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'09 CIV 1976

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

E*TRADE CAPITAL MARKETS LLC,

Defendant.

CIVIL ACTION FILE NO.

COMPLAINT

Plaintiff Securities and Exchange Commission ("Commission") alleges the following against defendant E*Trade Capital Markets LLC ("ETCM"):

SUMMARY

1. This case concerns the failure of ETCM, a specialist firm, to meet its basic obligation as a specialist to serve public customer orders over its own proprietary interests while executing trades on the Chicago Stock Exchange ("CHX").

2. ETCM specialists operating on the CHX had a general duty to match executable public customer or "agency" buy and sell orders and not to fill customer orders through a trade from the specialist firm's own account when those customer orders could be matched with another customer order. From January 1999 through 2005 (the "Relevant Period"), ETCM violated this obligation by filling orders through proprietary trades rather than through other customer orders, thereby causing customer orders to be disadvantaged by approximately $28.3.

3. Specifically, ETCM engaged in improper trades for its own proprietary accounts by failing to match opposing buy and sell orders in the three following ways:

a. *Trading Ahead.* In certain instances, specialists at ETCM filled one agency order through a proprietary trade for the firm's account while a matchable agency order was present on the opposite side of the market, thereby improperly "trading ahead" of such opposite-side executable agency order. The customer order that was traded ahead of was then disadvantaged when it was subsequently executed at a price that was inferior to the price received by the firm's proprietary account.

b. *Interpositioning.* In certain instances, after trading ahead, ETCM specialists also traded proprietarily with the matchable opposite-side agency order that had been traded ahead of, thereby "interpositioning" themselves between the two agency orders that should have been paired off in the first instance. By participating on both sides of trades, the specialist captured the spread between the purchase and sale prices, thereby disadvantaging the other parties to the transactions.

c. *Trading Ahead of Unexecuted Open or Cancelled Orders.* In certain instances, ETCM specialists traded ahead of opposite-side executable agency orders, as described in paragraph 3(a) above, but in these instances, the unexecuted order was left open until the end of the day, or was cancelled by the customer prior to the close of the trading day before receiving an execution.

4. By engaging in the conduct described in paragraph 3 above, ETCM violated CHX Article 9, Rule 17 (Personal Selling and Purchasing Prohibited) (formerly Article IX, Rule 5) and CHX Article XXX, Rule 2 (Precedence to Orders in Book) (prior to its repeal effective September 29, 2006).

5. Further, by failing to make or keep current a blotter containing an itemized daily record of all purchases and sales of securities effected by ETCM for its proprietary accounts, ETCM violated Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78q(a), and Rule 17a-3(a)(1) thereunder, 17 C.F.R. § 240.17a-3(a)(1).

NATURE OF THE PROCEEDINGS AND THE RELIEF SOUGHT

6. The Commission brings this action pursuant to the authority conferred upon it by Sections 21(d), (e) and (f) of the Exchange Act, 15 U.S.C. §§ 78u(d), (e) and (f), to enjoin ETCM from violating provisions of the federal securities laws and several conduct rules in place on the CHX. In addition, the Commission seeks other relief, including disgorgement and civil penalties.

STATUTES AND RULES ALLEGED TO HAVE BEEN VIOLATED

7. ETCM has engaged, and unless enjoined will continue to engage, directly or indirectly, in acts, practices, or courses of business, that constitute violations of CHX Article 9, Rule 17 (Personal Selling and Purchasing Prohibited) (formerly Article IX, Rule 5).

8. ETCM has engaged, and unless enjoined will continue to engage, directly or indirectly, in acts, practices, or courses of business, that constitute violations of Section 17(a) of the Exchange Act, 15 U.S.C. § 78q(a)(1), and Rule 17a-3 thereunder, 17 C.F.R. § 240.17a-3.

JURISDICTION AND VENUE

9. 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), 78u(e) and 78aa.

10. Venue lies in this Court pursuant to Section 27 of the Exchange Act, 15 U.S.C. § 78aa. ETCM's principal executive offices are located in New York, New York. Moreover, certain of the transactions, acts, practices and courses of business alleged herein occurred within the Southern District of New York. In particular, certain of the violative transactions alleged herein were executed on the New York Stock Exchange, a national stock exchange located in New York, New York.

11. ETCM, directly or indirectly, has made use of the means or instrumentalities of interstate commerce, the means or instruments of transportation or communication in interstate commerce, and/or the mails, in connection with the acts, practices and courses of business alleged herein.

12. Unless enjoined, ETCM will continue to engage in the transactions, acts, practices and courses of business set forth in this Complaint, and transactions, acts, practices and courses of business similar in purport and object.

DEFENDANT

13. **ETCM** is a broker-dealer that, during the Relevant Period, was registered with the Commission pursuant to Section 15(b) of the Exchange Act. ETCM is a wholly owned subsidiary of E*Trade Financial Corp., whose common stock is registered with the Commission pursuant to

Section 12(b) of the Exchange Act. ETCM is the successor by merger of E*Trade Capital Markets Execution Services LLC, which, in turn, was formed in 2001 to acquire the business of, and was the successor in interest to, Dempsey & Company, LLC ("Dempsey"), a broker-dealer that was registered with the Commission pursuant to Section 15(b) of the Exchange Act prior to its acquisition. During the Relevant Period, ETCM (or certain of its predecessor entities) was a member of the CHX.

14. During the Relevant Period, ETCM acquired, in addition to the foregoing, merged with, or conducted joint venture operations with other specialist firms. Certain of the conduct that forms the basis of the allegations herein took place at those predecessor firms or joint venture entities.

FACTS

A. Obligations and Role of Specialists

15. On the CHX, specialist firms are responsible for the quality of the markets in the securities in which individual specialists are registered. A specialist is expected to maintain, insofar as is reasonably practicable, a "fair" and "orderly" market. A "fair" market, among other things, affords no undue advantage to any participant. An "orderly" market is characterized by regular, reliable operation, with price continuity and depth, in which price movements are accompanied by appropriate volume, and unreasonable price variations between sales are avoided.

16. Specialists have two primary duties: performing their "negative obligation" to execute customer orders at the most advantageous price with minimal dealer intervention, and fulfilling their "affirmative obligation" to offset imbalances in supply and demand. Specialists participate as both broker (or agent), absenting themselves from the market to pair executable customer orders against each other, and as dealer (or principal), trading for the specialists' dealer or

proprietary accounts when needed to facilitate price continuity and fill customer orders when there are no available contra parties to those orders.

17. Whether acting as brokers or dealers, specialists are required to hold the public's interest above their own and, as such, are prohibited from trading for their dealers' accounts ahead of pre-existing customer buy or sell orders that could be executed against each other.

18. When matchable customer buy and sell orders are received by the specialists – generally delivered either through an exchange's order processing system to a specialist's terminal, or, in limited circumstances, by floor brokers gathered in front of specialists' workstations ("the crowd") – specialists are required to act as agent and cross or pair off those orders and to abstain from participating as principal or dealer.

B. <u>Improper Proprietary Trading by ETCM</u>

19. During the Relevant Period, ETCM breached its duty to refrain from dealing for its own account while in possession of executable buy and sell customer orders. Instead, ETCM effected improper proprietary trades that disadvantaged customer orders.

20. ETCM specialists operating on the CHX possessed, or had access to, information concerning customer orders on both sides of the market. Where there were matchable orders on both sides of the market, specialists on the CHX were obligated to "pair off" or cross the buy and sell orders by executing each side of the market for identical prices and in commensurate order quantities. In numerous instances, however, ETCM specialists did not "pair off" or cross these matchable buy and sell orders with each other. The violative conduct took three basic forms.

21. *Trading Ahead.* In certain instances, ETCM specialists filled one agency order through a proprietary trade for the firm's account while a matchable agency order was present on the opposite side of the market, thereby improperly "trading ahead" of such opposite-side

executable agency order. The customer order that was traded ahead of was then disadvantaged when it was subsequently executed at a price that was inferior to the price received by the firm's proprietary account.

22. For example, if a specialist has present on his book, at the same time, a marketable customer order to buy 1,000 shares of a security and a marketable customer order to sell 1,000 shares of the same security, the specialist would be obligated to pair off those matchable orders. Trading ahead would occur if the specialist filled the sell order from the firm's proprietary account at $25.00 per share, and then subsequently executed the buy order at the inferior price of $25.05 per share. In this example, the buy order received a price inferior to that which it was entitled ($25.00) and the customer was disadvantaged by $50.00 (1,000 shares x $0.05 per share).

23. *Interpositioning*. In certain instances, after trading ahead, ETCM specialists also traded proprietarily with the matchable opposite-side agency order that had been traded ahead of, thereby "interpositioning" themselves between the two agency orders that should have been paired off in the first instance. By participating on both sides of trades, the specialist captured the spread between the purchase and sale prices, thereby disadvantaging the other parties to the transactions.

24. Alternatively, specialists sometimes sold shares of a security into a customer buy order, and then filled the customer sell order by buying for the firm's proprietary account at a lower price. In either case, the specialists participated on both sides of trades, capturing the spread between the purchase and sale prices, and disadvantaging the other parties to the transaction.

25. *Trading Ahead of Unexecuted Open or Cancelled Orders*. In certain instances, ETCM specialists traded ahead of an executable agency order, as described above in paragraphs 21 and 22, but the unexecuted agency order was left open until the end of the trading day, or was cancelled by the customer prior to the close of the trading day before receiving an execution.

26. During the Relevant Period, ETCM engaged in tens of thousands of violative trades of the three types described above, resulting in overall customer disadvantage of approximately $28.3 million. The majority of this customer disadvantage relates to violative trading that occurred between 1999 and 2002.

C. ETCM's Books and Records Violations

27. During the Relevant Period, ETCM failed to make or keep current a blotter containing an itemized daily record of all purchases and sales of securities effected by it for its proprietary accounts.

28. Specifically, ETCM sometimes received orders to buy or sell securities that are dually listed on the CHX and on a different exchange, such as the New York Stock Exchange ("NYSE"). In order to fill these orders, the specialist would sometimes place a corresponding order (a "lay-off trade") on the NYSE for the firm's proprietary account. With respect to lay-off transactions, ETCM failed to make or keep current records showing the account for which each such transaction was effected, the name and amount of the securities, the unit and aggregate purchase or sale price, and the trade date.

FIRST CLAIM FOR RELIEF

Violations of Chicago Stock Exchange Article 9, Rule 17
(Personal Selling and Purchasing Prohibited)

29. The Commission repeats and realleges the allegations contained in paragraphs 1 through 28 by reference as if fully set forth herein.

30. During the Relevant Period, CHX Article 9, Rule 17 (formerly known as Article IX, Rule 5) prohibited a specialist from trading for his own account while holding an unexecuted customer market or marketable limit order for the same security, on the same side of the market.

31. As alleged above, ETCM bought or initiated the purchase of, and sold or initiated the sale of, securities on the CHX for its own account while holding unexecuted, marketable customer orders on the same side of the book.

32. By reason of the foregoing, ETCM, directly or indirectly, has violated and, unless permanently enjoined, will continue to violate CHX Article 9, Rule 17.

SECOND CLAIM FOR RELIEF

Violations of Section 17(a) of the Exchange Act, and Rule 17a-3 Thereunder (Books and Records)

33. The Commission repeats and realleges the allegations contained in paragraphs 1 through 28 by reference as if fully set forth herein.

34. During the Relevant Period, ETCM failed to make or keep current for prescribed periods of time a blotter containing an itemized daily record of all purchases and sales of securities effected by ETCM for its proprietary accounts.

35. Specifically, with respect to purchases and sales of securities made by ETCM for its proprietary accounts on stock exchanges other than the CHX, ETCM failed to make or keep current records showing the account for which each such transaction was effected, the name and amount of the securities, the unit and aggregate purchase or sale price, and the trade date.

36. By reason of the foregoing, ETCM, directly or indirectly, has violated and, unless permanently enjoined, will continue to violate Section 17(a) of the Exchange Act, 15 U.S.C. § 78q(a), and Rule 17a-3(a)(1) thereunder, 17 C.F.R. § 240.17a-3(a)(1).

PRAYER FOR RELIEF

WHEREFORE, Plaintiff Commission respectfully requests that this Court enter an Order:

I.

Permanently restraining and enjoining ETCM, directly or indirectly, from violating CHX Article 9, Rule 17 and Section 17(a) of the Exchange Act and Rule 17a-3 thereunder;

II.

Directing ETCM to disgorge the ill-gotten gains obtained from its conduct;

III.

Requiring ETCM to pay a civil penalty pursuant to Section 21(d) of the Exchange Act, 15 U.S.C. § 78u(d); and

IV.

Granting such other and further relief as the Court may deem just and appropriate.

Dated: New York, New York
March 4, 2009

Respectfully Submitted,

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