assess liquidity at the market opening provided by market centers and, as a result, did not consider the availability of executions that may be superior to the NBBO, such as single or midpoint pricing, for its Nasdaq pre-open orders.<sup>3</sup>

2. Second, as a broker-dealer, Scottrade has a legal duty to seek to obtain for its customers' orders the most favorable terms reasonably available under the circumstances, taking into account price, order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market, as well as the potential for price improvement (i.e., best execution). By accepting customers' orders, a broker-dealer impliedly represents to customers that it will regularly and rigorously review the quality of execution that it receives on its orders, and where material differences exist between the price improvement opportunities offered by market centers, these differences will be taken into account by the broker-dealer when deciding where to route its orders. Just prior to the relevant

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<sup>1</sup> Nasdaq pre-open orders refer to those orders traded in the Nasdaq Stock Market, Inc. that are received after the previous day's close and before the current day's market open to be executed at the market open.

<sup>2</sup> Market center refers to a market maker, i.e., in this case, a firm that maintains firm bid and offer prices in any given security by standing ready to buy or sell stocks at publicly quoted prices. The National Best Bid and Offer ("NBBO") is the best ask price available to a customer when he buys securities and the best bid price available to a customer when he sells securities. Liquidity refers to, among other things, the volume of trading in a particular stock. A liquid market allows buying and selling with relative ease and, accordingly, allows market centers to offer opportunities for superior executions.

<sup>3</sup> "Midpoint pricing" is one price that is offered by a market center to both buy and sell orders at the midpoint between the NBBO. A single opening price ("single price") is an execution price offered to both buy and sell orders somewhere between the NBBO, depending on order imbalances. A single or midpoint price offering could allow the customer to receive superior execution than an NBBO price offering because corresponding customer buy and sell orders are executed against each other at a price between the national bid and offer price. See Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43590, 2000 WL 1721163 (November 17, 2000) ("Order Routing Release") (adopting Rules 605 and 606, which required market centers that trade national market system securities to make available publicly monthly electronic reports that include uniform statistical measures of execution quality and required broker-dealers that route customers' orders in equity and options securities to make available publicly quarterly reports that, among other things, disclose to what venues individual orders were routed).

time period, the Commission stated that some market centers offered investors an opportunity to avoid paying a liquidity premium at the opening. The Commission stated that an example of this is “midpoint pricing” for Nasdaq pre-open orders and that broker-dealers should take these alternative pricing options into consideration when seeking to obtain best execution for their customers’ Nasdaq pre-open orders.

3. Contrary to these implied representations, Scottrade did not conduct a regular and rigorous review of the execution quality of its Nasdaq pre-open orders during the relevant time period because its procedures did not require it to consider the availability of market centers that could have provided executions superior to the NBBO through single or midpoint pricing when routing its customers’ Nasdaq pre-open orders to market centers.

### **Respondent**

4. Scottrade is a discount brokerage firm serving individual investors with its home office in St. Louis, Missouri. Scottrade is a private company that was incorporated in Arizona. It has been registered with the Commission as a broker-dealer since 1980. At its inception, Scottrade offered customers deeply discounted commissions on trades placed via the telephone through a registered representative. In the fall of 1996, Scottrade expanded its services and introduced online trading at Scottrade.com.

### **The Pre-Open Market for Nasdaq Securities**

5. During the relevant time period, after the previous day’s market close and before the current day’s market open, Scottrade received customer orders to buy and sell Nasdaq securities. Customers’ Nasdaq orders received after the close of the market from the prior day queued in Scottrade’s system, awaiting routing and possible execution at 9:30 a.m., when the market opened. Prior to market open, Scottrade routed its pre-open orders to market centers that Scottrade had previously selected to execute orders in a specific security. Once Scottrade set its computers to route orders for a specific security to a certain market center, all orders were generally sent to that market center.

6. From at least January 2001 until December 13, 2004, unlike the listed marketplace, there was not a unified single opening for Nasdaq securities.<sup>4</sup> Therefore, market centers had the option of executing orders several different ways, each of which could result in a different price for broker-dealers’ customers’ orders. For example, some market centers looked for the first unlocked/uncrossed<sup>5</sup> NBBO and then automatically executed all buy and sell orders at a

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<sup>4</sup> Nasdaq now offers a pricing option called the Nasdaq Official Opening Price (“NOOP”). The NOOP is a single price opening for Nasdaq pre-open orders, which means that a customer can receive a single price for its trade somewhere between the bid price and the offer price. The NOOP was first offered in a pilot program and Nasdaq launched its first stage on October 2, 2004. By December 13, 2004, all stocks sold on the Nasdaq were added to the NOOP and broker-dealers could receive the single price opening for their customers if they chose to opt in.

<sup>5</sup> A market is “locked” if the bid price equals the ask price. A market is “crossed” when the inside market (refers to the best or highest bid and best or lowest ask) consists of a highest bid price that is higher than the lowest

single crossing price, which, depending on the order imbalances, would be somewhere between the best bid and best offer. In comparison, others matched their pre-open orders at the midpoint of the first unlocked, uncrossed NBBO. Finally, still other market centers executed Nasdaq pre-open orders at the NBBO. During the relevant time period, Scottrade failed to consider alternate Nasdaq pre-open pricing such as single or midpoint pricing when determining where to route Nasdaq pre-open orders.

**Scottrade Misrepresented to Customers in Account Opening Documents  
and Statements that it Considered Liquidity at the Market Open and that its  
Policies and Procedures Gave its Customers Opportunities to  
Receive Prices that were Better than the NBBO**

7. Scottrade made representations in the account opening documents and account statements that it sent to its customers regarding the factors that Scottrade examined when routing its customers' Nasdaq pre-open orders.

8. Specifically, from at least January 2001 through December 2004, Scottrade's customer account opening documents contained the following language:

It is our policy to route customer orders to execution centers that can provide superior execution services based on factors such as: price improvement; speed of execution; order size; liquidity at market opening; and high limits on automatic order execution for the thousands of securities our customers trade. This policy gives our customers the opportunity to receive executions that may be superior to the national best bid offer ("NBBO") in any one market center.

9. During the relevant time period, however, Scottrade did not have policies in place to route pre-open orders to market centers that could have provided superior execution services based on liquidity at the market open and, as a result, did not consider the availability of executions that may be superior to the NBBO, such as single or midpoint pricing, for its Nasdaq pre-open orders.

**Scottrade Failed to Perform a Regular  
and Rigorous Review of its Nasdaq Pre-Open Orders**

10. In November 2000, the Commission's Order Routing Release stated:

The Commission is aware that several important market centers trading Nasdaq securities have begun to offer services that give investors an opportunity to avoid paying a liquidity premium on opening orders. Such services can include, for example, "midpoint pricing," pursuant to which both buy and sell orders are executed at the midpoint of the opening quoted bid and offer . . . The Commission also is concerned that many investors may not be

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ask price. Conversely, a market is "unlocked" when there is a spread between the bid and the ask price and a market is "uncrossed" when the ask price is higher than the bid price.

aware of the differing services offered by market centers for execution of opening orders in Nasdaq securities, and their impact on execution quality.

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[T]he Commission believes that the markets and broker-dealers handling customer orders should be given a further opportunity to improve execution quality at the opening in Nasdaq securities. Market centers generally inform broker-dealers in advance how they will execute opening orders. Broker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customers orders.<sup>6</sup>

11. Scottrade's Written Supervisory Procedures ("WSPs") are procedures that govern how different departments within Scottrade should operate.<sup>7</sup> During the relevant time period, the WSPs failed to provide for a regular or rigorous review of Nasdaq pre-open orders. Consequently, no one at Scottrade performed this review.

12. For example, the 2001 and 2002 WSPs discussed sending orders to outside market centers and noted that "[t]raders are obliged to use reasonable diligence to route the order to obtain a price as favorable as possible under prevailing market conditions." Although the WSPs listed factors to consider when sending orders to outside market centers, the WSPs did not list options such as single or midpoint pricing as factors to consider for Nasdaq pre-open orders.

13. In January 2003, senior personnel revised the WSPs to provide that an employee in Scottrade's compliance department and Scottrade's head trader would prepare a monthly trading summary that would provide an overall view of trading statistics and a list of the factors used to compile the summary. Nasdaq pre-open orders were not a category of trading statistics that was separately reviewed. When the employee in compliance and the head trader began to document their best execution evaluations, senior personnel did not provide any guidance on how to do so or at what they should be looking. The monthly trading report was circulated and supposed to be reviewed monthly by senior personnel; however, the report was not reviewed by all responsible senior personnel on a regular basis.

14. Also in December 2003, an employee in the compliance department drafted and circulated a memo to senior personnel suggesting that Scottrade undertake certain procedures, including establishing a best execution committee, developing a clear supervisory hierarchy and procedures and creating a system to determine the best order routing practices on a stock-by-stock

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<sup>6</sup> See Order Routing Release, Exchange Act Release No. 43590, 2000 WL 1721163, at \*15 (November 17, 2000). Although the Commission stated at the time of the Order Routing Release that many investors may not be aware of the differing services offered by market centers for execution of Nasdaq pre-open orders, neither the Commission, nor Nasdaq had any specific rule requiring that market centers offer a single or midpoint price.

<sup>7</sup> Scottrade did not establish separate procedures for non-supervisors and Scottrade had no separate compliance manual.

basis, so Scottrade could find the best execution venue for individual securities. The employee noted that best execution and trade desk monitoring were important because Scottrade was doing an increasingly greater number of trades, which left Scottrade increasingly open to regulatory scrutiny. The employee also noted that there had been several high profile best execution related lawsuits in 2003 and his suggestions were “a good way to find problems before they find us.” The employee further noted that currently best execution and trade desk monitoring was a part-time job that he devoted about 10 hours a week to, when he could. He deemed that inadequate for a firm of Scottrade’s size and ended the memo with suggestions that his responsibilities be shifted from other compliance duties to best execution monitoring and trade desk compliance support. He also recommended that Scottrade hire someone with trading supervision experience.

15. It was not until approximately September 2004 that senior personnel revised the WSPs to provide for a regular and rigorous review of the quality of its routing decisions and established a “Best Execution Review Committee.” The WSPs still did not direct that Nasdaq pre-open orders be analyzed.

**Market Centers Offered Pre-Open Single or Midpoint Pricing During the Relevant Time Period, but Scottrade did not Consider the Single or Midpoint Pricing Options for its Customers**

16. At various times, from January 2001 to December 2004, market centers offered a single or midpoint price option for Nasdaq pre-open orders that was reasonably available to Scottrade. Scottrade was also notified by a market center during this time period that single or midpoint pricing was available.

17. Scottrade had no procedures that provided for a regular and rigorous review of the execution quality it received from market centers for its Nasdaq pre-open orders and it did not perform such reviews during the relevant time period because Scottrade failed to consider whether alternatives such as single or midpoint pricing were available for its customers.

**LEGAL DISCUSSION**

18. Section 15(c)(1)(A) of the Exchange Act makes it unlawful for any broker or dealer to “effect any transaction in . . . any security by means of any manipulative, deceptive, or other fraudulent device or contrivance.” A broker-dealer violates Section 15(c)(1)(A) when it makes material misrepresentations in connection with the execution of customer orders.<sup>8</sup>

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<sup>8</sup> See Section 15(c)(1)(A) of the Exchange Act (“No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security . . . by means of any manipulative, deceptive, or other fraudulent device or contrivance.”). See also Disclosure of Order Routing and Execution Practices, Exchange Act Rel. No. 43084, 2000 WL 1092311, at \*35 (July 28, 2000) (“False or misleading statements made by market centers to routing firms regarding execution quality, if material and made with the requisite state of mind, may be actionable under antifraud provisions.”) (citations omitted). The Commission has charged Section 15(c)(1)(A) violations against broker-dealers where material misrepresentations in connection with the execution of customer orders existed. See, e.g., In re Pacific Growth Equities, LLC, et al., Exchange Act Release No. 55148, 2007 WL 162559 (Jan. 23, 2007) (settled

19. A broker-dealer has a legal duty to seek to obtain best execution of customer orders.<sup>9</sup> By accepting an order, a broker-dealer impliedly represents that the order will be executed in a manner consistent with the duty of best execution.<sup>10</sup> The duty of best execution includes a requirement that the broker-dealer “seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances.”<sup>11</sup> The duty of best execution does not require “an order-by-order analysis of competing market [centers].”<sup>12</sup> It, instead, requires a broker-dealer to regularly and rigorously evaluate the quality of the execution it obtains for customers’ orders, consider the best reasonably available terms from competing market centers for its customers’ orders, and where material differences exist between the price improvement opportunities offered by market centers, take these differences into account when deciding where to route its orders.<sup>13</sup>

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action finding broker-dealer violated Section 15(c)(1)(A) by failing to disclose that it would add mark-ups and mark-downs in addition to commissions.

<sup>9</sup> See Newton v. Merrill, Lynch, Pierce, Fenner & Smith, 135 F.3d 266, 269-70, 274 (3d Cir. 1998) (finding Merrill Lynch may have failed to maximize the economic benefit to its customers by failing to take advantage of prices better than the NBBO); Geman v. SEC, 334 F.3d 1183, 1192-93 (10<sup>th</sup> Cir. 2003) (finding that broker-dealer violated its duty of best execution by failing to disclose that its method of executing orders deprived customers of the possibility of getting a price better than the NBBO). In addition, the Commission has instituted settled enforcement actions addressing a broker-dealer’s duty of best execution. See, e.g., In re Morgan Stanley & Co., Inc., Exchange Act Release No. 55726, 2007 WL 1364323 (May 9, 2007) (settled action finding that broker-dealer violated its duty of best execution by embedding undisclosed mark-ups and mark-downs in retail orders for over-the-counter securities); Certain Market Making Activities on Nasdaq, Exchange Act Release No. 40900, 1998 WL 919673, at \*5 (Jan. 11, 1999) (settled action finding that Nasdaq market makers failed to provide best execution for their customers’ orders by favoring their own interests, or those of a cooperating market maker, over the interests of their customers).

<sup>10</sup> Newton, 135 F.3d at 269 (“[A] broker-dealer, by accepting an order without price instructions, impliedly represents that the order will be executed in a manner consistent with the duty of best execution and that a broker-dealer who accepts such an order while intending to breach that duty makes a misrepresentation that is material to the purchase or sale.”).

<sup>11</sup> Newton, 135 F.3d at 270.

<sup>12</sup> See Order Execution Obligation, Exchange Act Release No. 37619A, 1996 WL 506154, at \*51-53 (September 6, 1996).

<sup>13</sup> Newton, 135 F.3d at 269-72; see also Order Execution Obligation, Exchange Act Release No. 37619A, 1996 WL 506154, at \*51-53 (September 6, 1996) (“[T]he Commission has emphasized that best execution obligations require that broker-dealers routing orders for automatic execution must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers’ orders . . . In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security. . . . [W]here reliable, superior prices are readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders . . . . [T]he Commission believes that because technology is rapidly making these systems more accessible, broker-dealers must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for purposes of seeking best execution of these customer orders.”); NASD Notice to Members 01-22, “Regulation Reiterates Member Firm Best Execution Obligations and Provides Guidance to Members” (April 2001) (stating “a member

20. As described above, during the relevant time period, Scottrade expressly represented to its customers in account opening documents and account statements that its policy was to route its customers' orders based on factors that included "liquidity at market opening," which gave its customers the opportunity to receive executions "that may be superior to the national best bid offer ('NBBO') in any one market center." During the relevant time period, Scottrade had no written policies and procedures to assess liquidity at the market opening provided by the market centers to which it routed its customers' Nasdaq pre-open orders and, as a result, did not consider the availability of executions that may be superior to the NBBO, such as single or midpoint pricing, for its Nasdaq pre-open orders. Further, Scottrade impliedly represented to its customers when it accepted its orders that it would regularly and rigorously evaluate the quality of the execution of customers' Nasdaq pre-open orders and that it would consider the availability of superior pricing when routing its customers' Nasdaq pre-open orders to market centers. Scottrade, however, did not conduct a regular and rigorous review of its customers' Nasdaq pre-open orders because it did not consider the availability of market centers that could have provided executions superior to the NBBO through single or midpoint pricing. Accordingly, Scottrade willfully violated Section 15(c)(1)(A) of the Exchange Act.

#### **Remedial Efforts**

21. In determining to accept the Offer, the Commission considered remedial actions by Scottrade.

#### **IV.**

In view of the foregoing, the Commission deems it appropriate and in the public interest, to impose the sanctions agreed to in Respondent Scottrade's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

- A. Scottrade is censured.
- B. Scottrade shall cease and desist from committing or causing any violations and any future violations of Section 15(c)(1)(A) of the Exchange Act;
- C. It is further ordered that Scottrade shall, within 30 days of the entry of this Order, pay a civil money penalty in the amount of \$950,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Scottrade as a Respondent in these proceedings, the file number of

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firm, in conducting its regular and rigorous review, should take into account [midpoint pricing or some other form of price improvement] in determining how to obtain best execution for [its] customer orders").



these proceedings, a copy of which cover letter and money order or check shall be sent to Elaine C. Greenberg, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 701 Market Street, Suite 2000, Philadelphia, PA 19106.

By the Commission.

Florence E. Harmon  
Acting Secretary