

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9662 / October 9, 2014

SECURITIES EXCHANGE ACT OF 1934
Release No. 73324 / October 9, 2014

ADMINISTRATIVE PROCEEDING
File No. 3-16192

In the Matter of

E*TRADE SECURITIES, LLC,
and
G1 EXECUTION SERVICES,
LLC

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE AND
CEASE-AND-DESIST
PROCEEDINGS, PURSUANT
TO SECTION 8A OF THE
SECURITIES ACT OF 1933
AND SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT
OF 1934, MAKING FINDINGS,
AND IMPOSING REMEDIAL
SANCTIONS AND 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 Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”) against G1 Execution Services, LLC and E*TRADE Securities, LLC (together, “Respondents” or “E*Trade”).

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”), 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 them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act

of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondents’ Offers, the Commission finds¹ that:

A. Summary

These proceedings arise from Respondents’ facilitation of thousands of unregistered sales of penny stocks by three institutional customers. During various periods between March 2007 and April 2011, these customers routinely deposited to their E*Trade accounts large quantities of newly issued penny stocks that they had acquired from little known, non-reporting issuers, through private transactions. The customers claimed that these penny stocks were “freely tradable.” Shortly after the three customers deposited these securities, the customers placed orders for Respondents to sell these securities to the public (“resales”) without any registration statements being in effect. Circumstances such as these constitute red flags of possible unlawful distributions of securities in violation of Section 5 of the Securities Act.

Section 5 of the Securities Act generally requires registration of securities offerings, or an available exemption from registration, including for resales such as these. Although brokers frequently rely on an exemption under Section 4(a)(4) of the Act, known as the brokers’ transaction exemption, this exemption was not available to Respondents for these resales. For this exemption to be available, Respondents were required, before selling securities on their customers’ behalf, to engage in a reasonable inquiry into the facts surrounding the customers’ proposed sales to determine if the customers were engaging in an unlawful distribution of securities. The amount of inquiry a broker must conduct as part of this reasonable inquiry varies with the facts and circumstances of each transaction. Here, Respondents were presented with numerous red flags, over a long period of time, indicating that the customers could be engaging in repeated, unlawful distributions of securities. In light of these red flags, Respondents were required to conduct a searching inquiry in order to claim the brokers’ transaction exemption. As part of a searching inquiry, and among other things, Respondents had a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act, and for each resale transaction they needed to be reasonably certain that an exemption was available.

Respondents initially made limited inquiries regarding the customers’ resale transactions, and later they expanded those inquiries by adding additional steps to their review process. Respondents, however, failed to take adequate steps to be reasonably certain that the proposed sales were exempt from the registration requirements of the Securities Act. For example, Respondents initially did not ascertain the specific

¹ The findings herein are made pursuant to Respondents’ Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

exemptions on which the customers were relying. Later, beginning in March 2010, when Respondents enhanced their review process (by, among other things, identifying the customers' claimed exemptions and obtaining legal opinions), they did not conduct the required searching inquiry so that they could be reasonably certain that the claimed exemptions or any other exemptions were available. Accordingly, Respondents did not perform a reasonable inquiry and thus were not entitled to rely upon the brokers' transaction exemption.

By virtue of their conduct, Respondents willfully violated Sections 5(a) and 5(c) of the Securities Act.²

B. Respondents

1. **G1 Execution Services, LLC (“G1 Execution”)**, formerly known as **E*TRADE Capital Markets, LLC**, is a broker-dealer located in Chicago and is registered with the Commission pursuant to Section 15(b) of the Exchange Act. G1 Execution offers execution services and is a market maker. It was a wholly owned subsidiary of E*TRADE Financial Corporation during the period at issue in this Order but was sold to a third party in February 2014.

2. **E*TRADE Securities, LLC (“E*Trade Securities”)**, is a broker-dealer located in New York and is registered with the Commission pursuant to Section 15(b) of the Exchange Act. E*Trade Securities is an indirect, wholly owned subsidiary of E*TRADE Financial Corporation.

C. Facts

Respondents Facilitated Unregistered Sales of Penny Stocks

3. In March 2007, one of the three institutional customers, Customer A, opened a brokerage account at E*Trade. Another of the three institutional customers, Customer B, whose sole principal previously worked at Customer A, opened a brokerage account at E*Trade in December 2007. The last of the three institutional customers, Customer C, opened a brokerage account at E*Trade in March 2010. E*Trade terminated the brokerage accounts for all three customers in April 2011.

4. During various periods between March 2007 and April 2011 (the “Relevant Period”), Customers A, B and C routinely acquired large quantities of newly issued penny

² A “willful” violation of the securities laws means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

stocks from little known, non-reporting issuers in private offerings.³ The three customers each represented to E*Trade that these penny stocks were acquired in Private Investment in Public Equity (“PIPEs”) transactions. These penny stocks traded in the over-the-counter market and were quoted on quotation mediums operated by OTC Markets Group (formerly known as the Pink Sheets). No registration statements were filed with the Commission in connection with any of the private offerings through which these customers acquired their shares.

5. At various times during the relevant period, Customers A, B and C deposited the penny stocks they acquired through private offerings in their E*Trade accounts shortly after those transactions closed. Their deposits of these securities were either in the form of physical certificates (which did not bear restrictive legends) or electronic transfers from transfer agents known as deposit/withdrawal at custodian (“DWAC”) transfers. During the respective periods when each of the customers traded through E*Trade,⁴ they made these deposits almost daily, and the deposits ranged in size from tens of thousands to approximately a billion shares of penny stocks. All three customers often made numerous deposits of penny stocks from the same issuer over several weeks or months.

6. Shortly after Customers A, B and C submitted the penny stocks to E*Trade for deposit, they resold them. During the respective periods when the customers traded through E*Trade, Respondents executed these resales almost daily. After the resales, Customers A, B and C wired the sales proceeds out of their accounts. No registration statements were filed with the Commission in connection with any of these resales.

7. On behalf of Customers A, B and C, Respondents facilitated the sale of shares of penny stock issued by approximately 247 different companies. For these transactions, the three customers realized gross sales proceeds in the millions of dollars, and Respondents earned substantial commissions.

Respondents’ Inquiries Regarding the Three Customers’ Resale Transactions

8. Between March 2007 and March 2010, Respondents did not ask Customers A and B to identify the specific exemptions from registration on which they were relying. Respondents did not ask the customers to submit documentation, such as attorney opinion letters, that may have helped substantiate the availability of an exemption. Respondents

³ See, 15 U.S.C. § 78c(a)(51); 17 C.F.R. § 240.3a51-1 (defining the term “penny stock”). Through their E*Trade accounts, the customers mostly traded stocks that traded for less than a penny per share.

⁴ Customer A traded from March 2007 to April 2008, and from March 2009 to April 2011. Customer B traded from December 2007 to April 2010, and thereafter traded on a few occasions through April 2011. Customer C traded from March 2010 to April 2011.

also did not become aware of any other exemptions potentially available to Customers A and B.

9. Between March 2007 and March 2010, Respondents made the following general inquiries regarding the trading activities of Customers A and B: (1) prior to accepting Customers A and B, Respondents inquired as to the nature of their intended trading activities; (2) Respondents obtained written representations from Customer A, and later from the issuers, that the securities Customer A sold were “freely tradable” (but these representations were not supported by any facts); (3) Respondents received written representations from Customer A that it would comply with laws and regulations applicable to its trading activities; (4) on multiple occasions, Respondents visited the offices of Customer A and B in New York in an effort to gain comfort that they were responsible customers; (5) beginning in late March 2009, Respondents reviewed pending deposits by Customers A and B to assess whether Respondents would assume any financial risk associated with their resales; and (6) around November 2009, Respondents reviewed the trading history for securities that Customers A and B had already resold, to assess whether those securities had been subject to market manipulation.

10. From approximately late March 2010 through April 2011, Respondents expanded their review of pending security deposits by Customers A and C under a process they referred to as the Enhanced Due Diligence review. Under this review, Respondents made additional inquiries and collected certain documentation for the purpose of addressing potential unregistered sales of securities and anti-money laundering issues.

11. Under the Enhanced Due Diligence review, Customers A and C submitted to Respondents, with each of their pending security deposits, written representations from themselves and the issuer of the securities that the securities to be deposited were “freely tradable.” Respondents reviewed these representations. With each pending security deposit, Customers A and C also submitted to Respondents an attorney opinion letter. Those letters claimed to identify an applicable exemption from the registration requirements of the Securities Act and claimed to explain why that exemption was available for the securities to be deposited. These attorney opinion letters indicated that the legal conclusions were based primarily on representations made by the reseller and issuer and that the attorneys did not independently verify the facts forming the basis for their opinions.

12. Under the Enhanced Due Diligence process, Respondents regularly reviewed these attorney opinion letters to identify the registration exemption on which Customers A and C were relying and to verify that the securities described in the letters matched the related deposits. Respondents also researched the attorneys who had authored the opinions to identify any potentially negative information about them, including confirming that the attorneys were not on a list of banned attorneys maintained on pinksheets.com (now known as otcm Markets.com).⁵

⁵ Respondents conducted other inquiries under the Enhanced Due Diligence review. Prior to accepting each penny stock deposit from the customers, and for each

Respondents Did Not Engage in a Reasonable Inquiry

13. Sections 5(a) and 5(c) of the Securities Act prohibit the offer and sale of securities through interstate commerce or the mails, unless a registration statement is filed with the Commission and is in effect, or the offer and sale are subject to an exemption. 15 U.S.C. § 77e(a) and (c).

14. Section 4(a)(4) of the Securities Act exempts from the registration requirements of Section 5 “brokers’ transactions executed upon customers’ orders on any exchange or in the over-the-counter market but not the solicitation of such orders.” 15 U.S.C. § 77d(a)(4). Section 4(a)(4) of the Securities Act is unavailable, for example, when a broker-dealer “knows or has reasonable grounds to believe that the selling customer’s part of the transaction is not exempt from Section 5 of the Securities Act.” In the Matter of John A. Carley, Exchange Act Rel. No. 57,246, 2008 WL 268598, *8 (Jan. 31, 2008) (Commission opinion). To rely on this exemption, the broker must, among other things, engage in a “reasonable inquiry” into the facts surrounding the proposed unregistered sale, and after such inquiry it must not be “aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is part of a distribution of the securities of the issuer.” 15 U.S.C. § 77d(a)(4); 17 CFR § 230.144(g)(4). Section 2(a)(11) of the Securities Act defines an underwriter as “any person who has purchased from an issuer, with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.” 15 U.S.C. § 77b(a)(11).

15. Whether a broker has conducted a “reasonable inquiry” depends on the facts and circumstances surrounding the transaction:

A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for. Distribution by Broker-Dealers of

such stock, Respondents reviewed, among other things: the security’s rating on pinksheets.com, six month trading charts showing price and volume and the SEC’s website to determine if there were any actions against the issuer or those affiliated with it. Respondents also obtained confirmation of shares outstanding from the transfer agent and conducted internet searches to learn information about the issuer, its affiliates or a potential stock promotion.

Unregistered Securities, Securities Act Release No. 4445 (Feb. 2, 1962)
(Commission interpretative release).

16. From the time that Customers A, B and C each began trading penny stocks through their E*Trade accounts, Respondents were presented with the following recurring red flags, which together should have raised a question as to whether these customers were engaged in an unlawful distribution by, for example, acting as statutory underwriters: (1) the three customers acquired substantial amounts of newly issued penny stocks; (2) directly from little known, non-reporting issuers; (3) through private, unregistered transactions; (4) then immediately resold those shares; and (5) wired out the sales proceeds.

17. Given the specific red flags associated with Customers A, B and C's deposited securities and resale transactions, Respondents were required to engage in a searching inquiry to properly rely on the Section 4(a)(4) brokers' transaction exemption. As part of a searching inquiry, Respondents had a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act, and for each resale transaction they needed to be reasonably certain that such an exemption was available. In the Matter of World Trade Financial Corp., et. al., Exchange Act Release No. 66114 (Jan. 6, 2012) (Commission opinion), petition denied, 739 F.3d 1243 (9th Cir. 2014); In the Matter of Stone Summers & Co., et.al., 45 S.E.C. 105, 108 (1972) (Commission opinion).

18. For resale transactions that Customers A and B executed between March 2007 and March 2010, however, Respondents did not reasonably ascertain that an exemption from registration was available. During this period, Respondents did not ask Customers A and B to identify the specific exemptions from registration on which they were relying, and they also did not become aware of any other exemptions potentially available to the customers. Thus, Respondents could not be reasonably certain that any exemptions were available. Moreover, Respondents were presented with circumstances indicating that Customers A and B were engaging in unlawful distributions of securities including, for example, that Customers A and B were acting as underwriters. As a consequence, for resale transactions that Respondents facilitated for Customers A and B between March 2007 and March 2010, Respondents did not engage in a reasonable inquiry, and thus were not entitled to the brokers' transaction exemption under Section 4(a)(4) of the Securities Act.

19. For resale transactions that Respondents facilitated for Customers A and C between late March 2010 and April 2011, Respondents also did not engage in a reasonable inquiry, and were likewise not entitled to the brokers' transaction exemption under Section 4(a)(4) of the Securities Act. During this period, the inquiries Respondents made under the Enhanced Due Diligence review enabled Respondents to identify the claimed exemptions upon which Customers A and C were relying. Those inquiries, however, were not sufficient for Respondents to meet their obligation, given the continued presence of red flags, to be reasonably certain that those exemptions were available. In addition, during this period, Respondents did not become aware of any other exemptions that were potentially available to Customers A and C for their resale transactions.

20. For Respondents to qualify for the brokers' transaction exemption set forth in Section 4(a)(4), in circumstances such as those found here, where a searching inquiry was required because numerous, recurring red flags suggested that the customers were engaging in unregistered distributions of securities, it was necessary for Respondents to be reasonably certain that the customer's claimed exemption – or another exemption – was available for each resale transaction. Here, Respondents relied on the following inquiries to conclude that the exemptions claimed by Customers A and C were available: conclusory representations made by Customers A and C that the claimed exemptions were available, the attorney opinion letters that the customers submitted and certain independent inquiries that Respondents performed under the Enhanced Due Diligence review.

21. The independent inquiries that Respondents performed under the Enhanced Due Diligence review, however, were not sufficient for Respondents to be reasonably certain that the exemptions claimed by Customers A and C were available to them for one of two reasons. Those inquiries either revealed facts that called into question whether the claimed exemptions were available, or they did not address sufficiently facts that were necessary to support the claims of Customers A and C that those exemptions were available to them.

22. In addition, in the circumstances here, Respondents could not rely on the conclusory representations of Customers A and C, or the particular attorney opinion letters that those customers submitted, to be reasonably certain that the exemptions claimed by Customers A and C were available to them. When a broker is faced with recurring red flags suggesting that its customer is engaging in unregistered distributions of securities, it cannot satisfy its reasonable inquiry obligations by relying on the mere representations of its customer, the issuer, or counsel for the same, without reasonably investigating the potential for opposing facts. See, World Trade Financial Corp. v. SEC, 739 F.3d 1243, 1249 (9th Cir. 2014) (rejecting the argument that under the circumstances the duty of reasonable inquiry was met by reliance on third parties in conformity with industry practice and stating “brokers rely on third-parties at their own peril, and will not avoid liability through that reliance when the duty of reasonable inquiry rests with the brokers”); Wonsover v. SEC, 205 F.3d 408, 415-16 (D.C. Cir. 2000) (rejecting broker's argument that under the circumstances he justifiably relied on the clearance of sales by his firm's restricted stock department, the transfer agent, and counsel); see also, Distribution by Broker-Dealers of Unregistered Securities, Securities Act Release No. 4445 (Feb. 2, 1962) (“It is not sufficient for [a dealer] merely to accept self-serving statements of his sellers and their counsel without reasonably exploring the possibility of contrary facts.” (internal quotation omitted)).

23. As discussed above, Respondents' customers engaged in a pattern of depositing large quantities of thinly traded securities that they acquired directly from little known non-reporting issuers through private transactions, and then immediately resold the securities and withdrew the proceeds. In these circumstances, a broker may reasonably rely on an attorney opinion concluding that an exemption from registration is available only where: (1) that opinion letter describes “the relevant facts in sufficient detail to provide an

explicit basis for the legal conclusions stated,” Sales of Unregistered Securities by Broker-Dealers, Exchange Act Release No. 9239 (July 7, 1971);⁶ and (2) the broker’s reasonable independent investigation does not uncover contrary facts.

24. Here, in light of a pattern of recurring red flags over several years that strongly suggested that the customers were engaged in illegal, unregistered distributions of securities, the particular attorney opinion letters that Customers A and C submitted did not provide Respondents with a reasonable basis upon which to conclude that the claimed exemptions were available for several reasons. First, Respondents were aware of facts that should have called into question whether the representations that the customers and the issuers made to the attorneys who issued the opinions were accurate. For example, in some cases, the attorney opinion letters indicated that Customers A and C had investment intent. Respondents, however, knew that these two customers had a pattern of repeated deposits of newly issued shares followed immediately by requests to sell those same shares, which is inconsistent with investment intent. Second, nearly all of the letters were based primarily on conclusory representations by the issuers and Customers A or C. Third, some of the letters described facts to support the tacking of holding periods that should have put Respondents on notice that such tacking was not permitted, and thus the claimed exemption was not available. Finally, nearly half of the letters did not describe all of the elements of the exemptions they identified and they did not describe facts showing that those elements were met.

25. Because the attorney opinion letters that Customers A and C submitted to the Respondents did not provide a sufficient basis for Respondents to be reasonably certain that the claimed exemptions were available in light of other facts of which Respondents were aware, and because the further inquiries that Respondents made were not sufficient for them to be reasonably certain that those or any other exemptions were available, Respondents could not conclude that they were not aware of facts showing that Customers A and C were engaging in improper distributions of securities. As a consequence, Respondents could not claim the brokers’ transaction exemption under Section 4(a)(4) with respect to their facilitation of Customers A’s and C’s resales of securities that were not registered under the Securities Act.

⁶ Exchange Act Release No. 9239 is a statement issued by the Director of the Division of Trading and Markets. On several occasions, Commission opinions have cited to different aspects of the guidance discussed in this release regarding a broker’s duty to investigate the potential that a customer might be unlawfully distributing securities. See, e.g., In the Matter of Ronald S. Bloomfield et.al., Exchange Act Release No. 71632 (Feb. 27, 2014) (Commission opinion); In the Matter of World Trade Financial Corp., et. al., Exchange Act Release No. 66114 (Jan. 6, 2012) (Commission opinion), petition denied, 739 F.3d 1243 (9th Cir. 2014), In the Matter of Midas Securities LLC et.al., Exchange Act Release No. 66200 (Jan. 20, 2012) (Commission opinion).

D. Violations

26. As a result of the conduct described above, Respondents willfully violated Sections 5(a) and 5(c) of the Securities Act, which prohibit the direct or indirect sale and offer for sale of securities through the mails or interstate commerce unless a registration statement has been filed or is in effect.

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offers.

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

A. Respondents cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act.

B. Respondents are censured.

C. Respondents shall, within 30 days of the entry of this Order, pay, jointly and severally, disgorgement of \$1,402,850 and prejudgment interest of \$182,166 to the Securities and Exchange Commission for transfer to the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

D. Respondents shall, within 30 days of the entry of this Order, pay, jointly and severally, a civil money penalty in the amount of \$1,000,000 to the Securities and Exchange Commission for transfer to the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. §3717.

E. The foregoing payments must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

(3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying G1 Execution Services, LLC and E*TRADE Securities, LLC as Respondents in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Steven L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

By the Commission.

Brent J. Fields
Secretary