

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

ANDREW P. GONCHAR
(CRD No. 1659516)

and

POLYVIOS T. POLYVIOU
(CRD No. 1659532),

Respondents.

Disciplinary Proceeding
No. CAF040058

Hearing Officer – DRP

**EXTENDED HEARING
PANEL DECISION**

October 26, 2006

Respondents violated: (i) Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and NASD Conduct Rules 2120 and 2110 by fraudulently interpositioning a third-party between their member firm and 71 retail customers in 142 transactions; (ii) Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and NASD Conduct Rules 2120, 2440 and 2110 by charging excessive and fraudulent mark-ups in 142 transactions; and (iii) Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and NASD Conduct Rules 2120 and 2110 by failing to disclose excessive and fraudulent markups in 142 transactions. For these violations, Respondents are barred from association with any member firm. Each Respondent is also fined \$115,000, reflecting his ill-gotten commissions.

Appearances

For the Department of Enforcement: Philip J. Berkowitz, Gregory R. Firehock and David L. Fenimore (Rory C. Flynn, Of Counsel), Washington, DC.

For the Respondents: Martin H. Kaplan and Melvyn J. Falis of Gusrae, Kaplan, Bruno & Nusbaum, New York, NY.

DECISION

I. Introduction

The Department of Enforcement filed a four-count Complaint on August 3, 2004, alleging that in 142 transactions with 71 retail customers between August 2000 and January 2002, Respondents Andrew P. Gonchar and Polyvious T. Polyviou engaged in a scheme whereby they sold convertible bonds to a hedge fund, bought back the bonds, and without disclosing the prior transactions, resold the same bonds at a higher cost to retail customers.¹ Enforcement charges that in so doing, Respondents interpositioned the hedge fund and: (i) knew, should have known or were reckless in not knowing that such interpositioning would result in increased costs to their retail customers, in violation of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder and NASD Conduct Rules 2120 and 2110; (ii) in the alternative, increased costs to their retail customers, in violation of NASD Conduct Rules 2320 and 2110; (iii) knew, should have known or were reckless in not knowing that customers paid unfair, excessive and fraudulent mark-ups, in violation of Section 10(b) of the Exchange Act and Rule 10b-5, as well as NASD Conduct Rules 2120, 2440 and 2110; (iv) failed to disclose excessive and fraudulent mark-ups to customers, in violation of Section 10(b) of the Exchange Act and Rule 10b-5, as well as NASD Conduct Rules 2120 and 2110.²

On September 24, 2004, Respondents filed an Answer in which they denied the charges and requested a hearing. In their Answer, Respondents asserted that the firm's trading desk determined the prices charged in the transactions at issue.

¹ The Complaint charged 143 violative transactions. Enforcement subsequently removed one transaction (trade 51); thus, Respondents were ultimately charged with misconduct involving 142 transactions.

² The Complaint refers to the hedge fund as AP. The entity was identified during the hearing as Avalon Asset Management, Inc.

From February 14-24, 2006, an eight-day hearing was held in New York before an Extended Hearing Panel composed of the Hearing Officer, a former member of NASD's District 3 Committee, and a former member of NASD's District 5 Committee. Enforcement called 11 witnesses and introduced 161 exhibits in evidence.³ Respondents testified on their own behalf, called Leslie Seff as an expert witness, and introduced 26 exhibits in evidence.⁴ The parties submitted post-hearing briefs on May 5, 2006.⁵

The case reveals a pattern of trading involving Avalon Asset Management, Inc. (Avalon). In 142 convertible bond transactions on 72 days from August 2000 through January 2002, Respondents earned double commissions by first selling bonds to Avalon, then cross selling the same bonds to the ultimate customer(s) later the same day. In every transaction, the ultimate customer(s) unknowingly paid more for the bonds than Avalon paid earlier in the day, based on prices determined by Respondents. As a result, Avalon profited on 97% of the cross trades arranged by Respondents. The cross trading ended, and Respondents resigned, after the firm questioned Gonchar and Polyviou about this trading activity.⁶

³ Enforcement called seven witnesses who are currently or formerly associated with member firm CIBC World Markets Inc. (CIBC): Jeffrey Thibeault, Director of Compliance; Jonathan Hubschman, former Fixed Income Surveillance/Compliance Manager; Bruce Shreiber, former supervisor of the Convertible Bond Trading Desk; Timothy Reilly and Kevin Lowe, former traders on the Convertible Bond Trading Desk; Debora Frank, former registered representative and retail liaison on the Convertible Bond Trading Desk; and Mark Zuckerman, a registered representative. Enforcement also called JS and RP, two of Respondents' former customers, as well as Mark Susens, an assistant director of technology and strategic planning in NASD's Department of Enforcement, and Joseph Ozag, an assistant director in NASD's Department of Enforcement, who supervised the investigation that led to the initiation of this proceeding.

⁴ Leslie Seff is familiar with the methodology by which convertible bonds are priced by virtue of his 35 years' experience in the securities industry, which includes starting and managing the trading department at two member firms, in addition to starting his own firm. Seff was permitted to offer his expert opinion regarding pricing of convertible bonds at issue in this proceeding. (Tr. 2600-03, 2614-15.)

⁵ References to the hearing transcript are noted as Tr. Enforcement's exhibits are cited as CX; Respondents' exhibits are cited as RX.

⁶ CIBC filed a Form U-5 Termination Notice for each Respondent, disclosing that Gonchar and Polyviou resigned while an internal investigation was pending. As a result, NASD staff opened a review of the matter and conducted an investigation that resulted in the initiation of this disciplinary proceeding. (Tr. 1516-22, 1637-38.)

II. Findings of Fact and Conclusions of Law

A. Respondents Gonchar and Polyviou

Respondents Andrew P. Gonchar (Gonchar) and Polyviou T. Polyviou (Polyviou) first met in 1986 while attending college in New York. In 1987, Gonchar entered the securities industry as a general securities representative. Polyviou also entered the industry as a general securities representative in 1987. In 1988, Respondents formed a partnership, and they subsequently moved together to several member firms. (Complaint ¶¶ 3-4; Answer ¶¶ 3-4; Tr. 2043, 2327.)

From October 1996 to February 2002, Respondents were registered with member firm CIBC World Markets Inc. (CIBC).⁷ CIBC hired Respondents as a team, and Gonchar and Polyviou promoted themselves as partners. Respondents shared office space and a single representative number, and though they maintained separate customers, they split commissions, markups and markdowns equally. They specialized in selling convertible bonds to their retail clients.⁸ During the height of the stock market in 1999, Respondents each earned one million dollars, but as the market declined, their business decreased. By 2001, their annual income was approximately \$300,000 each. After leaving CIBC in early 2002, Respondents registered with another member firm and are currently in the industry.⁹ (Complaint ¶¶ 3-5; Answer ¶¶ 3-5; Tr. 2044-46, 2328-30, 2531-32; CX-4 at 4-5.)

⁷ Respondents were hired by Oppenheimer & Co., which was subsequently taken over, then sold, by CIBC. The firm will be referred to in this Decision as CIBC. (Tr. 2049, 2326.)

⁸ Convertible bonds (CBs or bonds) are hybrid securities: they have features similar to debt securities that provide a fixed return, but CBs can also be converted to shares of the underlying equity security. The hybrid nature of CBs make them difficult for investors to evaluate. (RX-16 at 22, 24.)

⁹ Respondents Gonchar and Polyviou are subject to NASD jurisdiction, because they were registered with a member firm at the time of the alleged violations and when Enforcement filed the Complaint.

B. CIBC's Convertible Bond Trading Desk

During the relevant period, CIBC engaged in proprietary trading of convertible bonds; the firm also bought and sold bonds for its institutional and retail customers. The five convertible bonds at issue – Juniper Networks, Inc.; Redback Networks Inc.; Protein Design Labs, Inc.; Enzon, Inc.; and Cell Therapeutics, Inc. – were not listed on an exchange, and transactions in these bonds were not reported. Because the market was not transparent, CIBC's traders used a computer model to determine the theoretical price of a convertible bond, based on characteristics of the bond itself and the price of the underlying stock.¹⁰ Bond prices were, of course, affected by the market, i.e., the price at which institutional customers and brokers' brokers were willing to buy from, and sell to, CIBC's traders.¹¹ Intra-day changes in the price of a convertible bond were mostly attributable to intra-day changes in the price of the underlying stock. (Complaint ¶ 6; Answer ¶ 6; Counter-Statement of Facts ¶ 3; Tr. 224, 367-70, 1971-73, 1984-88, 2011.)

When Respondents joined CIBC, retail brokers obtained prices for convertible bonds directly from the firm's convertible bond trading desk (Desk). Respondents, who estimated that convertible bonds constituted 35% to 70% of their business, complained to their supervisors about this system; they contended that traders paid more attention, and gave better prices, to institutional customers. For their part, traders were not enamored of working with retail brokers, who generated no income for the trading desk.¹² To address these concerns, CIBC created a retail liaison position on the Desk in February 2000. Debora Frank (Frank), a sales assistant who

¹⁰ To compute the price, CIBC's traders primarily used the MONIS model but also had access to a Bloomberg model and a dollar-neutral model. The traders input information about a convertible bond (maturity date, call features, interest rate) and the underlying stock (price, dividends or yield) to obtain a value for a particular bond. (Tr. 367-70, 1986-87.)

¹¹ A broker's broker is an intermediary who acts on behalf of one firm when dealing with another firm. (Tr. 2608.)

¹² Retail trades constituted approximately 0.1% of trading on CIBC's convertible bond desk. (Tr. 390.)

was working as a liaison between the Desk and the firm's research analysts, was named to the retail liaison position in February 2000. Frank's primary role was to serve as a "bridge of communication" between the Desk and CIBC's retail brokers. (Tr. 394, 1074-75, 1267-68, 2057-60, 2126, 2545-46; CX-4 at 5-6.)

C. Frank's Responsibilities as Retail Liaison

Once Frank was installed as retail liaison, Respondents phoned her to obtain prices for convertible bonds and to place trades. Frank's usual practice was to provide Respondents with price levels at the beginning of the day for specific bonds, including the five bonds at issue, which she obtained from the traders. Timothy Reilly (Reilly), who traded technology bonds, usually gave Frank price levels for Juniper Networks; Kevin Lowe (Lowe), who traded telecommunication and biotechnology bonds, generally provided price levels for Redback, Protein Design Labs, Enzon and Cell Therapeutics. When relaying information to Respondents, Frank quoted bond prices "versus" the price of the underlying equity security. (Tr. 652-53, 1378-80, 1952-53; CX-56-2, 57-2; CX-56-14, 57-14; CX-56-23, 57-23; CX-56-27, 57-27; CX-56-34, 57-34.)

To illustrate, Frank gave Respondents the following price levels before the market opened on January 8, 2002: PDLI versus 30, 106-1/2, 107-1/2. In so doing, Frank conveyed that CIBC would buy Protein Design Lab (PDLI) bonds from a retail customer at 106-1/2, and sell PDLI bonds to a retail customer at 107-1/2, based on PDLI's stock price of 30. The bond prices Frank provided were not considered a firm quote; rather, they were price levels or indications of where the trader was willing to purchase or sell bonds based on a particular stock price.¹³ (Tr. 655-59, 676-77, 2605; CX-56-23, 57-23.)

¹³ Bonds typically have \$1,000 face (par) value but are quoted in hundreds. (Tr. 1548-49.)

Throughout the trading day, Frank updated price information for Respondents and other brokers in one of two ways. She either asked the traders for a price or used the computerized dollar-neutral model on her desk.¹⁴ By entering the price of the underlying equity security in the computerized model, Frank was able to obtain the price level of the bond versus the underlying stock price. In the example cited above, Respondent Gonchar asked Frank about PDLI bonds approximately two hours after the market opened on January 8, 2002. When he gave Frank a stock price of 30.45 for PDLI, she used her computer model to give him a price level of 107-1/2, 108-1/2 for PDLI convertible bonds. If the price of the underlying stock did not accurately reflect the price at which the stock was trading, the bond price would similarly be away from the market. As Respondent's expert witness, Leslie Seff, testified, the models are "only as good as the information you put into them . . . in computer language, GIGO, garbage in, garbage out." (Tr. 653-54, 660-62, 673-74, 1967-68, 2607-08, 2645; CX-56-24, 57-24.)

In addition to providing prices to Respondents and other retail brokers, Frank was also responsible for entering trade information into CIBC's computerized trading and inventory system, known as the convertible bond system (CBS). CBS was designed, in part, to replace paper tickets on the Desk.¹⁵ Though Frank should have entered information in CBS at the time an order was placed, she kept handwritten records on a notepad and completed order entry at the end of the day. As a result, CIBC's records regarding the timing of retail trades were often inaccurate. (Tr. 177-79, 356-57, 682-85, 1534-37.)

¹⁴ If CIBC did not hold the bonds in inventory, Frank obtained prices, and purchased bonds, from brokers' brokers. In a July 2004 settlement with NASD, Frank was censured and fined for executing trades without a Series 55 equity trader license, in violation of NASD Conduct Rule 2110. CIBC also reached a settlement with NASD for failing to register Frank as a Series 55, as well as for its failure to supervise adequately the trading of convertible bonds by Respondents' retail customers and charging customers unfair and excessive prices as a result of Respondents' interpositioning a third-party between the firm and the customers. (Tr. 393-94, 1105, 1252-53; CX-3 at 20, CX-58, CX-59.)

¹⁵ CBS also maintained "real time" inventory of bonds. Traders could monitor the activity in their trading accounts using CBS; Frank was not permitted to view the activity in the trading accounts. (Tr. 356-59.)

Frank was also responsible for a trading account known as the retail facilitation account or the 128 account. The 128 account did not hold inventory, take risk positions or carry positions overnight. Its purpose was to facilitate order flow between the firm and its retail customers in riskless principal transactions and capture commissions in the form of markups and markdowns.¹⁶ (Tr. 175-77, 401-02, 2651-52.)

D. Cross Trading in the 128 Account

Shortly after Frank became retail liaison, Respondents asked her to execute a cross trade between two retail customers.¹⁷ Frank consulted the supervisor on the Desk, who gave her authority to execute cross trades. Frank testified that she was uncomfortable handling this type of trade, which she considered a “gray area,” because there was not “an exact bid or offer.” Nevertheless, she was soon executing cross trades on a regular basis, primarily for Respondents. (Tr. 640-43.)

When Frank purchased bonds for a retail customer from one of CIBC’s traders, the trader determined the price. At first, Frank confirmed with the trader bond prices for cross trades, even though the trades were between retail customers, and Frank could execute the trades without buying from, or selling to, a trader. After a few months, however, she stopped seeking the trader’s approval to execute cross trades at a specific price.¹⁸ Furthermore, CIBC did not require traders to approve the price of cross trades. (Tr. 231-32, 645-46.)

¹⁶ After confirming the price with the trader, Frank executed a customer buy order by purchasing bonds from the trader and selling them to the customer, adding a markup that was determined by the broker. The bonds would thus move by journal entry from the trader’s account to the 128 account to the customer’s account. (Tr. 386-87, 404, 925.)

¹⁷ A cross trade is a sale from one customer account to another customer account. Because a cross trade is typically executed between the bid and the offer, it is generally advantageous to both customers. The cross trades at issue were actually riskless principal transactions, because CIBC executed the buy and sell orders simultaneously through the firm’s 128 account. (Tr. 236-37, 1524, 2609-10.)

¹⁸ The Panel rejects Frank’s testimony that the traders were required to “push a button” to approve a cross trade. Frank’s testimony was directly contradicted by Reilly, a trader who was straightforward and direct and whose testimony the Panel fully credits. (Tr. 1114-15, 1960.) The Panel discounts much of Frank’s

Cross trades involved retail customers and were only recorded in the 128 account. The head of the Desk monitored the 128 account simply to ensure there were no overnight positions held in the account and that profit was derived solely from markups and markdowns. No one at the Desk reviewed trades in the 128 account to ensure that brokers were charging customers fair prices for these transactions.¹⁹ (Tr. 406-07.)

E. Respondents' Cross Trades Involving Avalon

According to the testimony of Mark Zuckerman, a registered representative at CIBC, Avalon was a "trading vehicle" for Anthony Coscio (Coscio), a former registered representative with Olde Discount Corporation and CIBC, who left the securities industry in 1999.²⁰ Avalon and Coscio had several accounts at CIBC, including Account No. 433-10791, an Avalon account that was involved in cross trades with Respondents' other clients. Avalon was one of Respondents' most active customers.²¹ (Tr. 612-14, 2521; CX-70.)

Trading records show that in 142 transactions on 72 days from August 2000 through January 2002, Respondents first sold convertible bonds to Avalon, then cross-sold the same

testimony due to her demeanor during the hearing, which was argumentative and overtly hostile when questioned by Enforcement (and occasionally when questioned by the Panel), but cooperative and friendly to Respondents' counsel. Furthermore, Respondents helped Frank obtain another position after she left CIBC, in part by promising they would provide business for the firm; Frank testified that Respondents were responsible for more than half of her business at the new firm and at two other firms for which she subsequently worked. For all these reasons, the Panel finds that Frank's testimony was slanted in Respondents' favor and not entirely credible. (Tr. 647-51.)

¹⁹ It is unclear whether Respondents' retail supervisors reviewed their cross trades, but even if they had, there is no evidence that they were able to determine whether the prices were fair or properly calculated. It is also unclear who, if anyone, was supervising Frank's activities on the Desk. (Tr. 876-77, 1797-1800.)

²⁰ Coscio, who is no longer subject to NASD's jurisdiction, did not testify at the hearing, but his former business partner, Mark Zuckerman, remains registered with CIBC. Zuckerman testified briefly about Coscio's background and trading practices. Zuckerman characterized Coscio as an aggressive trader. (Tr. 610-17.)

²¹ Though Coscio primarily dealt with Gonchar, Polyviou testified that Avalon "may have been" his customer. (Tr. 2520-21.) Regardless of whose customer Avalon was, Respondents concede they shared all commissions. Furthermore, the evidence establishes that Respondents shared an office and that they each handled Avalon's cross trades with their other customers.

bonds to their retail customer(s) through the 128 account. In each instance, the retail customer unknowingly paid more for the bonds than Avalon had paid, regardless of whether the underlying stock price had risen or declined. Despite paying markups and markdowns for each leg of these transactions, Avalon suffered a net loss only once (of \$125). The evidence shows that Avalon achieved this degree of success because Respondents set sufficiently high prices for cross trades with their customers.²² (Tr. 1523-24, 1529-30; CX-101-173.)

1. Respondents set prices for cross trades

Tape-recordings of Frank's phone conversations on the Desk demonstrate that after purchasing bonds in the morning, Respondents waited until late in the day to execute cross trades. Deferring the trades allowed Respondents to use the high stock price of the day to obtain the highest possible bond price, which they then charged customers in cross trades with Avalon. By setting prices for cross trades in this fashion, Respondents disadvantaged their customers and ensured that Avalon's trades were profitable.²³

For example, minutes before the market opened on January 7, 2002, Frank gave Polyviou a level of 109-1/2, 110-1/2 for Protein Design Labs, Inc. (PDLI) bonds versus the opening stock

²² Though Avalon was occasionally referred to as a hedge fund, there is no evidence that it was anything other than a personal account for Coscio. Furthermore, the evidence does not support Respondents' contention that Avalon received better prices because it was an institutional customer. Not only did Avalon trade in small lots typical of a retail customer, but in tape-recorded conversations with Frank, which are discussed in detail below, Respondents neither identified Avalon as the purchaser when obtaining prices, nor informed her that the inquiry was on behalf of an institutional client. (Tr. 2518-19, 2645-46.)

²³ CIBC did not have surveillance or exception reports capable of detecting violative trading practices in convertible bonds until approximately 2001. A January 2002 exception report prompted Compliance to examine Respondents' convertible bond trading practices. During the ensuing investigation, CIBC reviewed tapes from the Desk, which were later provided to NASD. Tape-recordings (with accompanying transcripts) were admitted in evidence for these dates: January 4, 7, 8, 14, 15, 16, 17, 29, 2002. Because CIBC recycles tapes every 15 days in the normal course of business, tapes prior to January 4, 2002 had been destroyed. At the conclusion of its internal investigation, CIBC voluntarily paid restitution of \$300,000 to 71 customers; the firm paid additional restitution with interest to customers pursuant to its subsequent settlement with NASD. (Tr. 55-60, 85-86, 238-39, 622-23; CX-21, CX-22, CX-56, CX-57, CX-59 at 10.)

price of 31-1/2. At 10:11 a.m., in response to Gonchar's question about the level for PDLI bonds versus a stock price of 30-1/2, Frank quoted 107-7/16, 108-7/16. Gonchar replied, "Buy us 100."

After additional phone calls about the stock price versus the bond price, Frank told Gonchar at 10:41 a.m. that his order for PDLI bonds had been executed by the trader at 108-5/8. At the time, PDLI stock was trading at approximately 30-3/4. Gonchar did not provide a customer account number for the bond purchase, nor did Frank ask for one, but the purchase was later attributed to Avalon. (CX-56-14, 17-20; CX-57-14, 17-20; CX-167-B.)

At 11:22 a.m., Gonchar phoned Frank to tell her he wanted to cross the bonds. Though PDLI stock was trading at approximately 29-3/4, she asked him what stock price he wanted to use to calculate the bond price. Frank pointed out that the stock opened at 31.46 and peaked at 31-3/4. Gonchar told her that the high price of 31-3/4 was "the preference point." Frank then calculated a bond price of 110, 111 versus 31-3/4, but Gonchar said he would execute the cross trade at 112.²⁴ (CX-56-21, 57-21; CX-167-B.)

At 3:06 p.m., Polyviou phoned Frank and gave her the details of the PDLI trades, providing customer account numbers and prices. He told her that Avalon had bought 100 bonds

²⁴ The verbatim exchange was as follows:

Gonchar: Hey, how are you. You know what I want to do? I want to cross these things.

Frank: Okay.

Gonchar: I keep forgetting.

Frank: I am sorry I am not like so – enthralled. . . . Anyway, what price do you want me to use on the PDLI? Let's see, let me hit it up here, cause I have trouble seeing these new screen setup that we have. Let's see, it opened at 31spot 46. The high today was 31-3/4.

Gonchar: Anywhere in there is fine.

Frank: Oh, don't say anywhere.

Gonchar: It's going back to our past conversations. You know, if 31.75 is okay, that's preference point.

Frank: Yeah, okay, that's like 110, 111 versus 31 spot 75.

Gonchar: So I could do it at 112 without a problem.

Frank: Yeah.

Gonchar: Good, that's where I'm going to do 'em.

at 108-5/8; Respondents added a 3 point markup to 111-5/8. Avalon then sold 100 bonds at 112 (including 1/8 markdown). Avalon sold the bonds to the 128 account in a riskless principal trade arranged by Respondents, who re-sold the bonds to two customers, in what Respondents and Frank referred to as cross trades. Each customer bought 50 bonds at 112, to which Respondents added a 3-1/4 markup. To calculate the bond price for Respondents' customers, Gonchar asked Frank to use 31.75, the high stock price of the day, which occurred at 9:30:34 a.m. Not only did he use the high, rather than the current, stock price, but he added another point to the high bond price, then added a 3-1/4 markup. Thus, Respondents charged customers 112 (before markups) for bonds that Respondents bought from CIBC at 108-5/8 (subsequently attributed to Avalon), even though the stock price had declined throughout the day. Avalon made a net profit (after markups/markdowns) of \$250, and Respondents each earned \$1,155.63 in commissions from these transactions. (CX-74 at 16, CX-167.)

On January 8, 2002, the same sequence occurred. After Gonchar purchased 100 PDLI bonds at 104-3/4 versus a stock price of 28-5/8 for an unnamed buyer, he and Frank discussed crossing the bonds at 11:27 a.m. Though the stock was trading at approximately 29-1/4 at that time, they discussed using 30.45 to calculate the bond price. Frank gave Gonchar a price of 107-1/2, 108-1/2 versus 30.5.²⁵ (CX-56-24, 57-24; CX-168-B.)

At 2:28 pm, PDLI was trading a point lower, at approximately 28-1/4, when Gonchar again phoned Frank. They debated whether to complete the cross trade or to wait and see if the

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- Gonchar:** At some point we are probably going to cross.
- Frank:** You know, you can do it now. You can wait. It's up to you. It doesn't matter to me. We have all –
- Gonchar:** How about in the meantime versus 30.45 which is where we were. What does it work?
- Frank:** Okay . . . 30 spot 5 would equal like 107-1/2, 108-1/2.
- Gonchar:** . . . Thank you very much, I'll talk to you in a little while.

stock price “popped.” Gonchar decided to execute the cross trade at 109-1/2 “for now.”²⁶

In the next hour, PDLI moved up slightly, to 28-1/2, but never reached 30-1/2. At 3:47 p.m., Polyviou called Frank to provide account numbers and prices for the PDLI transactions. He told her that Avalon purchased 100 bonds at 104-3/4 (plus a 3 point markup), then sold 100 bonds at 109-1/2 (with a 1-1/4 markdown). Two customers bought 50 bonds each at 109-1/2 (plus a 3 point markup to make it 112-1/2). (CX-56-25, 26; CX-57-25, 26; CX-168-B.)

At Gonchar’s request, Frank had calculated the bond price using 30.5. This was slightly above the high stock price of the day, 30.45, which occurred at 9:32:01 a.m. Once again, Respondents waited until late in the day to execute cross trades. Not only did they use the high

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Gonchar: . . . I wanted to cross these things. I forgot.

Frank: No, you didn’t forget. I mean, you know. I told you to wait until later in the day anyway. It doesn’t look like it –

Gonchar: Okay. I can do them later. I don’t have a problem either. I just want to make sure that –

Frank: Whenever. It doesn’t matter. It doesn’t matter to me. . . . I’ll just keep watching it for awhile. That’s what I’m going to judge on.

Gonchar: Okay.

Frank: Yeah, and see if we get any – I doubt it but. You never know we may get this little pop here. You know?

Gonchar: Whatever you tell me is fine.

Frank: Alright. Whenever, whenever you want. I mean, you know. I don’t care. It’s up to you. I’m throwing it back in your lap.

Gonchar: No. No. I mean I can do it here, that’s okay.

Frank: That’s fine. Whatever you want to do. Okay, what do you want to do? I just want you to be happy (laughing) . . .

Gonchar: . . . I was going to use [10]9-1/2; if that’s okay?

Frank: Okay. Yeah, that’s fine. . . .

Gonchar: Let’s use that for now and –

Frank: You never know in life.

Gonchar: Let’s pray.

stock price of the day, they added one point to the bond price Frank provided, then added a 3 point markup. Thus, Respondents bought bonds from CIBC for 104-3/4 versus a stock price of 28-5/8 (a purchase they later attributed to Avalon), then charged customers 109-1/2 (before markups). The stock price was lower (28-1/4) when Gonchar called Frank to discuss crossing the bonds and when Polyviou phoned Frank with information about the trades (28-1/2). Respondents each earned \$1,377.50 from markups/markdowns on these transactions, and Avalon made a net profit of \$500. (CX-74 at 17, CX-168.)

On January 14, 2002, Frank phoned Gonchar at 10:16 a.m. to tell him that the trader had filled his order to purchase PDLI at 104-1/4 versus a stock price of 28-1/4. One minute later, Gonchar phoned Frank to ask about bond levels for a cross trade, telling her he wanted to cross the bonds “temporarily” using a stock price of 29.16. Based on that stock price, Frank told Gonchar the bonds would cost 105.18, 106.18. After Gonchar said he would use 107-1/4 “for now,” Frank replied that she was “not going to write anything down . . . because you want to watch and see where it is anyway.”²⁷ (CX-56-32, 57-32.)

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Gonchar: . . . Where would they come in versus 29.16, which is where I want to cross them temporarily?

Frank: Okay. Hold on. Hold on. Hold on. 29 spot 16?

Gonchar: Yeah, thanks.

Frank: . . . It's 105.18 to 106.18 rounded up or down to the . . .

Gonchar: Then I can use 107-1/4?

Frank: Yeah.

Gonchar: I'm going to do that for now.

Frank: I'm not going to write anything down.

Gonchar: No problem.

Frank: Remind me later.

Gonchar: Absolutely.

Frank: Because you want to watch and see where it is anyway.

Gonchar: No doubt about it.

At 2:36 p.m., Polyviou phoned Frank to ask whether they had executed a cross trade at 107-1/4. Though they both agreed it was “still early,” Polyviou informed Frank that Respondents would cross the bonds at 107-1/4. He then proceeded to attribute the original bond purchase to Avalon at 104-1/4, plus a 2-1/2 point markup. Avalon sold the bonds at 107 in the cross trade with two customers who bought 50 bonds apiece at 107-1/4, plus a 3 point markup.²⁸ (CX-56-33, 57-33.)

Respondents executed the customer trades at 107-1/4 based on a stock price of 29.10. They again used the high stock price of the day, which occurred at 9:39:14 a.m., even though they did not “execute” the trades until Polyviou phoned Frank at 2:36 p.m. At that time, PDLI had dropped to 27. Had Respondents used the current stock price, as they should have, their customers would have paid less than Avalon, whose purchase price was calculated versus a stock price of 28-1/4. By using the high stock price of the day, then adding one point to the bond price, Respondents were once again able to ensure that, even after markups/markdowns, Avalon made a net profit (of \$250). Gonchar and Polyviou each earned \$1,092.50 in commissions from these transactions. (CX-74 at 17, CX-169.)

On the eight trading days in January 2002 for which there are tape-recordings, a similar pattern emerged. Gonchar bought bonds in the morning, without providing a customer account

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Polyviou: Hi. Did we cross those . . .

Frank: If you want to.

Polyviou: At [10]7-1/4.

Frank: Yeah. That’s fine. It was just that I was unfortunately, I guess a little too optimistic here.

Polyviou: Okay. Yeah. It’s still early.

Frank: Okay.

Polyviou: Okay. So we are going to cross the second batch at 107-1/4. Let me give you the first batch [went to Avalon at 104-1/4, plus a 2-1/2 point markup]. . . . The sell side of that is coming out at 107 . . . Same [Avalon] account. . . . Buy side is two 50 pieces . . . [t]hey both go out at [107-1/4 plus a 3 point markup].

number or otherwise identifying the purchaser. He sought the lowest price and often used a limit order. Shortly thereafter, Gonchar spoke of Respondents' intent to cross sell the bonds, "temporarily" or before the end of the day, and gave Frank a stock price to calculate bond prices, without regard to the current market. In fact, he gave Frank the high stock price of the day for her calculations, then asked if he and Polyviou could solicit customers to purchase bonds one point above her quote. Frank executed the cross trades at the higher price each time, but only after Polyviou phoned her at the end of the day to provide information about account numbers, prices and markups. In each instance, Polyviou identified Avalon as the original purchaser and subsequent seller of the bonds to the ultimate customer(s). Each time, the customer paid more for the bonds than did Avalon, even though the stock price had declined. Each time Avalon made a small profit. By artificially inflating prices for the ultimate customers, Respondents ensured that Avalon's costs were always covered. (CX-56, CX-57, CX-166-173.)

When asked about cross trades other than those captured on tape, Gonchar testified that he used the high stock price on some days and the "middle" on other days and "sometimes" asked for a point above the price levels Frank provided. According to Gonchar, Respondents had discretion to add or subtract 2-1/2 to 5 points in a cross trade, and the Desk would not have permitted a transaction to go through if the trader could have provided a better price. (Tr. 2133-35, 2146-48, 2157-60, 2162-66, 2169-70, 2184-86.)

Polyviou, who adopted Gonchar's testimony, denied any knowledge that Gonchar asked Frank to use the high stock price of the day or added a point to the levels Frank provided. He admitted, however, that he gave Frank the price at which he wanted to execute a cross trade on more than one occasion. He claimed that Frank had authority to approve trades outside the levels she provided and that Respondents could price cross trades from 2-1/2 to 5 points above the offer or below the bid. According to Polyviou, CIBC gave Respondents this latitude to add

markups/markdowns, because the firm “recognized there was a problem with the desk . . . specifically with keeping [Respondents] happy.”²⁹ (Tr. 2392-95, 2398-99, 2423-24, 2429-30, 2547-50.)

The Panel finds Respondents’ uncorroborated, self-serving testimony unbelievable. Respondents were retail brokers, not traders, and, as such, they were not qualified to determine or suggest pricing for convertible bonds. In fact, the very reason Respondents were required to phone Frank was to obtain prices, because she had a computer model for pricing bonds and access to the Desk. If Respondents had the pricing discretion they claimed, there would have been no need to use the high stock price of the day to calculate the price for cross trades, as was evidenced by their tape-recorded conversations with Frank. They could simply have added five points to the bond price based on the current market.

The Panel further notes that on all eight days for which there are tapes, Gonchar always added a point to the price charged the ultimate customer. Neither Respondent ever executed a trade within the level, or exercised his so-called discretion to execute a cross trade below the level Frank provided. Moreover, when soliciting customers to purchase bonds, Respondents never disclosed that these were cross trades or that Respondents had sold the same bonds to Avalon at a lower price. (Tr. 463-71, 484-91, 2506-07; CX-24, CX-26, CX-27, CX-28.)

The Panel particularly notes Respondents’ testimony that they were aware of, and complied with, CIBC’s policy limiting markups/markdowns to 3% for convertible bond transactions, 4% (combined) for cross trades. They nevertheless assert that they had discretion to set prices above or below levels that Frank provided. It makes no sense that CIBC would place limits on markups/markdowns but afford Respondents wide discretion in pricing bonds to retail

²⁹ Both Respondents testified that if Frank provided a level of 99, 100 (par) for a particular bond, they could buy bonds at 94 or sell bonds at 105 in a cross trade, before markups/markdowns. (Tr. 2163-64, 2547-49.)

customers, thereby allowing Respondents to assess additional markups/markdowns. (Tr. 73, 384-85, 2064-67, 2551-52.)

Finally, Respondents were evasive and failed to give direct answers to even the most straightforward questions. Their responses were often internally inconsistent, contradictory and convoluted. For all these reasons, the Panel finds that their testimony lacked credibility.

Respondents' expert witness testified that the tape-recorded conversations raise questions about how Gonchar and Polyviou priced convertible bonds. The Hearing Panel finds that the tape-recorded conversations do more than raise questions about Respondents' conduct. They provide compelling and convincing evidence that, with Frank's assistance, Respondents engaged in a course of conduct whereby they manipulated the timing and pricing of cross trades with Avalon to the disadvantage of their customers. (Tr. 2640-41.)

2. Avalon cross trades with itself

On 16 of the 72 days at issue, Avalon traded with itself, buying and selling the same bonds through the 128 account, before eventually cross-selling the bonds to the ultimate customer(s). Though these trades were simply journal entries in Frank's 128 account, Respondents nevertheless charged Avalon markups and markdowns on each transaction. Respondents then charged the ultimate customer a sufficiently high price that all of Avalon's markups/markdowns were covered. (Tr. 1600; CX-109-A, CX-110-A, CX-112-A, CX-113-A, CX-116-A, CX-117-A, CX-125-A, CX-130-A, CX-131-A, CX-132-A, CX-137-A, CX-140-A, CX-141-A, CX-144-A, CX-150-A, CX-157-A.)

The most extreme example of these "self-trades" occurred on January 3, 2001, when Juniper Networks, Inc. (JNPR) stock jumped from 98 to 136, an increase of approximately 39%. On that day, Avalon purchased 50 JNPR bonds at 89 (with 7/8 markup). Avalon then sold the bonds to the 128 account at 92-1/4 (minus 2-3/4 markdown) and re-purchased them at 92-1/4

(plus 2-3/4 markup). Avalon then sold the bonds to the 128 account at 95-1/2 (minus 1/4 markdown) and re-purchased them at 95-1/2 (plus 2-3/4 markup). Once again, Avalon sold the bonds to the 128 account, this time at 98-1/2 (minus 1/8 markdown), then re-purchased them at 98-1/2 (plus 2-7/8 markup). Once more, Avalon sold the bonds to the 128 account at 102-1/2 (minus 1 point markdown), re-purchasing them at 102-1/2 (plus 3 point markup). Finally, after having sold and purchased the same 50 bonds five times that day and having paid markdowns/markups for each transaction, Avalon sold the bonds in a cross trade to Polyviou's client, the SF Limited Partnership, which paid 106-1/4 per bond (109-1/4 after markups). Polyviou did not tell the customer about the trades Avalon made with itself, or that he was buying the bonds in a cross trade with another customer. (Tr. 467-68, 1600-05, 2506; CX-116-A, 116-B.)

For all these trades, Avalon paid \$8,312.50 in commissions (Respondents each received \$1,579.39) and made a net profit of \$750. Neither Respondent was able to explain why Avalon traded with itself, buying and selling the same bonds at the same price throughout the day, while paying hefty markdowns/markups for each transaction. Gonchar claimed that he "just took orders." He denied he had discretion to trade Avalon's account, claiming that he spoke to Coscio before each and every Avalon transaction and even negotiated the commission with him. Both Respondents speculated that Avalon's trading may have been part of a hedge strategy. Though Respondents' expert testified that Avalon's cross trades with itself might have been a trading strategy if there were offsetting trades in JNPR stock, he conceded that "no professional account would pay three points on its own cross." (Tr. 1606-07, 2178-80, 2238-43, 2499, 2501, 2627-33; CX-74 at 5, CX-116-A.)

Yet Avalon paid three points or more on all of its own crosses on January 3, 2001, and paid similar markups on its own cross trades on 15 other days. The Hearing Panel thus rejects

Gonchar's testimony that he merely took orders from Avalon. It defies logic that a seasoned securities professional like Coscio would maintain the same position, by trading with himself at the exact same price, and pay markups and markdowns for each transaction.³⁰

Furthermore, the stock price did not increase steadily throughout the day on January 3; rather, it jumped from 105 to 134 between 1:15 p.m. and 1:45 p.m. Because the price of the bonds increased 3 to 4 points every time Avalon bought them, the purchases would have had to occur during the period when the stock price rose dramatically. Though the lack of accurate order entry and execution times for cross trades in the 128 account makes it difficult to determine exactly when cross trades were executed, the Panel finds it extremely difficult to believe that Avalon timed its trades so perfectly that all of its own crosses occurred within the crucial half-hour.³¹

For these reasons, the Panel rejects Respondents' contention that they merely executed cross trades at Avalon's behest as simply not credible. Based on the pattern evidenced in the

³⁰ The Panel questions Respondents' assertion that Coscio day traded convertible bonds. Day trading convertible bonds is an unusual and risky strategy. It is difficult to earn a profit due to the nature of the instrument, lack of liquidity, and relatively high markups/markdowns. Furthermore, unlike Respondents, Coscio had no apparent experience with, or expertise in, convertible bonds. Finally, the Panel notes Polyviou's testimony that even though Avalon remained a client after Respondents left CIBC, Coscio did not place a single convertible bond trade. (Tr. 235-36, 422-25, 614, 618, 1962-65, 2526-27.)

³¹ Records from the 128 account are inaccurate, because Frank did not enter trades to the CBS system until the end of the day. Furthermore, no retail order tickets were introduced at the hearing, because CIBC located no order tickets for Respondents' convertible bond transactions involving Avalon. The Panel notes that any documents prepared prior to September 11, 2001, were maintained in CIBC's offices in the World Financial Center and were destroyed by the attacks on that day. However, the firm found no order tickets for Respondents' convertible bond transactions with Avalon after September 11. The Panel does not credit Respondents' testimony that they prepared time-stamped order tickets that would prove their innocence. Gonchar's testimony about completing order tickets for cross trades was, like much of his testimony, convoluted, evasive and not credible. Polyviou's claim that he possessed copies of exculpatory order tickets, yet failed to produce them when he knew CIBC was investigating Respondents' interpositioning, was also not believable. The handful of order tickets Respondents offered in evidence were completed after they relocated temporarily to the firm's Boca Raton office in September 2001, and do not involve Avalon, giving support to the Panel's conclusion that Respondents did not prepare order tickets for any transactions involving Avalon. The Panel rejects Respondents' unsupported claim that CIBC destroyed relevant order tickets and their contention that the firm attempted to "steamroll" them. (Tr. 333-37, 1519-20, 1821-22, 2201-07, 2579-81; RX-E; Respondents' Brief at 25.)

tape-recordings - that Respondents waited until the end of the day to execute cross trades in order to obtain the highest price for the bonds - the Panel infers that Respondents also waited until late in the day on January 3, 2001 to execute cross trades. Had Respondents simply conducted a single cross trade between Avalon and the customer, however, Avalon would have captured the huge gain. By cross trading with itself, Avalon instead paid more than \$8,000 in commissions to CIBC (38% of which went to Respondents), earning a net profit of \$750.

The circumstantial evidence supports the Panel's conclusion that Respondents manufactured Avalon's cross trades with itself, in order to collect additional commissions and reap the benefit of the dramatic intra-day price increase. The Panel concludes that on January 3, 2001, and on 15 additional days when Avalon traded with itself prior to cross selling bonds to the ultimate customer, Respondents executed exactly the same scheme. In so doing, Respondents collected additional commissions, while also ensuring that Avalon's costs were covered.

F. Discussion

The Hearing Panel considered whether Respondents violated: (i) Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder and NASD Conduct Rules 2120 and 2110, by interpositioning Avalon between CIBC and the ultimate retail customers in 142 transactions, when they knew, should have known, or were reckless in not knowing that it would result in higher prices for the ultimate customers; (ii) Section 10(b) of the Exchange Act and Rule 10b-5, as well as NASD Conduct Rules 2120, 2440 and 2110, by knowingly or recklessly charging customers unfair, excessive and fraudulent markups; and (iii) Section 10(b) of the Exchange Act and Rule 10b-5, as well as NASD Conduct

Rules 2120 and 2110, by failing to disclose unfair, excessive and fraudulent markups to customers.³²

1. Fraudulent interpositioning

Interpositioning occurs when a member or person associated with a member interjects a third party between a customer and the member in a securities transaction.³³ A member's obligation to provide best execution is generally not fulfilled when he channels transactions through another party, unless he can show that by so doing, he reduced the costs of the transaction to the customer.³⁴

To constitute fraudulent interpositioning under Section 10(b) and Rule 10b-5, and therefore, under NASD Conduct Rule 2120, a member must act with scienter.³⁵ Thus, to establish liability, Enforcement must demonstrate by a preponderance of evidence that Respondents knew, should have known, or were reckless in not knowing that by channeling

³² Section 10(b) of the Exchange Act makes it unlawful in connection with the purchase or sale of any security, for any person, directly or indirectly to use or employ "any manipulative or deceptive device or contrivance in contravention of such rules or regulations as the Commission may prescribe . . ." SEC Rule 10b-5, promulgated thereunder, renders it unlawful for any person: (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of circumstances under which they were made not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

NASD Conduct Rule 2120 prohibits the use of any manipulative, deceptive or other fraudulent device or contrivance to effect a transaction in, or induce the purchase or sale of, any security. Rule 2120 is the equivalent of SEC Rule 10b-5. *Market Regulation Comm. v. Shaughnessy*, No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (NBCC June 5, 1997).

³³ See NASD Conduct Rule 2320.

³⁴ *Id.*

³⁵ Scienter is "a mental state embracing intent to deceive, manipulate or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Reckless conduct can satisfy the scienter element under Rule 10b-5. *SEC v. Burns*, 816 F.2d 471 (9th Cir. 1987); *Dep't of Enforcement v. Levitov*, No. CAF970011, 2000 NASD Discip. LEXIS 12, at *11 (NAC June 28, 2000). Scienter may be shown by circumstantial evidence. *U.S. v. Mylett*, 97 F.3d 663 (2nd Cir. 1996).

transactions through Avalon, they deprived their customers of best execution.³⁶ The Hearing Panel finds that Enforcement has sustained its burden of proof.

On 72 days, rather than sell bonds directly to their customers, Respondents sold bonds to Avalon, then bought back the bonds, before cross selling them to the ultimate customers in 142 transactions. In every transaction, the customer paid more for the bonds than did Avalon. Respondents offered no evidence that cross trades with Avalon resulted in reduced costs to the ultimate customers.³⁷ To the contrary, the evidence establishes that interpositioning Avalon operated to the customers' detriment.³⁸

Interpositioning Avalon to effect cross trades would not necessarily have deprived the ultimate customers of best execution; in some situations, *e.g.*, where a trade is executed between the bid-ask, a cross trade may be advantageous to both parties. However, Respondents did not execute cross trades at or near the prevailing market. Instead, they asked Frank to calculate the customers' cost based on the high stock price of the day, which necessarily resulted in the highest possible price for the bonds. Respondents then added another point to arrive at the customers' cost, before markups.

Respondents would have been unable to manipulate pricing had they sold bonds directly to customers from the firm's proprietary account, because the trader would have filled the orders at the prevailing market. By interjecting Avalon, Respondents were able to bypass the trader by

³⁶ See *Dist. Bus. Conduct Comm. v. Johansen*, No. C8A940073, 1996 NASD Discip. LEXIS 16, at *37 (NBCC Jan. 5, 1996) (citations omitted).

³⁷ Respondents' own expert witness testified that there was no evidence presented that executing cross trades with Avalon resulted in better pricing for the ultimate customers. (Tr. 2642-43.)

³⁸ In finding that Respondents fraudulently interpositioned Avalon, because they knew, should have known, or were reckless in not knowing that their actions deprived their customers of best execution, the Hearing Panel necessarily finds that Respondents did not provide their customers with best execution, in violation of NASD Conduct Rules 2320 and 2110, as charged in the second cause of the Complaint, which was included as an alternative theory of liability.

executing cross trades through Frank and the 128 account, set prices that were higher than the prevailing market, and collect additional commissions.³⁹

To carry out their plan, Respondents needed Frank's assistance. Based on her deferential tone and attitude during phone conversations with Respondents, her testimony that she did not know if she ever refused to execute a cross trade using the price suggested by Gonchar or Polyviou, and the fact that Respondents never interpositioned Avalon on days when Frank was not at work, the Panel concludes that Respondents received Frank's cooperation in every cross trade, not only on transactions that were captured on tape.⁴⁰

The tape-recorded conversations and the pattern of trading, particularly on 16 days when Avalon cross traded with itself, lead the Panel to conclude that Respondents engaged in a course of conduct in which they intentionally doubled their commissions in 142 transactions on 72 days by channeling bond transactions through Avalon. Respondents then inflated prices for the ultimate customers to ensure that Avalon was reimbursed for the markups/markdowns that Respondents charged.

The Panel rejects Respondents' claim that the Desk and/or Frank approved these cross trades. Not only is their contention unsupported by any evidence save their own testimony, but

³⁹ By first selling bonds to Avalon, before cross selling the same bonds to the ultimate customer(s), Respondents earned two separate commissions. CIBC permitted a 3% markup per transaction, a 4% combined markup/markdown for cross trades. During the relevant period, Respondents' payout rate varied, ranging from 38% to 45%, though for a few trades, their payout was 25%. (CX-74.)

⁴⁰ Tr. 1302, 1334, 2135, 2492-93; CX-56, CX-60. Frank's deference to Respondents stands in stark contrast to the way she treated another broker who phoned on January 16, 2002, a conversation that was captured on tape. Frank refused to execute his buy order for 50 PDLI bonds at 98, telling him "[t]his is not a negotiation. [The trader's] bond prices are hooked into his stock prices." When the broker requested that Frank ask the trader about buying 50 bonds at 98, she responded, "He will tell you when the stock versus the stock price of . . . 25-1/4." Approximately 15 minutes later, Frank called the broker to tell him that his order to buy 50 PDLI bonds was executed at 98 because the stock was at 25-1/4. She immediately asked, "Do you have the account numbers? I've got to have them." He replied, "You don't let me breathe. I need to breathe sometimes." (CX-56-48, 49; CX-57-48, 49.)

Respondents were obligated to obtain the best prices possible for their customers.⁴¹ Instead, Gonchar and Polyviou chose to enrich themselves at their customers' expense.

The evidence establishes, and the Hearing Panel finds, that Respondents acted with scienter. By interpositioning Avalon in cross trades and charging customers prices based on the highest stock price of the day, rather than the prevailing market, Respondents knew, should have known, or were reckless in not knowing that they deprived their customers of best execution.⁴²

Futhermore, Respondents did not disclose to customers that they were buying bonds in a cross trade with another customer, who acquired the same bonds at a lower price earlier that day. Nor did they inform customers of the true market price when soliciting them to buy bonds in these cross trades. Respondents' failure to make such disclosures constitutes an intentional omission of material fact, and provides further evidence that Respondents acted with scienter.⁴³

Based on the credible evidence, the Hearing Panel concludes that from August 2000 through January 2002, Respondents fraudulently interpositioned Avalon between the firm and 71 customers in 142 transactions, in violation of Section 10(b) of the Exchange Act and Rule 10b-5

⁴¹ See, e.g., *Marc N. Geman*, Exchange Act Release No. 43,963, 2001 SEC LEXIS 282, at *50 (Feb. 14, 2001), *aff'd* 334 F.3d 1183 (10th Cir. 2003) (basis for duty of best execution is mutual understanding that clients engage in trades and retain services of a broker as an agent to maximize their economic benefit, and broker receives compensation because he assists clients to achieve that goal).

⁴² Even if Respondents did not use the high price of the day in every transaction, Gonchar's testimony that he sometimes used the high or the "middle" price implies that he used a price that exceeded the current stock price and supports the Panel's conclusion that Respondents knew, should have known, or were reckless in not knowing that by interpositioning Avalon and executing cross trades away from the prevailing market, they deprived their customers of best execution.

⁴³ *Dist. Bus. Conduct Comm. v. Johansen*, No C8A940073, 1997 NASD Discip. LEXIS 54, at *23 (NBCC Sept. 18, 1997). Cf. *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1467-68 (2nd Cir. 1996), *cert. denied* 522 U.S. 812 (1997) (failing to disclose that the "market" was an internal system controlled by the broker is material omission) (citations omitted).

thereunder, as well as NASD Conduct Rules 2120 and 2110, as charged in the first cause of the Complaint.⁴⁴

2. Excessive, undisclosed and fraudulent markups

A member firm is obligated to deal with its customers honestly and must “buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that [the firm] is entitled to a profit.”⁴⁵ Markups of more than 5% above the prevailing market price are generally considered excessive and violative of NASD Conduct Rules 2440 and 2110, though a markup of 5% or less may be unfair or unreasonable in certain situations.⁴⁶ Five percent is thus a guideline, not a rule.⁴⁷ In order to comply with NASD guidelines, CIBC generally prohibited markups in excess of 3% for convertible bonds.

The key issue in determining whether a markup is excessive is establishing the prevailing market price, the price at which dealers trade with one another.⁴⁸ When a dealer is not a market maker in a security, it must base its markups on the price it pays in contemporaneous transactions to purchase the security, unless there is countervailing evidence of the prevailing

⁴⁴ A violation of an SEC or NASD rule also constitutes a violation of Rule 2110’s ethical obligation to observe high standards of commercial honor and just and equitable principles of trade. *See Steven J. Gluckman*, Exchange Act Release No. 41,628, 1999 SEC LEXIS 1395, *22 (July 20, 1999) (citations omitted).

⁴⁵ NASD Conduct Rule 2440.

⁴⁶ IM-2440.

⁴⁷ *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996) (no single definition of what constitutes an excessive markup).

⁴⁸ *Alstead, Dempsey & Co., Inc.*, Exchange Act Release No. 20,825, 1984 SEC LEXIS 1847, at *3 (Apr. 5, 1984).

market price.⁴⁹ In other words, a dealer’s “contemporaneous cost” is the best evidence of the current market.⁵⁰

CIBC was not a market maker in the five bonds at issue. The firm did not furnish quotations or effect transactions at quoted prices with other broker-dealers. Rather, CIBC’s traders sold the bonds out of inventory to the firm’s customers and “made a market” only to the extent the traders provided prices to the firm’s sales force.⁵¹ Absent countervailing evidence of the prevailing market price, CIBC’s contemporaneous cost would be the best evidence of the current market.

In the Panel’s view, CIBC’s contemporaneous cost is not the relevant issue. Rather, Respondents’ contemporaneous cost when purchasing bonds is the critical question, because Respondents used the firm’s 128 account as a *de facto* trading account. Respondents bought bonds for an unnamed customer and maintained them in inventory in the 128 account until they could find a customer to purchase the bonds at a price Respondents determined would be profitable. Respondents then used Avalon’s account to orchestrate a cross trade in the 128 account at the artificially inflated price.

Given these facts and the absence of countervailing evidence of the prevailing market price, the Panel finds that Respondents’ contemporaneous cost to acquire bonds (a purchase they

⁴⁹ *D.E. Wine Investments*, Exchange Act Release No. 43, 929, 2001 SEC LEXIS 222, at *11 (Feb. 6, 2001) (citation omitted).

⁵⁰ *Dist. Bus. Conduct Comm. v. Escalator Securities, Inc.*, No. C07950049, 1997 NASD Discip. LEXIS 78 (NBCC Dec. 31, 1997); *Alstead*, 1984 SEC LEXIS 1847, at *3 (citations omitted).

⁵¹ Tr. 174, 1954, 1960-61.

attributed to Avalon a few hours later) constitutes the prevailing market price for each sale to Respondents' customers.⁵²

Applying these principles, the Hearing Panel finds that Enforcement correctly calculated the prevailing market price for the bond transactions at issue in reaching its determination that Respondents charged markups ranging from 3.5% to 23.97%.⁵³ Respondents charged markups greater than 3% on every sale to the ultimate customer, and greater than 5% on 108 of 142 cross trades.⁵⁴

The Panel finds that markups above 3% are excessive in this case. In reaching this conclusion, the Panel considered CIBC's policy that limited markups to 3%, as well as the following factors: the type of security involved, the availability of the security; the price of the security; the amount of money involved in the transactions; disclosure to the customer; and the pattern of markups.⁵⁵

The Panel notes that markups for debt securities are customarily lower than for equities,⁵⁶ the bonds were readily available, and the amount invested was significant (ranging from \$25,750 to \$212,250). Moreover, Respondents concealed the actual markups by interpositioning Avalon. Finally, Respondents exceeded CIBC's 3% limit in every transaction at issue.

⁵² Cf. *Dep't of Enforcement v. SFI Investments, Inc.*, No. C10970176 (OHO Mar. 28, 2000) available at http://www.nasd.com/web/groups/enforcement/documents/oho_disciplinary_decisions/nasdw_006679.pdf (prevailing market price determined by price paid by *de facto* firm trading account to acquire bonds).

⁵³ See CX-73 (prevailing market price is gross cost of bonds for Avalon's original purchase).

⁵⁴ *Id.*

⁵⁵ IM-2440(b).

⁵⁶ See *Mark David Anderson*, Exchange Act Release No. 48,352, 2003 SEC LEXIS 1935, at *24 (Aug. 15, 2003) (citations omitted); *Investment Planning, Inc.*, Exchange Act Release No. 32,687, 1993 SEC LEXIS 1897, at *3 (July 28, 1993) (it has long been recognized that debt securities markups are normally lower than those for equities). The Panel also notes Frank's testimony that CIBC's retail brokers commonly charged a 1 point markup on bond transactions. (Tr. 773-74.)

Based on all the relevant circumstances, the Hearing Panel concludes that in 142 riskless principal cross trades, CIBC, acting through Gonchar and Polyviou, charged a total of \$293,282.50 of markups in excess of 3%, which were excessive and unfair.⁵⁷

The Panel further finds that Respondents violated anti-fraud provisions, because they failed to disclose excessive markups and acted with scienter.⁵⁸ Respondents' fraudulent intent is evidenced by intentionally interpositioning Avalon in order to conceal the actual markups.

The Hearing Panel thus finds that, based on the credible evidence, Respondents violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and NASD Conduct Rules 2120, 2440 and 2110, by charging excessive, fraudulent and undisclosed markups, as charged in the third and fourth causes of the Complaint.

III. Sanctions

In determining appropriate sanctions, the Hearing Panel considered NASD's Sanction Guidelines (Guidelines) for specific violations,⁵⁹ as well as the Guidelines' General Principles Applicable to All Sanction Determinations and Principal Considerations in Determining Sanctions.⁶⁰

Respondents devised a scheme to increase their declining commission income by interpositioning Avalon in cross trades with unsuspecting customers. For 18 months,

⁵⁷ See CX-73.

⁵⁸ *D.B. Wine Investments*, 2001 SEC LEXIS at *9 (citations omitted); *Feminella*, 947 F. Supp. at 731 (citations omitted).

⁵⁹ The Panel considered the following Guidelines: Excessive Markups (recommend a fine of \$5,000 to \$100,000, restitution, and a suspension for up to 30 business days; in egregious cases, a suspension for up to two years or a bar is suggested); Failure to Comply With Requirements for Best Execution (recommend a fine of \$20,000 to \$200,000, and a suspension of 10 business days to two years for intentional or reckless misconduct; in egregious cases, a fine in excess of \$200,000 and a bar are suggested); and Misrepresentations or Material Omissions of Fact (recommend a fine of \$10,000 to \$100,000 and a suspension of 10 business days to two years for intentional or reckless misconduct; a bar is suggested for egregious cases). *NASD Sanction Guidelines* (2006 ed.) at 52, 93, 95.

⁶⁰ *Guidelines* at 2, 6.

Respondents defrauded their customers and collected double markups: one from the sale of bonds to Avalon, and another from the cross trade. Avalon cooperated with Respondents' plot, because Gonchar and Polyviou, together with Frank, were able to manipulate prices in the cross trades to ensure that Avalon did not suffer a loss despite paying full markups. Respondents thus earned double commissions, Avalon made a profit, and the customers unknowingly paid for it all. All told, Respondents earned more than \$200,000 in commissions from their fraudulent activity, while Avalon made approximately \$30,000.⁶¹

The Panel finds that Respondents' misconduct was highly egregious. Respondents engaged in an intentional pattern of wrongdoing, motivated by pecuniary gain, which resulted in widespread customer harm. Furthermore, Respondents made no effort to remedy their misconduct, which only ceased when CIBC launched an internal investigation into their cross trades. To date, Respondents have utterly failed to acknowledge, or accept responsibility for, their egregious behavior.⁶²

Moreover, both Gonchar and Polyviou are equally culpable. They were partners who shared a representative number and an office. They both solicited customers to purchase in cross trades and shared equally in the ill-gotten gains. Though Gonchar may have made the initial purchase, it was Polyviou who belatedly phoned in the account number attributing the trade to Avalon; he also provided relevant information regarding the pricing of the Avalon-related transactions. Polyviou also participated in a February 4, 2002 conversation with Gonchar and Frank in which all three attempted to coordinate their explanations prior to meeting with

⁶¹ CX-72, 74.

⁶² Respondents contend that CIBC launched its investigation due to a vendetta against them for attempting to steal a client from the institutional sales force. There is no evidence to support their claim. Moreover, this disciplinary proceeding was initiated by Enforcement after an independent investigation. (Tr. 76-77, 221-23, 225-27, 1517-22.)

Compliance regarding Respondents' interpositioning.⁶³ The Panel does not believe that Polyviou was in the dark about Gonchar's price manipulation or any other aspect of this scheme to defraud their customers and rejects his attempt to distance himself from the misconduct.

Respondents' offenses, including their untruthful testimony at the hearing, demonstrate a blatant disregard of federal securities laws and NASD Rules, as well as a complete lack of integrity. The Panel concludes that any association by Gonchar or Polyviou with a member firm would create an unacceptable risk of future misconduct. Though Respondents' egregious misconduct justifies a separate bar for each violation, the Hearing Panel finds it appropriate to aggregate the misconduct for purposes of imposing sanctions.⁶⁴

Accordingly, Respondents Gonchar and Polyviou are each barred from association with any member firm in any capacity for fraudulent interpositioning and for charging excessive, fraudulent and undisclosed markups, as charged in the Complaint.

Enforcement recommends that, in addition to imposing a bar, the Hearing Panel order each Respondent to disgorge \$114,024 in commissions earned in their illegal scheme, plus interest accruing from the date their misconduct ceased. Enforcement also recommends imposition of a \$250,000 fine for each Respondent.⁶⁵

The Guidelines provide that when a bar is imposed, the Panel may exercise its discretion and refrain from imposing a fine.⁶⁶ In our view, a fine is warranted in this case, because fraud is one of the most serious violations a respondent can commit. Moreover, in cases in which a respondent obtained a financial benefit from his misconduct, as occurred here, a fine reflecting

⁶³ RX-D-1, D-2.

⁶⁴ See *Dep't of Enforcement v. J. Alexander Securities, Inc.*, No. CAF010021, 2004 NASD Discip. LEXIS 16, at *69 (NAC Aug. 16, 2004). The Panel finds that Respondents' conduct in fraudulently interpositioning Avalon in cross trades was inextricably intertwined with their charging excessive, fraudulent and undisclosed markups.

⁶⁵ Enforcement does not seek restitution, because CIBC has made the customers whole.

⁶⁶ *Guidelines* at 10 (Technical Matters: Fines).

some or all of his ill-gotten gain may be considered.⁶⁷ The Panel believes that imposing a fine to deprive Respondents of their ill-gotten financial benefit is an appropriate remedial measure that will also serve to deter others from engaging in similar misconduct. Accordingly, in addition to barring Respondents, the Panel also imposes a fine of \$115,000 on each Respondent, reflecting commissions they received as a result of their fraudulent activity.

IV. Conclusion

Respondents Andrew P. Gonchar and Polyvious T. Polyviou are barred from association with any member firm in any capacity for: (i) fraudulently interpositioning a third party between their member firm and 71 retail customers in 142 transactions, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, and (ii) charging excessive, fraudulent and undisclosed markups in 142 transaction, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10-5 promulgated thereunder, and NASD Conduct Rules 2120, 2440 and 2110. In addition, Gonchar and Polyviou are each fined \$115,000, representing ill-gotten commissions.

Finally, Respondents shall pay costs in the amount of \$21,558.54, which includes an administrative fee of \$750 and hearing transcript costs of \$20,808.54.⁶⁸

These sanctions shall become effective on a date set by NASD, but not sooner than 30 days after this Decision becomes the final disciplinary action of NASD, except that if this Decision becomes NASD's final disciplinary action, the bars shall become effective immediately.

SO ORDERED.

Dana R. Pisanelli
Hearing Officer
For the Hearing Panel

⁶⁷ *Guidelines* at 5 (General Principles Applicable to All Sanction Determinations No. 6).

⁶⁸ The Hearing Panel has considered all of the arguments of the parties. They are sustained or rejected to the extent they are in accord or inconsistent with the views expressed in this Decision.

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