

**NASD OFFICE OF HEARING OFFICERS**

DEPARTMENT OF MARKET REGULATION,

Complainant,

v.

Respondent.

Disciplinary Proceeding  
No. 20042000056-01

Hearing Officer – AWH

**HEARING PANEL DECISION**

March 30, 2007

**Respondent found not liable for (1) failing timely to report Reportable Order Events to the Order Audit Trail System (“OATS”), in violation of NASD Marketplace Rule 6955(a) and Conduct Rule 2110, and (2) failing to take and document all supervisory steps, corrections, and/or reviews set forth in its written supervisory procedures concerning OATS data submission and reporting. Respondent found liable and issued a Letter of Caution for failing to ensure that it retained such documentation for the full period required, in violation of Conduct Rules 2110 and 3010.**

Appearances:

Gerard M. Babendreier, Esq.; Peter D. Santori, Esq.; and Jeffrey K. Stith Esq.  
for the Department of Market Regulation.

Kevin J. Harnisch, Esq.; Michael A. Umayam, Esq.; and Erin Jaskot, Esq., of FRIED, FRANK,  
HARRIS, SHRIVER, & JACOBSON, LLP, for Respondent.

**DECISION**

**Procedural History**

On May 4, 2006, the Department of Market Regulation (“Market Regulation”) filed the Complaint against [the Respondent Firm] (“Firm” or “Respondent”), alleging that the Firm (1) failed timely to report to the Order Audit Trail System (“OATS”), Reportable Order Events (“ROEs”), on behalf of itself and as a Reporting Agent for two separate OATS Reporting Members, and (2) failed to enforce written supervisory procedures concerning OATS data

submission and reporting that were reasonably designed to achieve compliance with applicable federal securities laws and regulations, and NASD Rules. On May 26, 2006, the Firm filed its Answer to the Complaint, denying the alleged violations, asserting affirmative defenses, and requesting a hearing.

On September 1, 2006, the Firm filed its Motion for Summary Disposition, arguing that it cannot be sanctioned for any alleged violation of the OATS rules because those rules were not promulgated in accordance with the Paperwork Reduction Act.<sup>1</sup> On September 15, 2006, the Department of Market Regulation filed its Opposition to the motion, arguing that the Hearing Panel lacks authority to consider such a challenge to the OATS rules. On October 4, 2006, Respondent filed its reply to Market Regulation's Opposition, asserting that the Hearing Panel does have authority to consider its challenge to the OATS rules. On October 9, 2006, the Hearing Panel deferred consideration of the Motion for Summary Disposition pending a hearing on the merits of the issues raised by both causes in the Complaint. A hearing was held in Washington, DC, on October 25 and 26, 2006, before a Hearing Panel composed of the Hearing Officer, a current member of the District 9 Committee, and a former member of the District 9 Committee. The parties filed post-hearing submissions on December 15, 2006. Both parties filed motions to strike post-hearing submissions, and replies to those motions.<sup>2</sup> The last response was filed on January 2, 2007.

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<sup>1</sup> Pub. L. No. 194-13, 109 Stat. 163 (1995) (codified at 44 U.S.C. §§ 3501-3520 (2006)). In view of the conclusion that no violation of the OATS rules took place, the Hearing Panel does not reach the question whether the OATS rules were promulgated in accordance with the Paperwork Reduction Act.

<sup>2</sup> The motions are resolved at n. 36, *infra*.

## Findings of Fact<sup>3</sup> and Conclusions

### I. The Allegations of Late OATS Reporting

#### A. Background

The Firm became an OATS reporting member on October 8, 2002, and submitted its OATS information to NASD by email.<sup>4</sup> Prior to the commencement of its OATS reporting, the Firm conducted internal and external testing, including testing with NASD, before receiving approval from NASD to begin its OATS reporting.<sup>5</sup> NASD informed [Respondent] that after the Firm had submitted four consecutive days of testing, NASD found that “conditions [had] been met for the [Respondent] to proceed [with] production,” and that the Firm had “met conditions for OATS test[s].”<sup>6</sup> Nevertheless, although the Firm did not make any changes to its submission practices after the test period, problems began to surface almost immediately after the Firm went “live.”<sup>7</sup>

The Firm's first contact with Market Regulation regarding its compliance with OATS reporting requirements was the receipt of a Wells notice on March 10, 2003, which alleged that on thirteen days between October 1, 2002, and December 31, 2002, the Firm submitted 180,517 ROEs after the 4:00 a.m. Eastern Time OATS reporting deadline.<sup>8</sup> During the hearing, Market Regulation amended the allegation in the Wells notice, stating that it was charging only that the Firm submitted 174,971 late ROEs. It excluded the 5,546 alleged late ROEs submitted October 25, 2002, because of OATS processing delays caused by data submitted by another member

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<sup>3</sup> References to the Department of Market Regulation's exhibits are designated CX-; Respondent's exhibits, as RX-; joint stipulations, as Stip.-; and the transcript of the hearing, as Tr.-.

<sup>4</sup> Tr. 370, 402-04.

<sup>5</sup> RX-14, RX-15.

<sup>6</sup> *Id.*

<sup>7</sup> Tr. 421-22, 531-32, 534.

<sup>8</sup> RX-1. Market Regulation no longer initiates investigations with a Wells notice. Tr. 322-23.

firm.<sup>9</sup> The remaining 12 days on which Market Regulation alleges late submission of ROEs are October 8, 9, 14, 17, 21, and 22 (the first two weeks the Firm began “live” reporting), and December 2, 3, 19, 20, 23, and 24, 2002.<sup>10</sup>

On August 18, 2003, Market Regulation again issued a Wells notice to the Firm alleging that, during the first quarter of 2003, the Firm submitted as a reporting agent 61,854 ROEs on behalf of ABN Amro, Inc. (“ABNA”) and Robeco USA Brokerage Services (“WPGC”) after the 4:00 a.m. Eastern Time OATS reporting deadline.<sup>11</sup> Two weeks prior to the hearing, Market Regulation was informed by its regulatory analyst that the Firm should not have been charged with 3,474 late ROEs submitted on behalf of ABNA and WPGC because the ROEs had no relation to the Firm.<sup>12</sup> The remaining ROEs that were alleged to have been filed late by the Firm occurred on six days during the first quarter of 2003: January 8 and 9, February 7, and March 19, 21, and 25.<sup>13</sup>

### **B. The Firm's System for Transmitting OATS Files**

The Firm's primary business focus is on execution and clearing of trades for institutional and professional customers.<sup>14</sup> Its business accounts for about 60 million shares a day, one to two percent of the entire daily volume of equities and options traded in the United States.<sup>15</sup> In order to transmit its OATS submissions to NASD, the Firm developed an in-house computer program that used Microsoft Outlook as an email provider; email transmission is an NASD approved method for submitting OATS ROEs.<sup>16</sup> JF, an Firm employee at the time, developed the program

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<sup>9</sup> CX-1; Tr. 62-63.

<sup>10</sup> RX-1.

<sup>11</sup> RX-7.

<sup>12</sup> CX-13; Tr. 162-68.

<sup>13</sup> CX-13.

<sup>14</sup> Tr. 391.

<sup>15</sup> Tr. 406, 423.

<sup>16</sup> Tr. 36, 402-04. The Firm transmitted 200 to 300 other files each day by email.

and was responsible for it. He was instructed to develop a system that could run unattended and report anything that went wrong.<sup>17</sup>

### **C. NASD System for Receiving and Processing OATS Files**

The *OATS Subscriber Manual* and the *OATS Reporting Technical Specifications* provide that order events occurring during a particular OATS Business Day must be “reported” by 4:00 a.m. Eastern Time the following calendar day. Order reports that are “submitted” later than this deadline must be marked late by NASD.<sup>18</sup>

Shelly Bohlin, manager of Market Regulation’s OATS team, explained that the information flow of OATS submissions by email that are received by NASD involves two separate steps: (1) receipt, and (2) processing. A firm submitting OATS information sends an email to NASD with a Firm Order Report (“FORE”)<sup>19</sup> attached to the email. The FORE file contains all of the firm’s information, including the identity of the firm. If NASD cannot open the FORE file attached, it does not conclusively know who sent it. An email message is then sent back to the submitter, indicating that either the FORE file was received and will be processed, or the FORE file was received but NASD could not open it, decrypt it, or process it because something was wrong with it. If the FORE file can be processed, it is fed (by something called “Loader”) into the OATS system to process the individual ROEs. If a ROE reaches the “Processor” after 4:00 a.m. on the day following the order event, the ROE is marked late, even if the FORE file containing it had been received before the deadline. The “processing date” triggers the late reporting flag, and ROE rejections occur by processing date. Within 24 hours of processing, firms can log on to the OATS website to determine whether ROEs were accepted or

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<sup>17</sup> Tr. 404, 406-08.

<sup>18</sup> CX-37, RX-53 at 1-5, RX-56 at 1-3.

<sup>19</sup> The FORE file is erroneously identified in the transcript of the hearing as the “FOR file.”

rejected, and, if rejected, the reason for the rejection. The firms can then make appropriate repairs to a rejected ROE and resubmit the data.<sup>20</sup>

**D. Conflicts between Submission of Emails and Their Receipt and Processing**

1. On October 25, 2002, the Firm called the OATS Business Help Desk to question 5,546 ROEs that were marked late, but which it believed were submitted on time. The Firm was told that the files should not have been marked late. The Help Desk told JF of the Firm that OATS could not load its FORE files for processing until the system completed processing a large number of rejected ROEs another firm was attempting to repair. Bohlin testified that, under the circumstances, the OATS staff found cause not to charge the Firm with the 5,546 late ROEs. However, she asserted that, in any event, the OATS system had properly marked the ROEs as late, even if [Respondent] had sent the data prior to the 4:00 a.m. deadline.<sup>21</sup>

2. On December 20, 2002 (one of the dates at issue in the Complaint), the Firm notified NASD that, as happened with the previous two days, it had received confirmation that NASD received all three of its OATS submissions prior to the 4:00 a.m. deadline, but the Firm had gotten status reports on only two. The Firm attempted to address the problem by implementing a procedure that submitted the first OATS data file to NASD twice. Retransmission of the file for which it hadn't received a status report was successful. The only change to the original file was modification of the date sent. The original file was not processed because the OATS system stated that no FORE was attached to the email. However, the Help Desk noted the following in its case notes:

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<sup>20</sup> Tr. 251-54, 329, 340-41, 373.

<sup>21</sup> RX-18; Tr. 337-41.

(December 23, 2002)

Contacted customer - - explained that the file was dropped due to no attachment - - I checked his sent folders and it did have an attachment . . . .<sup>22</sup>

(December 24, 2002)

Called user and they did have the same issue before - - He stated that he checked his sent items again and that there was something strange - - The attachment that was not processed was only showing as 1KB in size when it had a couple thousand ROES in it - - It should be at least 1MB in size - - He went back through the past couple of weeks and a lot of the attached files were showing only 1KB in size but they had all been successfully processed by us - - To alliviate the current problem he is going to have his automated sys send the first file twice as that is the one that keeps getting dropped for no attachment to see if this well correct the issue . . . .<sup>23</sup>

Two years later, Wilma George, the OATS Compliance Analyst who investigated this case, asked the Help Desk for a recap of the problem the Firm was having with dropped files.

After noting that the Firm “was advised to submit the 1<sup>st</sup> files twice,” Ms. George wrote:

Is the firm doing something wrong, why would it need to send one file twice, is the firm going outside what OATS requires. Please advise. This firm is pending disciplinary action and we need to understand the significance of this. The firm continues to send one of its files twice.<sup>24</sup>

The Help Desk employee responded:

I think the basic issue here is that the firm is not using approved email client to submit. They had been having problems in the past and did not want to switch to Outlook Express or Netscape Messenger. They wanted to work out the problem with their current setup and they eventually did by submitting files twice.<sup>25</sup>

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<sup>22</sup> The case note itself shows the receipt of the email and attachment that was 1.01 MB in size and contained 10,114 records. It also shows attachments to the other two emails that were sent on the same day. RX-21; Tr. 436-438. On brief, Market Regulation asserts that RX-21 “could just as easily and fairly be read to indicate that the dropped attachment . . . was never actually received by OATS until its retransmission on December 23, 2002.” (Emphasis in the original). Brief, at 7, n. 38. The case note precludes such an assertion. It states; “As with the previous two days, OATS returned 3 *Received* emails . . . on 12/20/02.” (Emphasis added). All three are shown with attachments.

<sup>23</sup> *Id.* See also RX-20.

<sup>24</sup> RX-22.

<sup>25</sup> *Id.*

The advice of the Help Desk employee is apparently incorrect. The parties now agree that the Firm's use of Microsoft Outlook to send OATS emails instead of Outlook Express or Netscape Messenger "would not result in such submissions being marked late or rejected."<sup>26</sup>

3. In mid-March 2003, the Firm sent OATS emails to NASD, but NASD did not receive them. After SJ, a network manager for the Firm, contacted the NASD Help Desk, the Help Desk employee agreed to receive from the Firm and submit to NASD the OATs emails that the Firm could not submit to NASD directly. The Help Desk (Custom Applications Support Helpdesk or "CASH") has its own email address – nasd.cash@erols.com – that is outside of NASD's email domain. After the Firm sent OATS emails to CASH, CASH then successfully sent the Firm's OATS emails to NASD.<sup>27</sup>

SJ assisted other Firm employees in trying to resolve OATS's sudden inability to receive email submissions from the Firm. After researching the issue, he concluded that one potential cause was NASD's possible implementation of a security patch that may have activated reverse DNS lookup, a process, as described by John Stancik of the NASD Help Desk, by which "an attempt is made when an email is delivered to [NASD] to track back the sending email address and if it is not a true valid email address the email we received is dropped."<sup>28</sup> Although Stancik told SJ that he would get back to SJ after looking into the problem, Stancik never did get back to SJ. The problem went away within a few days, and the Firm was able to resume emailing OATS submissions to NASD in the same manner as it had done so before.<sup>29</sup>

On May 28, 2003, Ms. George wrote to Stancik about the Firm's inability to send files.

She wrote:

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<sup>26</sup> Stip. ¶ 2.

<sup>27</sup> Tr. 545-47, 612-13; RX-28, RX-30.

<sup>28</sup> Tr. 540-42; RX-28, RX-29, RX-30.

<sup>29</sup> Tr. 547-48.



The firm contends that its problem is the result of changes to our mail servers that do not allow access from hosts that do not support DNS lookup. (Whatever that means) [P]lease . . . provide me with a high level explanation of the problem with the firm's submissions.<sup>30</sup>

Stancik replied that DNS lookup, as noted above, is an attempt "when an email is delivered to us to track back the sending email address . . . ." <sup>31</sup> As he had told SJ, Stancik told George that he would get back to her "asap." He did not get back to her.<sup>32</sup> In February 2004, George contacted Mike Wei, an NASD consultant on technology, about the DNS lookup issue. He told her that NASD engineers determined that the problem was due to reverse DNS.<sup>33</sup> Finally, Len Gatrell, NASD Vice-President of Technology, testified that, within a few days of the hearing, he researched the issue of reverse DNS look-up and "found some emails that indicated that [o]n March 28<sup>th</sup> of 2003, reverse DNS was not enabled for the NASD and that the bottom of the email alluded to the fact that it hadn't been enabled for six months prior."<sup>34</sup>

4. Once NASD offered an alternative way to submit information to OATS, the Firm switched to that system. As soon as the Firm began using that system, OATS transmission problems essentially disappeared.<sup>35</sup>

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<sup>30</sup> RX-22.

<sup>31</sup> *Id.*

<sup>32</sup> Tr. 203.

<sup>33</sup> RX-33. George's handwritten notes in RX-33 and her testimony indicate that she did not understand the reverse DNS issue. Her notes state that the Firm was initiating DNS lookup and those notes are, therefore, inconsistent with Stancik's advice that it was NASD that initiated the reverse DNS lookup. As Stancik noted, reverse DNS lookup is used to track a sender's address, not a recipient's address. On brief, Market Regulation concedes George's "lack of understanding as to the mechanics of Reverse DNS Look-up," and states that Wei "himself clearly misapprehended the mechanics of Reverse DNS Look-up insofar as his description contradicts the testimony of all other witnesses who testified knowledgeably about the issue." Brief, at 9, n. 48.

<sup>34</sup> Tr. 359-60, 575-76.

<sup>35</sup> Tr. 455, 461.

### **E. Conclusions on Allegations of Late OATS Reporting<sup>36</sup>**

The Hearing Panel concludes that Market Regulation has failed to prove by a preponderance of reliable evidence that the Firm failed timely to submit OATS reports as alleged in the Complaint or as modified as the proceeding progressed. There is no question that a computer program marked ROEs as late filed. There is no question that internal NASD summary reports counted the number of ROEs so marked. However, there is no way to determine, on this record, whether the alleged late filed ROEs were so marked because they were submitted after the 4:00 a.m. deadline or because NASD did not process them before the deadline. There is no reliable evidence to demonstrate whether anecdotal evidence of dropped files, failure to recognize valid email senders, misdiagnosis of email bugs, or other errors may have occurred on occasions other than those brought to light by the record evidence. The inability to resolve those issues is caused by the failure of Market Regulation to review, base its contentions on, or submit evidence of, the underlying emails transmitting the OATS files in

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<sup>36</sup> The Firm filed a motion to strike Market Regulation's post-hearing submissions for (1) exceeding the 25 page limit of Procedural Rule 9266, (2) providing new testimony outside the hearing process, and (3) offering analysis that is unsupported by the evidentiary record. Market Regulation filed a 24 page brief, a seven page "appendix" to that brief which contains proposed findings of fact, and a two page affidavit of Shelly Bohlin. Market Regulation cites part of Procedural Rule 9266 that states that the parties may be ordered to file proposed findings of fact and conclusions of law, or post-hearing briefs, or both, and that the Rule states that each shall not exceed 25 pages. However, Market Regulation does not cite that portion of the Rule which states: "The Hearing Officer may order that such proposed findings and conclusions be filed together with, or as part of, post-hearing briefs." In this case, and as noted by the Firm, the Hearing Officer ordered that findings and conclusions were to be included in the briefs. However, giving the benefit of the doubt to Market Regulation that it may have misunderstood the order, and finding that the motion to strike gave the Firm an opportunity to comment on matters raised in Market Regulation's brief, the Hearing Officer will not strike the brief or the seven page appendix. However, the Hearing Officer will strike the affidavit of Shelly Bohlin as an impermissible addition of testimony after the hearing that does not address the limited issue to which post-hearing comment was permitted. Clearly, the Hearing Officer ruled that Market Regulation could show, post-hearing, only that figures which were totaled on RX-66 differed from the figures on RX-2 which were not totaled on that exhibit. Tr. 155. (a similar ruling was made on the admission of RX-67; Tr. 219). The Firm's motion to strike the analysis of the supervisory issue is denied. The substance of the analysis is treated later in this decision. Finally, Market Regulation filed a motion to strike portions of the Firm's post-hearing brief on grounds that it "may not misstate the evidence, introduce facts not already in the record, or otherwise attempt to mislead the Panel as to the inferences it may reasonably draw." However, as this decision demonstrates, the facts do not support the allegations in the motion. Accordingly, the motion is denied.

question, the OATS submissions themselves, the confirmation messages, and the status reports indicating which files have been processed. Wilma George testified as follows:

Q. Now you talked about steps you tried to take to make sure that information was, in fact, accurate on this matter. But if I understood you correctly, you did not review the actual submissions themselves. Is that correct?

A. That is correct.

Q. So in terms of verifying the accuracy, you were just what, comparing different summary reports?

A. Summary reports from the OATS database, yes.

Q. So getting yourself comfortable that things were accurate, you're pre-supposing the accuracy of those summary reports. Correct?

A. Yes.<sup>37</sup>

The Hearing Panel does not suggest that underlying documents for each allegedly late ROE must be produced and verified. There are methods of statistical sampling to which litigants may resort. Here, there is no underlying evidence; rather, Market Regulation asserts that to require it to verify the accuracy of its charges by comparing summary information to the actual submissions at issue "is simply an unrealistic, unnecessary, and outdated requirement that refuses to accept the validity of computerized counting." However, there is no question in this case about the general validity of computerized counting. The question is the validity of the charges against the Firm that ROEs were, in fact, submitted late.

The burden of proof rests with Market Regulation, not on Respondent. Here again, Market Regulation's post-hearing brief is predicated on surmise and speculation, rather than solid evidence upon which the Hearing Panel could rely:

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<sup>37</sup> Tr. 128-29.

As appears to have happened . . . the initial failure to submit the ROEs . . . on time most likely resulted in a domino effect whereby the firm did not “catch up” . . . .

Similarly, [Respondent]'s initial failure to timely submit the firm's ROEs of December 18, 2002 was most likely the catalyst for all four successive days' late ROEs, rather than NASD's supposed dropping of some of [Respondent]'s FORE files or any other email transmission problems. . . . any alleged dropping of [Respondent]'s FORE file attachments could simply have occurred in cyberspace, anywhere along the line of [Respondent]'s email transmission. Such is the risk that [Respondent] assumed in choosing to transmit its ROEs to OATS in that manner.<sup>38</sup>

Finally, the Hearing Panel cannot determine the extent to which reverse DNS look-up may have affected the timely transmission or timely receipt of OATS data. Mere “*indications* that NASD was not employing any Reverse DNS Look-up during the review periods,” as asserted by Market Regulation, do not rise to proof that it was not employed during that period. Neither does the assertion that NASD's ability to receive emails from CASH prove that the ability to receive those emails “was likely due to that particular email address's ability to recognize OATS encryption codes rather than to avoid a Reverse DNS Look-up problem.”<sup>39</sup>

Put simply, the Firm may indeed have submitted a number of ROEs in an untimely manner. However, the Hearing Panel cannot determine, with any degree of confidence, the dates on which, or the extent to which, it might have done so. The Firm developed a program to run unattended, and there is no evidence that its program was flawed. On the other hand, NASD's method of processing ROEs involved the receipt of emails, followed by the transmission of data to a separate processor. There is evidence that, at least on a number of occasions, there were problems with NASD's ability to receive and/or immediately process data that had been

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<sup>38</sup> Post-hearing brief, p. 7. It is fundamentally unfair to hold a member firm liable for utilizing a reporting method approved by NASD for use by its member firms.

<sup>39</sup> Post-hearing brief, p. 9.

transmitted by email. Finally, even if NASD did not receive a number of ROEs, that evidence alone does not demonstrate that the Firm failed to transmit them. Whatever caused any late submissions in the first two quarters that the Firm was required to begin its submission of OATS data, SL's testimony that "when [NASD] got the new program [and alternative system for submission of information] . . . the problem went away," is un rebutted.<sup>40</sup>

## **II. The Allegations of Failing to Repair Rejected ROEs**

The Complaint alleges that the Firm failed to repair 3,066 ROEs that were rejected by OATS during the fourth quarter of 2002. NASD Firm Reporting Statistics for that quarter assert that the Firm had 9,673 ROEs rejected; however, the 6,607 remaining ROEs were either repaired by the Firm or non-repairable.<sup>41</sup>

Market Regulation asserts that all but seven of the rejected ROEs were caused by the Firm's submissions of a subsequent order event for an order not existing in the OATS database, or because the Firm submitted "Cancel and Replace" order events more than five business days after submitting the original new order event, "resulting in there being nothing in the OATS database to which the subsequent order event could be related."<sup>42</sup> However, the rejection and repair issue is derivative of the manner and method by which OATS data is first received, and then processed, as discussed in the preceding section.

Logically, it makes no sense to cancel and replace something that does not exist, or something that will exist only at sometime in the future. The submission of a "cancel and replace" order event must be predicated on the existence of an original order. Logic and consistency with the evidence discussed in the previous section convince the Hearing Panel to

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<sup>40</sup> Tr. 461. *See also* 454-55.

<sup>41</sup> CX-1, RX-67; Tr. 232. No evidence was introduced to demonstrate how any of these rejected ROEs may have been repaired while 3,066 others are alleged not to have been repaired or repaired incorrectly.

<sup>42</sup> Post-hearing brief, at 10-11.

credit SL's testimony that he personally confirmed that the original order events were in the Firm's files at the time any subsequent order event was submitted to OATS.<sup>43</sup> Either OATS did not receive and process the ROEs that the Firm originally submitted by email, or it failed to process the original or subsequent ROEs on the same date they were received. Under the circumstances, the Hearing Panel finds that Market Regulation has not proved by a preponderance of the evidence (1) that the ROEs it alleges were not repaired were properly rejected in the first place, or (2) that the Firm submitted "Cancel and Replace" order events more than five business days after submitting the original new order event, resulting in there being nothing in the OATS database to which the subsequent order event could be related.

The Firm tracked and analyzed rejections and repaired them in a manner it believed was compliant with NASD rules, concluding that the most effective way to repair them was to ensure that the original order events were resubmitted and actually processed by OATS. SL personally confirmed that the original orders had been resubmitted and processed.<sup>44</sup>

The Hearing Panel concludes that Market Regulation has failed to prove by a preponderance of the evidence that the Firm failed to repair ROEs that were properly rejected by OATS. Even assuming that the Firm's efforts to repair any of those improperly rejected ROEs fell short of any published technical requirements,<sup>45</sup> the Hearing Panel concludes that fundamental fairness dictates that, where the firm is not responsible for an initial rejection of a

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<sup>43</sup> Tr. 456-57.

<sup>44</sup> Tr. 457, 460-61, 497. Apparently, the Firm did not trigger the "resubmit flag" on December 23, 2002, enabling OATS to recognize the resubmission as a repair. CX-22. However, as discussed previously, it was during this period of time that the Firm's attachments to emails were being dropped, and NASD knew that the Firm was advised to submit its first files twice in an effort to alleviate the problem.

<sup>45</sup> On December 24, 2002, the Firm resubmitted seven cancel orders for which it failed to trigger a "Y" flag to indicate that the order was a repair. Consequently OATS could not recognize it as a repair and count it appropriately. Shelly Bohlin testified: "So that is why it appears, and is technically an unrepaired rejection." Tr. 316. *See also* CX-22.

ROE, it should not be called to account for making a good faith effort to resolve the situation in a manner it believes is reasonable, logical, and will be successful.

### **III. Written Supervisory Procedures**

The Complaint alleges that, during the first quarter that the Firm was required to submit data to OATS, the Firm failed to implement and enforce written supervisory procedures reasonably designed to achieve compliance with securities laws, rules, and regulations. Specifically, the Complaint alleges that the Firm failed to take all supervisory steps, corrections, and/or reviews as set forth in its written supervisory procedures or to document and retain such documentation of supervisory steps, corrections, and/or reviews “set forth in the firm’s written supervisory procedures concerning OATS data submission and reporting.”

To support those contentions, Market Regulation offered the testimony of Wilma George.<sup>46</sup> Ms. George testified that her opinion that the Firm failed to enforce its written supervisory procedures was based on her conclusions that (1) “the firm failed to repair and submit their rejected ROEs,” and (2) [Respondent] was unable, in the first quarter of 2003, to supply her with supervisory logs for the fourth quarter of 2002. However, as Market Regulation points out in its post-hearing brief, the “action” of repairing and submitting rejected ROEs “is not supervisory in nature, but merely describes the required task itself rather than a procedure to ensure compliance with the task.” Consequently, her testimony does not support a contention that the Firm failed to enforce its written supervisory procedures. Second, her testimony that [Respondent], in a subsequent quarter, could not supply her with supervisory logs from a previous quarter does not demonstrate that supervisory logs were not maintained. To the contrary, SL’s testimony, which the Hearing Panel finds credible, demonstrates that such records

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<sup>46</sup> Market Regulation’s Post-hearing Brief cites only to Ms. George’s testimony on transcript pages 109:20 – 118:17. Post-hearing brief, at 15, n.70.

**This Decision has been published by NASD's Office of Hearing Officers and should be cited as OHO Redacted Decision 20042000056-01.**

were kept electronically, albeit for a short period of time, and, because a number of logs were created by the Firm's computerized program, the records were voluminous.<sup>47</sup>

On brief, Market Regulation charges for the first time that the written supervisory procedures that the Firm sent to NASD in response to an 8210 request did not name a "Designated Supervisor." The brief also charges that the Firm's supervisory reviews were "almost exclusively electronic in nature, consisting of various "bug files" that were retained for no longer than a week." However, Market Regulation did not ask the Firm for its complete written supervisory procedures. While it is true that the portion of the written supervisory procedures that the Firm submitted with its response to the Wells notice did not name a designated supervisor, the Hearing Panel cannot conclude that there was no separate section of [Respondent]'s written supervisory procedures that named its designated supervisors, because the balance of written supervisory procedures were not offered in evidence. Second, while the process of "corrections and reviews" was electronic, SL was personally involved on a daily basis in an effort to ensure that OATS reporting was done properly, and at least four Firm employees were also involved in that process.<sup>48</sup>

Finally, Market Regulation, for the first time, charges in its post-hearing brief that the Firm retained its computerized supervisory logs for only one week, in violation of NASD Conduct Rule 3110(a) which mandates minimum retention periods of no less than three years:

Each member shall make and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations and statements of policy promulgated thereunder and with the Rules of this Association and as prescribed by SEC Rule 17a-3. The record keeping

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<sup>47</sup> Tr. 464-68. The Hearing Panel found SL's testimony to be clear, candid, and convincing. Although not an expert in computer programming, he was a tough task master who, as a supervisor, employed a hands-on approach and personal involvement on an almost daily basis with respect to all aspects of his business operations. *See, e.g.* Tr. 461-63.

<sup>48</sup> Tr. 457, 461-63, 476-77.



format, medium, and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.

The Complaint alleges, in part, that the Firm failed to document “and retain” documentation of supervisory steps, corrections and/or reviews” set forth in its written supervisory procedures concerning OATS data submission and reporting. The Complaint alleges that all of the conduct relating to written supervisory procedures described in Cause Two of the Complaint violates NASD Conduct Rules 2110 and 3010. However, the Complaint does not refer specifically to Rule 3110(a), nor does it specify that the conduct alleged to violate Rule 3110 is a failure to retain records for less than three years. However, the Hearing Panel concludes that use of the word “retain” was enough to put Respondent on notice that records retention is at issue in this proceeding.

The Hearing Panel concludes that the Firm violated Conduct Rule 3010 by failing to ensure that it retained its supervisory logs for the period of retention required by Conduct Rule 3110(a). However, the Hearing Panel notes that the violation (1) was based on SL's good faith, but mistaken belief, that because the files were voluminous, they should be, and could properly be, periodically purged to avoid overloading of computer disks;<sup>49</sup> and (2) occurred only during the first quarter that the Firm was required to submit OATS data to NASD.<sup>50</sup> Accordingly, the Hearing Panel concludes that, to remediate the violation, a Letter of Caution should be issued to the Firm.

### **Conclusion**

Respondent is found not liable for (1) failing timely to report Reportable Order Events to the Order Audit Trail System (“OATS”), in violation of NASD Marketplace Rule 6955(a) and

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<sup>49</sup> Tr. 467.

<sup>50</sup> Ms. George was “comfortable” with the Firm's enforcement of its supervisory procedures for the first quarter of 2003. Tr. 225.

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Conduct Rule 2110, and (2) failing to take and document all supervisory steps, corrections, and/or reviews set forth in its written supervisory procedures concerning OATS data submission and reporting. Respondent is found liable and issued a Letter of Caution for failing to ensure that it retained such documentation for the full period required, in violation of Conduct Rules 2110 and 3010.

**SO ORDERED.**

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Alan W. Heifetz  
Hearing Officer  
For the Hearing Panel