

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION

Complainant,

v.

Respondent.

Disciplinary Proceeding

No. CLG050048

Hearing Officer – AWH

HEARING PANEL DECISION

March 7, 2006

Member firm failed to accept or decline in the Automated Confirmation Transaction System, within 20 minutes after execution, transactions in eligible securities that it was required to accept or decline, in violation of NASD Conduct Rule 2110 and Marketplace Rule 6130(b). Respondent fined \$3,000, and assessed costs.

Appearances:

M. Catherine Cottam, Esq., Peter Santori, Esq., and Jeffrey K. Stith, Esq.,
for the Department of Market Regulation

_____, President; _____, Director; _____, Vice-President,
for Respondent Firm.

Decision

Introduction

On May 17, 2005, the Department of Market Regulation issued a single-cause Complaint alleging that [the Respondent Firm] (“Respondent” or “the Firm”)¹ violated NASD Conduct Rule 2110 and Marketplace Rule 6130(b) from July 30 through September 3, 2003, when it failed to accept or decline in the Automated Confirmation Transaction System (“ACT”), within 20 minutes after execution, 1,210 transactions in eligible securities that, as the Order Entry Firm, it was required to accept or decline. The

¹ _____ was Respondent’s predecessor firm at the time of the alleged violations.

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Complaint alleges that those transactions represent approximately 93 percent of all transactions that Respondent had an obligation to accept or decline in ACT during the third quarter of 2003.

On June 14, 2005, Respondent filed an Answer to the Complaint and a Request for Hearing. The Answer, among other affirmative defenses, alleges that the 93 percent non-compliance “which occurred over a relatively short period of time points to inadvertent system failure, rather than a repeat of violations over a longer period of time.” The Answer also alleges that the non-compliance occurred at a time when Respondent ceased clearing for its holding company, and Respondent was in the process of entering into an agreement with Schwab Capital Markets, L.P. (“Schwab”) whereby Schwab, as Executing Broker, would submit trade information to ACT on Respondent’s behalf.²

A hearing was held on December 1, 2005, in Washington, D.C., before a Hearing Panel composed of the Hearing Officer, a current member of the District 7 Committee, and a current member of the District 9 Committee. On January 19, 2006, Respondent filed its post-hearing brief, and, on January 20, 2006, Market Regulation filed its post-hearing brief.

² The Answer also avers that _____, (“_____”), which had complete control over Respondent, was “converting all accounts over to a new and more compliant trading system (BRASS)...” However, no evidence was introduced to show how such a conversion may have affected the Firm’s ability to comply with its reporting obligations under Rule 6130(b). In addition, the Answer alleges a hostile breakup of _____ and the Firm during which the present officers of Respondent had no management responsibilities at the Firm. Again, no evidence was introduced by either party to substantiate or controvert those allegations.

Discussion and Conclusions

The Violations

At the times relevant to the Complaint, Marketplace Rule 6130(b) stated:

ACT Participants shall transmit trade reports to the system for transactions in Nasdaq securities within 90 seconds after execution, or shall utilize the Browse function in ACT to accept or decline trades within twenty (20) minutes after execution, according to the requirements of paragraph (c) of this Rule.³

Marketplace Rule 6130(c) specifies which ACT Participant is to input trade reports into the ACT system, and which is to utilize the Browse function to accept or decline trades, within the applicable time frames. Marketplace Rule 6180 provides that an ACT Participant's failure to comply with any of the rules or requirements of ACT "may be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Rule 2110."⁴

Market Regulation's Trade Reporting and Compliance Team regularly and routinely conducts an automated "sweep" of ACT reports to monitor compliance with the 20 minute rule.⁵ NASD uses Statistical Analysis Software ("SAS") to analyze all trades submitted to ACT.⁶ The SAS program automatically excludes two types of trades: (1) those reported to ACT that are executed through an automated system, such as

³ The 6100 series of NASD Marketplace Rules was amended, effective May 5, 2004, to change the acronym "ACT" to "Nasdaq Market Center," a term that encompasses a number of Nasdaq systems, including ACT. The amendment did not affect the substance of the rules. *See* 69 Fed. Reg. 45866; Exchange Act Release No. 50,074 (July 30, 2004).

⁴ During the hearing, and again on brief, Respondent suggests that a violation of Rule 6130(b) requires evidence of a pattern or practice. It does not. Respondent may have in mind IM-4632-1 which provides that late trade reporting will violate Rule 4632 and Conduct Rule 2110, if NASD finds that there is a pattern or practice of violations. Also, in contrast to Rule 6130(b), IM-4632-1 provides that no violation may be found where a pattern or practice is found in cases of "exceptional circumstances," which may include "instances of system failure." As noted above, in its Answer, Respondent suggests "inadvertent system failure" as an affirmative defense to the alleged violations. Rule 6130 does not contemplate exceptions to its requirements.

⁵ Tr. 26-27.

⁶ Tr. 27.

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SuperMontage; and (2) those that are executed pursuant to an ACT agreement, such as a Qualified Service Representative Agreement or an Attachment 2 Agreement, both of which provide for an automated process whereby the contra side of a trade is locked into the trade and does not have to affirm the trade manually.⁷

The SAS program computes the difference between the time the trade was executed and the time the contra party responded to the trade report. It then identifies those trades where the difference between these two times exceeds 20 minutes. The program then compiles, by member firm, a list of trades identified as potential violations, and tags them as “alerts.”⁸

The SAS program identified 1,120 transactions during the period of July 30 through September 3, 2003, in which Respondent was the Order Entry Firm, with the obligation to accept or decline each of those trade reports. In each case, Respondent failed to accept or decline the trade within 20 minutes of execution.⁹ Accordingly, each of those transactions violated the 20 minute Rule, and, accordingly, the Hearing Panel concludes that Respondent violated NASD Marketplace Rule 6130(b) and Conduct Rule 2110.

Sanctions

At the times relevant to the Complaint, Respondent was a subsidiary of _____, and cleared trades for _____.¹⁰ At some time during the relevant time period, _____ changed clearing firms, from Respondent to Penson Clearing. Because _____ had an agreement

⁷ Tr. 27-28.

⁸ Tr. 28-31.

⁹ CX-2; Tr. 38-39.

¹⁰ At the times relevant to the Complaint, Respondent’s predecessor firm was known as _____, and used a market participant identifier _____. In this decision, “Respondent” encompasses both the current firm and its predecessor.

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with Schwab pursuant to which trades were routed to Schwab who would report those trades to ACT, Respondent was not required to report the trades to ACT. After it no longer cleared for _____, Respondent continued to route trades for other customers to Schwab, but Respondent did not have an ACT agreement with Schwab for an automatic lock-in for trades which would relieve Respondent from ACT reporting obligations. To address this problem, Respondent opened an account with Schwab on August 5, 2003, and entered into an Attachment 2 Agreement with Schwab on August 21, 2003, pursuant to which Schwab would report trades on behalf of Respondent.¹¹ (All but four of the trades identified as potential violations occurred on or before August 21, 2003.)¹² Before that Attachment 2 Agreement was in place, while Respondent was responsible for reporting its trades to ACT, it could have used the Browse function in ACT to comply with the 20 minute Rule.

Market Regulation's general practice was to select member firms for sweep investigations based on their quarterly performance on trade reporting.¹³ In this case, Complaint focuses on Respondent's performance in the third quarter of 2003. The vast majority of the alleged violations during this period, however, occurred in only one month, on 14 consecutive trading days beginning on August 4, 2003, and ending on August 21, 2003. The relevant period alleged in the Complaint began on Wednesday, July 30, when there were ten violations. On Thursday, July 31, there were nine violations, and on Friday, August 1, there was one. Following the 14-day period beginning on August 4 when the violations were numerous, there were only three on

¹¹ CX-5.

¹² CX-2, p. 22.

¹³ Tr. 182-84.

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Friday, August 22, none during the week of August 25, and one on Monday, September 1, the only violation that month.¹⁴

After the 14-day period, Respondent's compliance with Rule 6130(b) improved substantially. In fact, using its case selection criteria described above, Market Regulation would not have selected Respondent for investigation at any time during the nine months after the third quarter of 2003, based on the small number of alerts that indicated possible violation of the 20 minute Rule.¹⁵

NASD Sanction Guidelines for trade reporting violations recommend, for a first action, a fine of \$1,000 to \$2,000; for a second action, a fine of \$2,000 to \$10,000; and, for subsequent actions, a fine of \$5,000 to \$100,000.¹⁶ Arguing that there are numerous violations over an extended period of time, and that Respondent previously was sanctioned for trade reporting violations, Market Regulation seeks a censure and a \$30,000 fine in this case.

Exhibit CX-18 is the Order Accepting Offer of Settlement in Disciplinary Proceeding _____ to which Market Regulation cites as Respondent's disciplinary history.¹⁷ The Order in the exhibit is undated, and, as a result, its recency cannot be determined. Respondent argues that the Order cannot be considered in this proceeding because, in a state court-approved settlement order, the court required NASD to expunge CX-18 from the Central Registration Depository ("CRD"). That state court proceeding

¹⁴ CX-2, pp. 1-22.

¹⁵ Tr. 184. For example, in the fourth quarter of 2003, Respondent had three alerts on a total of only 14 trades that it was required to report.

¹⁶ NASD SANCTION GUIDELINES, at 68 (2005 ed.).

¹⁷ In addition to other violations, Respondent was fined \$1,500 for violation of Marketplace Rules 5430 and 6420 (a modifier was not appended to 38 transactions that were reported, and an unspecified number of reports were not designated as late and did not include the time of execution). Apparently the trade reporting violations were not disposed of as "minor violations" because they were included in a complaint that alleged two other violations. See NASD Rule 9216(b), IM-9216, and Notice to Members 01-54 (violations of Marketplace Rule 6130 may be treated as minor violations); see also SEC Rule 19d-1(c)(2).

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involved Respondent's former holding company, _____,
as a party in cross actions against Respondent's then and current director,
_____.¹⁸ While that state court proceeding lends some support to Respondent's
assertion, in its Answer, that there was a hostile breakup of ____ and the Firm, it is clear
that NASD was not a party to that proceeding, and that, therefore, the state court had no
jurisdiction to order any record expunged from CRD.¹⁹ Accordingly, the prior
disciplinary action may be considered in this case, and the Hearing Panel therefore
considers this to be a "second action" for purposes of the Guidelines.

General Principle 4 of the Sanction Guidelines provides that aggregation or
"batching" of violations may be appropriate for determining sanctions where, as here, the
violative conduct did not involve manipulative, fraudulent, or deceptive intent, or result
in injury to public investors. Moreover, aggregation may be appropriate where the
violations resulted from a single systemic problem or cause that has been corrected.²⁰

The violations occurred primarily during a 14 day period in August 2003, at a
time Respondent was negotiating an Attachment 2 Agreement with Schwab who would
then report trades on Respondent's behalf. In the six months that followed that August
agreement, Respondent had 5 alerts out of only 15 trades.²¹ Although there was an
increase in alerts during March 2004, those alerts are beyond the period at issue in this
case, and the Hearing Panel cannot determine the circumstances surrounding them. In

¹⁸ See Exhibits A, B, and C to Market Regulations Motion for Summary Disposition; CX-13, 14.

¹⁹ NASD did not waive the requirement that it be named as a party in any action seeking to expunge CRD records. *Id.*; see also Conduct Rule 2130.

²⁰ SANCTION GUIDELINES, at 4.

²¹ In September 2003, November 2003, and February 2004, Respondent had one alert each month out of one reported trade. Exhibit CX-6 shows those months as having 100 percent violations. On the other hand, October 2003 and January 2004, show zero alerts and zero trades for 100 percent compliance. There is no evidence of the total number of trades executed by Respondent and reported by Schwab on behalf of Respondent during any of the time periods on the exhibit.

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any event, the number of alerts dropped considerably during the three months following March 2004.²² Given Respondent's overall performance for the 12 months scrutinized in this case, the Hearing Panel concludes that, while the violations cannot be excused, the 1,190 violations occurring in August 2003 appear to be anomalous.

Even though Respondent was negotiating an Attachment 2 Agreement with Schwab, it had an obligation to ensure that its trades were timely reported, and cannot avoid responsibility for the violations, regardless of any purported confusion during the transition. Moreover, even if, as Respondent asserts, a prior management team was responsible for these violations as well as Respondent's prior trade reporting violations, Respondent still bears the corporate responsibility for those violations.

The Hearing Panel finds that Respondent has apparently resolved its reporting deficiencies by entering into an Attachment 2 agreement with Schwab. Accordingly, the Hearing Panel will aggregate the violations, treat them as a second trade reporting violation, and, for the violation, will fine Respondent \$3,000.²³ The Hearing Panel finds that no remedial purpose would be served by imposing a higher sanction.²⁴ The Hearing Panel will also order Respondent to pay costs of \$1,993.95, consisting of a \$750 administrative fee and a \$1,243.95 transcript fee.

Conclusion

Respondent is (1) fined \$3,000 for failing to accept or decline in the Automated Confirmation Transaction System, within 20 minutes after execution, transactions in

²² CX-6.

²³ The Hearing Panel declines to impose a censure, as requested by Market Regulation, because the monetary sanction is less than \$5,000; the violations involve the quality of markets; and extraordinary circumstances do not exist that would otherwise merit a censure. *See* SANCTION GUIDELINES, at 9.

²⁴ *See E. Magnus Oppenheim & Co., Inc.*, Exchange Act Release No. 51,479, 2005 SEC LEXIS 764 (Apr. 6, 2005).

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eligible securities that it was required to accept or decline, in violation of NASD Conduct Rule 2110 and Marketplace Rule 6130(b). It is also assessed total costs of \$1,993.95. These sanctions become effective at a time set by NASD, but not sooner than 30 days after this Decision becomes the final disciplinary action of NASD.

SO ORDERED.

Alan W. Heifetz
Hearing Officer
For the Hearing Panel