

**STATE OF ILLINOIS  
SECRETARY OF STATE  
SECURITIES DEPARTMENT**

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IN THE MATTER OF:	)	
	)	
E*TRADE SECURITIES LLC,	)	
	)	No. 08-00492
	)	
Respondent.	)	

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**NOTICE OF HEARING**

**TO THE RESPONDENT:** E\*Trade Securities LLC  
c/o its attorney  
F. Daniel Bell, III  
K&L Gates LLP  
4350 Lassiter at North Hills Avenue, Suite 300  
Raleigh, North Carolina 27619-7047

You are hereby notified in accordance with Sections 8.E and 11.F of the Illinois Securities Law of 1953 [815 ILCS 5/11.E and F] (“the Act”) and 14 Ill. Adm. Code 130, subpart K, that a public hearing will be held at the Secretary of State’s office at the office of the Illinois Securities Department, 69 W. Washington Street, Suite 1220, in Chicago, Illinois 60602, on September 10, 2012 or as soon thereafter as possible before Soula Spyropoulos, or such other hearing officer who shall be presiding at that time.

Said hearing will be held to determine whether an Order shall be entered pursuant to Section 8.E of the Act sanctioning the Respondents and/or granting such other relief as may be authorized under the Act including, but not limited to, the imposition of a monetary fine in the maximum amount pursuant to Section 11.E(4) of the Act, payable within ten (10) business days of the entry of the Order.

The grounds for this proposed action are as follows:

1. Respondent E\*Trade Securities LLC (“E\*Trade” or “Respondent”) was, at all times material herein, a limited liability company organized under the laws of Delaware with its principal place of business in New York, New York.

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2. Respondent is in the business of effecting transactions in securities in Illinois as a "dealer" within the meaning of the Act.

3. Respondent has customers located across the United States of America, including Illinois.

4. Respondent's business model centers upon customers who use the firm's website to buy and sell securities, generally known as on-line stock trading.

5. Although Respondent is an on-line trading firm, it also has about 30 branch offices across the country, at least some of which were purchased from earlier on-line trading firms.

6. Despite the focus of its business model upon on-line retail trading, Respondent maintained fewer than 20 "financial advisors" (FAs) who were authorized to provide investment advice to clients regarding ARS. The FAs are assigned to an Investment Specialist Group supervised by a branch manager. The FAs are alternatively referred to herein as investment specialists or registered representatives.

7. Respondent's FAs are permitted to recommend only those types of investments that have been previously approved by Respondent's management.

**ARS**

8. ARS, or auction rate securities, are fixed income long-term securities whose dividend rates are reset periodically at Dutch-style auctions that take place at set intervals, typically every 7, 28, or 35 days.

9. ARS are considered non-conventional investments (NCIs) in that they do not fall in the traditional categories of stocks, bonds, or mutual funds.

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10. ARS were introduced to the market in 1984 as a way for issuing entities to diversify their investor base and in the process lower their borrowing costs. ARS essentially allowed issuers to achieve long-term financing at short-term interest rates.

11. As of the end of 2007, there were approximately \$330 billion of ARS outstanding. Three categories of issuers dominated the market. Municipalities accounted for approximately half the market. Student loan trusts made up approximately 25% of the market. Closed-end mutual bond funds, seeking to leverage their portfolios by issuing preferred shares, made up approximately 20% of the market.

12. Initially, a high minimum investment precluded all but institutions from purchasing ARS. However, as the minimum investment declined to \$25,000, wealthy retail investors became a significant source of demand for the product.

13. ARS are designed to trade at a set price (par value) of \$25,000 per unit, but the interest rate fluctuates based upon bids made at periodic auctions. The rate that is sufficient to clear all the ARS offered for sale at any given auction is known as the "clearing rate." The clearing rate, however, cannot exceed the instrument's maximum or default interest rate (also known as the "penalty" rate), which is typically pegged to a short term index such as the LIBOR. If, at any given auction, the rate necessary to clear all shares for sale exceeds the maximum rate, then the auction "fails" and the maximum rate becomes the rate of interest the ARS earns until the next successful auction, at which time the rate is reset during the bidding process.

14. As is generally the case in the capital markets, issuers and investors are connected via intermediaries or financial institutions that serve in various capacities in the ARS marketplace. The major roles of intermediaries in the ARS market are: (1) large broker-dealers who act as ARS underwriters and often also serve as auction dealers, (2) auction agents selected

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by the underwriters to collect orders and match buyers with sellers, (3) major broker-dealers who trade in ARS and act as wholesalers, and (4) downstream broker-dealers who place retail customer orders through the wholesalers trading in ARS.

15. Respondent did not perform any of the major intermediary functions identified as (1) through (3) above. Rather, from 2003 to February 2008, it acted as a downstream broker-dealer that relayed retail customer orders to Oppenheimer & Co., which was a wholesaler trading in Auction Rate Preferred Securities ("ARPS"). Oppenheimer then transmitted Respondent's customer orders to auction dealers to complete the purchase or sale.

### ARPS

16. Of the types of ARS that were available from 2003 through February 2008, Respondent generally sold ARPS to its customers. ARPS are preferred stock issued by closed-end mutual funds. Because ARPS are preferred shares, they have no maturity date and there is no obligation upon the issuer to redeem shares on demand. Therefore, their period of existence is "in perpetuity."

17. Prior to February 2008 when the market for ARS (including ARPS) collapsed, ARPS were generally perceived to be a relatively safe and liquid fixed income investment. The primary benefit was a higher rate of interest than could typically be achieved by investing in Treasury bills or money market accounts. As a general rule, ARPS could be expected to pay a rate of at least 50 basis points, or one-half percent interest, in excess of what a money market account was paying at the same time.

18. ARPS were seen as a relatively safe credit risk because, by law, issuers had to maintain reserves sufficient to cover twice the amount of money outstanding in issued ARPS. If reserves fell below that amount, issuers were required by law to either increase their reserves or

redeem sufficient ARPS to restore the 200% ratio. Because of these and other factors, credit rating agencies typically gave ARPS high credit ratings.

19. Respondent chose to offer for sale only those ARPS that carried an AAA credit rating, which is the highest rating awarded by the credit rating agencies.

20. Liquidity risk is different from credit risk, and an AAA credit rating does not speak to the security's liquidity risk. Liquidity means the ability to sell a security quickly at the par value. Liquidity risk, therefore, is the possibility that an ARPS cannot be sold or traded upon demand. Thus, although an ARPS might have a low credit risk because the issuer is financially sound and is likely to continue to make the required interest payments, the ARPS might have high liquidity risk if, for whatever reason, it cannot be sold or otherwise liquidated quickly. Liquidity risk is an important feature of a security because, even if the security has good credit risk, it may have little value to an investor if the investor cannot sell it when necessary.

#### **Respondent's Sale of ARPS**

21. Due to their relative safety in terms of credit risk and perceived liquidity, Respondent chose to engage in the sale of ARPS to its retail customers, but generally eschewed sale of riskier types of ARS, especially those involving debt backed securities.

22. Contrary to its practice of making traditional stocks, bonds and mutual funds available for sale on line, Respondent opted to sell ARPS only through its FAs. A customer seeking financial advice might have called directly or have been referred to an FA by a local E\*Trade office, or alternatively, an FA might have initiated a call to a particular customer if the FA felt that the customer had a particular need. For example, an FA who noticed that a client had a large cash account balance might have called the client to suggest moving the cash to an investment with a better rate of return.

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23. Procedurally, when an FA received a buy or sell order from a client, the FA completed a trade ticket and forwarded it to the Fixed Income Desk located in the same office. The Fixed Income Desk then forwarded the buy or sell order to the intermediary broker-dealer, Oppenheimer & Co. Oppenheimer then aggregated the various buy and sell orders received from all client broker-dealers and forwarded them to the auction agent for presentation at the next available auction.

24. If the auction was successful and the buy or sell order was executed, a trade confirmation was prepared and forwarded back to the investor.

25. In recommending ARPS for investors' consideration, certain FAs described ARPS as "7-day paper" with "daily liquidity" that was as safe as a money market account. Although FAs also referred to ARPS as "auction rate preferreds," they rarely if ever explained that ARPS were in fact long-term securities that could only be sold at auction, nor mentioned that if an auction failed ARPS would lose liquidity.

### **The Dutch Auction Process**

26. ARS, including ARPS, are not traded on the New York Stock Exchange or any other open securities exchange. Rather, ARS (including ARPS) were, prior to the ARS market collapse in February 2008, traded through a "Dutch auction" process.

27. If, at any given auction, there are insufficient buyers to purchase all the ARS available for sale at a clearing rate below the maximum rate, the auction is said to have "failed." An investor who has been unable to sell his or her ARS at a failed auction must then wait until the next periodic auction to again offer them for sale. Until the ARS are sold at a successful auction, the interest rate paid on that ARS is the maximum or default rate.

28. Because ARS are typically long-term instruments, and in the case of ARPS are of perpetual maturity, their liquidity depends upon the ability of holders to sell the instruments at auction. If auctions fail, or if the auction process collapses entirely as it did in February of 2008, liquidity is severely impaired.

29. Because there is no established market for ARS apart from the auction process, there is limited ability to liquidate ARS outside that process. The ARS issuer may decide to redeem those shares if it is economically advantageous to do so, but there is no obligation upon issuers to do so. Alternatively, an ARS holder may be able to arrange a sale on an ad hoc basis outside the auction process. However, such sales are on a case by case basis and often involve discounts to the par value of the ARS, resulting in a financial loss to the holder.

30. Consequently, the liquidity of ARS (including ARPS) depended upon the continued success of the Dutch auction process.

#### **Collapse of the Dutch Auction Process**

31. The Dutch auction process functioned with very few auction failures for many years after the introduction of ARS in 1984. Over the years, there had been approximately 13 auction failures, typically arising when an issuer lost its creditworthiness, thus eliminating buyer interest in that security. However, prior to February 2008, there had not been an ARPS auction failure nor had there been a total collapse of the ARS auction market.

32. Beginning in August of 2007, deteriorating economic conditions and tightening credit markets caused a strain on the ARS market, resulting in a number of ARS auction failures. However, prior to February 2008, these failures did not involve the ARPS auction markets because ARPS were generally considered safer and more creditworthy investments.

33. However, in February of 2008, an event occurred that caused the wholesale collapse of the ARS auction market, including ARPS. The triggering event was the decision by a major underwriter, Goldman-Sachs, to stop submitting cover bids. Large underwriters, like Goldman-Sachs, found that due to deteriorating financial conditions, they could no longer afford to carry large balances of ARS on their books and thus they stopped buying ARS for their own accounts. Once Goldman-Sachs stopped submitting cover bids at auction, all the other large underwriters followed suit.

34. Without the support of the large underwriters, insufficient buy bids were received at most auctions to cover all the ARS offered for sale, and as a result the auction market totally collapsed. The ARPS auction market was particularly hard hit because the maximum, or default, rates for ARPS were generally very low and therefore there was insufficient investor interest to sustain the market in the absence of the underwriter's cover bids.

35. As of February 13, 2008, Respondent's investors nationwide held a balance of approximately \$581 million in ARPS, and approximately \$870 million altogether in the ARS market, that had lost liquidity as the result of the collapse of the auction process.

**Failure to Supervise**

36. Respondent had a policy of hiring experienced FAs who, presumably, had been trained by other employers with regard to the securities they handled. However, Respondent provided no formal training to its FAs with respect to ARPS.

37. Respondent's FAs were directly supervised by a branch manager whose supervisory responsibilities were set out in Branch Policies and Procedures manuals. In addition, FAs were provided with a Registered Representatives Manual that governed their professional practice. None of these documents specifically addressed the need for FAs to advise ARPS



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customers of the risks of auction failure and loss of liquidity. Respondent maintained a policy of reviewing FA-investor phone conversations and account records on a random basis and providing feedback. Despite these supervisory reviews, FAs continued to advise ARPS investors that ARPS were highly liquid "7-day paper," without the additional context that ARPS were in fact long term instruments that could only be liquidated at successful Dutch-style auctions.

38. Even when the significant risk of auction failure with regard to other types of ARS became apparent, FAs were not instructed to provide any warning about the risk of ARPS illiquidity.

39. Respondent should have known that its FAs marketed ARS to customers as highly liquid and as an alternative to cash or money market funds without adequately disclosing that ARS are complex securities that may become illiquid.

40. In connection with the marketing of ARS, Respondent failed to adopt policies and procedures reasonably designed to ensure that its FAs recommended ARS only to customers who had stated investment objectives that were consistent with their purchase of ARS. Some of Respondent's FAs recommended ARS to customers as a liquid, short-term investment. As a result, some of Respondent's customers who needed short-term access to funds invested in ARS even though ARS had long-term or no maturity dates.

41. By virtue of the forgoing, E\*Trade is subject to sanctions pursuant to Section 8.E(1)(e)(iv) of the Act.

NOTICE: You are further notified that you are required pursuant to Section 130.1104 of the Rules and Regulations (14 Ill. Adm. Code 130)(the "Rules"), to file an answer to the allegations outlined above within thirty (30) days of the receipt of this Notice. A failure to file an answer within the prescribed time shall be construed as an admission of the allegations contained in the Notice of Hearing.

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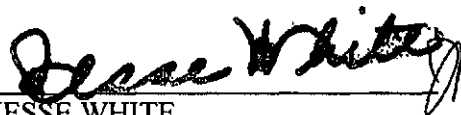
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Furthermore, you may be represented by legal counsel; may present evidence; may cross-examine witnesses and otherwise participate. A failure to so appear shall constitute default, unless any Respondent has upon due notice moved for and obtained a continuance.

A copy of the Rules and Regulations promulgated under the Illinois Securities Law and pertaining to hearings held by the Office of the Secretary of State, Illinois Securities Department, are available at the Department's website at: <http://www.cyberdriveillinois.com/departments/securities/lawrules.html>, or on request.

Delivery of Notice to the designated representative of any Respondent constitutes service upon such Respondent.

Dated: This 25th day of July 2012.

  
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