**FINANCIAL INDUSTRY REGULATORY AUTHORITY**
**LETTER OF ACCEPTANCE, WAIVER AND) CONSENT**
**NO. 2007009026302**

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Scottrade Inc. (CRD No. 8206)

Pursuant to Rule 9216 of FINRA's Code of Procedure, Respondent Scottrade Inc. ("Scottrade" or "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Scottrade alleging violations based on the same factual findings described herein.

## I.

## ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

## BACKGROUND

Scottrade has been a registered broker dealer and member of FINRA (f/k/a National Association of Securities Dealers or NASD) since May 23, 1980. The Firm's principal place of business is St. Louis, Missouri. It has more than 400 branch offices throughout the country and employs approximately 1,300 registered representatives. The Firm is an on-line discount broker-dealer. Its primary business consists of providing an on-line platform for customers to enter orders for trading stocks, including those traded on the NYSE, the Nasdaq, the Over-The-Counter Bulletin Board market ("OTCBB") and the Pink Sheets, listed options, fixed income securities and mutual funds. It is also a registered municipal securities dealer.

## OVERVIEW

Since 2002, NASD Conduct Rule 3011 has required firms to establish and implement policies, procedures, and internal controls that can be reasonably expected to detect and cause the reporting of suspicious transactions as required by the Bank Secrecy Act and the implementing regulations thereunder. This includes suspicious securities transactions.

Scottrade is an on-line discount broker-dealer. Its primary business consists of providing an on-line platform for customers trading in securities. Scottrade's business model allows customers to open accounts on a non-face-to-face basis, has limited person-to-person customer

relationships, offers a broad range of investment products, and provides customers with access to enter orders for securities on-line.

Between April 2003 and April 2008 (the "review period"), Scottrade failed to establish and implement AML policies, procedures, and internal controls that were reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder.

More specifically, between April 2003 through January 2005, Scottrade's AML policies, procedures, and internal controls were wholly inadequate to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder given the Firm's business model. During this time period, Scottrade failed to design and implement reasonable policies, procedures, and internal controls tailored to its business model. The Firm's AML monitoring was manual and relied exclusively on external sources and internal sources to refer potentially suspicious transactions to its AML Officer. The Firm did not provide adequate written guidance to its employees as to how to detect or review for potentially suspicious activity.

Until June 2004, Scottrade's AML Compliance Officer/Director of Risk Management was the only person specifically tasked with investigating the referrals. He investigated the referrals to determine whether any potentially suspicious money movement required reporting. In June 2004, the Firm hired one Risk Management Analyst to assist with this review. Despite the high volume of on-line trading at the Firm, Scottrade had no systematic or automated processes to monitor for potentially suspicious transactions and generate referrals to the Risk Management Department. Compounding the Firm's lack of internal controls was its failure to provide adequate written guidance in its procedures as to how to detect or review for potentially suspicious activities for escalation and reporting as appropriate.

It was not until February 2005, more than two years after Rule 3011 became effective, that Scottrade implemented a proprietary automated filter-based system (the "CARS System") to monitor for suspicious transactions. The CARS System utilized nine filters that queued transactions for further review by the Firm's AML analysts. In September 2006, the Firm implemented a proprietary volume exception report ("Analytics Volume Report") designed to detect pump-and-dump account intrusions and unauthorized trading activity resulting from such account intrusions. But even with the implementation of the CARS System and the Analytics Volume Report, the Firm's AML policies, procedures, and internal controls between February 2005 and April 2008 still were not designed to detect and cause the reporting of suspicious trading activity, unless such activity was accompanied by money movement. As a result, between February 2005 and April 2008, Scottrade's AML policies, procedures, and internal controls continued to be inadequate to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder because they were not reasonably designed to detect and cause the reporting of suspicious securities transactions.

By virtue of this conduct, Respondent Scottrade violated NASD Conduct Rules 3011(a) and (b) and 2110 and MSRB Rule G-41.

## LEGAL STANDARD AND FACTS

### A. Anti-Money Laundering Requirements

NASD Conduct Rule 3011, adopted on April 24, 2002 and amended on October 22, 2002, requires all member firms to "develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the firm's compliance with the requirements of the Bank Secrecy Act (31 U.S.C. § 5311, *et seq.*), and the implementing regulations promulgated thereunder by the Department of the Treasury." Similarly, MSRB Rule G-41 requires every registered municipal securities dealer to "establish and implement an anti-money laundering compliance program reasonably designed to achieve and monitor ongoing compliance with the requirements of the Bank Secrecy Act, 31 U.S.C. 5311, *et seq.* and the regulations thereunder."

In April 2002, FINRA issued Notice to Members ("NTM") 02-21, which reminded broker-dealers that by April 24, 2002, they were required to establish and implement AML programs designed to achieve compliance with the Bank Secrecy Act and the regulations promulgated thereunder.[1] The Notice further advised broker-dealers that their AML procedures must address a number of areas including monitoring of account activities, "including but not limited to, trading and the flow of money into and out of accounts."[2]

Title 31 U.S.C. § 5318(g) authorizes the United States Department of the Treasury to issue suspicious activity reporting requirements for broker-dealers. The Treasury Department issued the implementing regulation, 31 C.F.R., § 103. 19(a)(1) on July 1, 2002. It provided that, with respect to any transaction after December 30, 2002, "[e]very broker or dealer in securities within the United States . . . shall file with FinCEN . . . a report of any suspicious transaction relevant to a possible violation of law or regulation." Section (a)(2) of that regulation specifically provides:

> A transaction requires reporting ... if it is conducted or attempted by, at, or through a broker-dealer, it involves or aggregates funds or other assets of at least $5,000, and the broker-dealer knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):
>
> (i) Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law or regulation;

[1] Special NASD Notice to Members 02-21 at 5.

[2] *Id.*

(ii) Is designed, whether through structuring or other means, to evade any requirements of this part or of any other regulations promulgated under the Bank Secrecy Act, . . .;

(iii) Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or

(iv) Involves use of the broker-dealer to facilitate criminal activity.

The Bank Secrecy Act's implementing regulations define "transaction," in relevant part as "...a purchase, sale, loan, pledge, gift, transfer, delivery, or other disposition, and with respect to a financial institution includes a deposit, withdrawal, transfer between accounts, exchange of currency, loan, extension of credit, purchase or sale of any stock, bond, certificate of deposit or other monetary instrument, security, . . . or any other payment, transfer, or delivery by, through, or to a financial institution, by whatever means effected."

In August 2002, FINRA issued NTM 02-47, which set forth the final AML rules promulgated by the United States Department of the Treasury for the securities industry. This NTM further advised broker-dealers of their duty to file a SAR-SF for any suspicious transactions occurring after December 30, 2002.

Under NASD Conduct Rule 3011, firms are required to establish and implement policies, procedures, and internal controls that can be reasonably expected to detect and cause the reporting of suspicious transactions as required by the Bank Secrecy Act and the implementing regulations thereunder. This includes suspicious securities transactions irrespective of associated money movement.

A firm's obligation is not a one-size-fits-all requirement and each financial institution should tailor its AML program to fit its business. In this regard, each broker-dealer, in developing an appropriate AML program should consider factors such as its size, location, business activities, the types of accounts it maintains, and the types of transactions in which its customers engage.[3] In NTM 02-21, FINRA specifically instructed on-line firms such as Scottrade to "consider conducting computerized surveillance of account activity to detect suspicious transactions and activity."[4] This was consistent with prior FINRA guidance that one of the factors firms should consider when tailoring their supervisory procedures and systems to their business is the technological environment in which the firm operates.[5]

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[3] Special NASD Notice to Members 02-21 at 4.

[4] *Id.* at 7.

[5] NASD Notice to Members 99-45, *NASD Provides Guidance On Supervisory Responsibilities*, at 2.

### B. Scottrade's Business Model

Scottrade's primary business consists of providing an on-line platform for customers trading in securities. Scottrade's business model allows customers to open accounts on a non-face-to-face basis, has limited person-to-person customer relationships, offers a broad range of investment products, and provides customers with access to enter orders for securities on-line. The Firm facilitated approximately 49,000 trades per day in 2003, approximately 76,000 daily trades in 2004, approximately 100,000 in 2005, approximately 120,000 in 2006 and approximately 150,000 in 2007. Among the inherent risks of this business model, and the sheer volume of transactions involved, are an increased risk of identity theft and account intrusions, and the use of customer accounts to launder money using securities or other instruments or to violate securities laws.

### C. Scottrade's AML Policies, Procedures, And Internal Controls For Monitoring For Suspicious Transactions From April 2003 Through February 2005 Were Not Reasonable

Between April 2003 and February 2005, the Firm's AML policies, procedures, and internal controls were inadequate to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder given the Firm's business model. During this time period, Scottrade failed to establish and implement reasonable AML policies, procedures, and internal controls tailored to its business model.

Despite the high volume of on-line trading at the Firm, Scottrade did not have any systematic or automated system designed to detect potentially suspicious money movement or securities transactions for further analysis and reporting as appropriate. Instead, the Firm used a manual system for monitoring its accounts for suspicious activities, which relied exclusively on internal sources, including branch, cashiering and margin personnel, and external sources, to refer potentially suspicious activity to the Risk Management Department for further review. The Firm did not provide adequate written guidance to its employees as to how to detect or review for potentially suspicious activity.

Furthermore, until June 2004, Scottrade's AML Compliance Officer/Director of Risk Management was the only person specifically tasked with investigating the referrals to determine whether the activity was suspicious activity that required reporting. In June 2004, the Firm hired one Risk Management Analyst to assist with this review. Scottrade's AML procedures failed to provide adequate written guidance to the Firm's personnel, including the AML Compliance Officer and the Risk Management Analyst, as to how to detect or review for suspicious activity. Their review of accounts for suspicious activity focused on reviewing for suspicious money movement into and out of accounts. During this time period, neither the AML Compliance Officer nor the Risk Management Analyst nor anyone else at Scottrade specifically monitored for potentially suspicious trading activity.

The sheer volume of on-line trading rendered the lack of an automated system, along with the Firm's reliance on inadequate internal resources to detect suspicious activity, unreasonable.

### D. From February 2005 Through April 2008, Scottrade's AML Policies, Procedures, And Internal Controls For Monitoring For Suspicious Securities Transactions Were Inadequate

In February 2005, more than two years after Rule 3011 became effective, Scottrade implemented its CARS System, a proprietary, automated filter-based system to monitor for suspicious transactions. Originally, the CARS System was designed with nine filters that predominantly monitored for suspicious money movement. Through April 2008, the number of filters and the filters themselves were modified by Scottrade, but throughout this time period, all of the filters, except for two, were exclusively designed to detect suspicious money movement. The two exceptions were a filter designed to flag suspicious money movement in relation to the number of trades executed and a Penny Stock Filter, which was designed to monitor for potentially suspicious trading activity. The Penny Stock Filter, however, only generated an alert if there was money movement into or out of an account that independently triggered another filter.

In September 2006, the Firm implemented an Analytics Volume Report which was designed to detect pump-and-dump account intrusions and unauthorized trading activity resulting from such account intrusions. Absent indicia of a compromised account, the Analytics Volume Report was not utilized by the Firm to detect suspicious trading activity by *bona fide* account holders. In the summer of 2007, the Firm suspended its use of the Analytics Volume Report for a three month period.

Notwithstanding the implementation of the CARS System and the Analytics Volume Report, the Firm did not have adequate policies, proccedures, and internal controls to detect and cause the reporting of suspicious securities transactions. Under the CARS System, when suspicious activity triggered one of the filters, it generated an alert to the Firm's AML analysts, who were responsible for investigating the alerts. The Firm's AML Analysts only reviewed the CARS System for potentially suspicious trading activity captured in a filter if there was money movement into or out of an account that independently triggered one of the filters. Between February 2005 and April 2008, an average of 1,300 alerts were generated monthly. The alerts were weighted and reviewed by the AML Analysts based upon the weighting priority of the alert. Not every alert was reviewed. Alerts that were not reviewed were archived.

Scottrade's AML procedures failed to provide adequate written guidance to its AML Analysts as to when and how they should review accounts for suspicious trading activity in connection with money movements. In February 2007, the Firm added a procedure for its AML Analysts, which stated, "Check account activity for any other suspicious activity or potential AML violations." But the Firm's AML procedures still failed to identify and provide adequate written guidance on detecting and investigating potentially suspicious trading activities by customers in their accounts.

Between February 2005 and April 2008, except for the Firm's application of the Analytics Volume Report, Scottrade's AML policies, procedures, and internal controls were not designed to detect and cause the reporting of suspicious trading activity, unless such activity was accompanied by suspicious money movement. As a result, the Firm's AML policies, procedures, and internal controls were inadequate to achieve compliance with the Bank Secrecy Act and the

implementing regulations thereunder because they were not reasonably designed to detect and cause the reporting of suspicious securities transactions.

**Conclusion**

By virtue of the above, during the review period, Scottrade violated NASD Conduct Rules 3011 and 2110 and MSRB Rule G-41 by failing to establish and implement policies and procedures that could reasonably be expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder; and by failing to establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder.

B. Respondent also consents to the imposition, at a maximum, of the following sanctions:

1. a censure;

2. a fine of $600,000; and

3. an undertaking that the Firm's Chief Compliance Officer shall certify within 60 days of the effective date of this AWC that the Firm is in compliance with FINRA Rule 3011(a) and (b) and MSRB Rule G-41 by establishing and implementing AML policies, procedures, and internal controls with respect to its monitoring for suspicious transactions that are reasonably designed to achieve compliance with the requirements of the Bank Secrecy Act and the Treasury's implementing regulations.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

**II.**

**WAIVER OF PROCEDURAL RIGHTS**

Respondent specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

A. To have a Formal Complaint issued specifying the allegations against it;

B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the *ex parte* prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

## III.

## OTHER MATTERS

Respondent understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and

C. If accepted:

1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;

2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about the Firm's disciplinary record;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and

4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

Respondent certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that it has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

9/4/09
Date

Respondent Scottrade Inc.

By: A.C. SMALL, GENERAL COUNSEL
[Name and title]

Reviewed by:

Betty Santangelo
Counsel For Respondent
Schulte Roth & Zabel, LLP
919 Third Avenue
New York, New York 10022

Accepted by FINRA:

10/26/09
Date

Signed on behalf of the
Director of ODA, by delegated
authority

Samuel L. Israel
Associate Vice President and Chief
Counsel
FINRA Department of Enforcement
1801 K Street, N.W., Suite 800
Washington, D.C. 20006-1334
(t) 202-974-2868
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## ELECTION OF PAYMENT FORM

Scottrade intends to pay the fine set forth in the attached Letter of Acceptance, Waiver and Consent by the following method (check one):

☑ A personal, business or bank check for the full amount;

☐ Wire transfer;

☐ Credit card authorization for the full amount;[6] or

☐ The installment payment plan (only if approved by FINRA staff and the Office of Disciplinary Affairs).[7]

Respectfully submitted,

Date 9/4/09

Respondent, Scottrade, Inc.

By: A.C. SMALL, GENERAL COUNSEL
[Name and title]

[6] Only Mastercard, Visa and American Express are accepted for payment by credit card. If this option is chosen, the appropriate forms will be mailed to you, with an invoice, by FINRA's Finance Department. Do not include a credit card number on this form.

[7] The installment payment plan is only available for fines of $5,000 or more. Certain interest payments, minimum initial and monthly payments, and other requirements apply. Respondent must discuss these terms with FINRA staff prior to requesting this method of payment.