NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION, Complainant, v. JOHN PATRICK LEIGHTON (CRD No. 724359), and KENNETH D. PASTERNAK (CRD No. 710849), Respondents.	Disciplinary Proceeding No. CLG050021 Hearing Officer—Andrew H. Perkins EXTENDED HEARING PANEL DECISION April 11, 2007

Majority of Hearing Panel found that the Respondents failed to supervise Knight Securities' Institutional Sales Department reasonably, in violation of NASD Conduct Rules 3010 and 2110. The Respondents are each fined $100,000. In addition, John Patrick Leighton is barred in all supervisory capacities, and Kenneth D. Pasternak is suspended in all supervisory capacities for two years.

Appearances

For the Department of Market Regulation: Robert L. Furst, Jeffrey K. Stith, Michael R. Levy, Tina Salehi Gubb, and James J. Nixon, NASD, Department of Market Regulation, Rockville, MD.

For John Patrick Leighton: Joel E. Davidson, DAVIDSON & GRANNUM, LLP, Orangeburg, NY.

For Kenneth D. Pasternak: Howard Schiffman and James M. Wines, DICKSTEIN SHAPIRO MORIN, LLP, Washington, DC.

DECISION

I. INTRODUCTION

The Department of Market Regulation ("Department") brought this proceeding against John Patrick Leighton ("John Leighton") and Kenneth D. Pasternak ("Pasternak"), alleging that their supervisory failures allowed Joseph Leighton, John Leighton's brother and the head of the Institutional Sales Department at Knight Securities, L.P. ("Knight" or the "Firm"), to defraud his institutional customers through deceptive trading practices between January 1999 and September 2000. The Department alleged that the Respondents thereby violated NASD Conduct Rules 3010 and 2110.

The Complaint alleges that John Leighton did not reasonably supervise his brother and that in turn Pasternak did not reasonably supervise John Leighton to ensure that he fulfilled his supervisory responsibilities as head of the Institutional Sales Department. The Complaint further alleges that Pasternak failed to establish, maintain, and enforce a supervisory system and procedures that were reasonably calculated to ensure compliance with federal securities laws and NASD rules. The Complaint alleges that Knight's supervisory system was inherently defective because Pasternak had approved a joint compensation arrangement between John Leighton and his brother without establishing any procedures to address the resulting conflict of interest and ensure that John Leighton properly supervised his brother's trading.

II. PROCEDURAL HISTORY

The Department filed the Complaint on March 4, 2005. The Respondents filed their Answers on April 15, 2005. Each denied any wrongdoing and requested a hearing.

The hearing was held in New York City starting on May 1, 2006. The Extended Hearing Panel was comprised of the Hearing Officer, a former member of the District 10 Committee, and a former member of the District 2 Committee. Over the course of the 12-day hearing, the

Department presented in-person testimony from ten witnesses and excerpts from the recorded testimony of two additional witnesses. The Department also introduced 347 exhibits.

The Respondents presented in-person testimony from four witnesses, including the Respondents, played video excerpts from the recorded testimony of one witness, and presented excerpts from the recorded testimony of two other witnesses. The Respondents also introduced 1,223 exhibits.[1]

Following the hearing, the Parties filed post-hearing briefs and proposed findings of fact. On October 31, 2006, the Hearing Panel heard closing arguments in Washington, DC.

III. Facts

A. Kenneth D. Pasternak

Pasternak started his career in the securities industry in 1979 with Troster Singer, a subsidiary of Spear Leeds & Kellogg. Over the ensuing 15 years, he received a number of promotions, and, by 1990, he became Troster Singer's trading room manager. At the time, Troster Singer was one of the largest NASDAQ market makers.[2]

Pasternak left Troster Singer in 1994 to start a new firm that would concentrate on what he perceived to be the evolving execution needs of self-directed Internet investors. Accordingly, he and his co-founder formed a joint venture with 25 online brokerage firms. The firm was first

---

[1] The Department's exhibits are cited as "CX-__," the Respondents' exhibits are cited as "RX-__," and the hearing transcript is cited as "Hr'g Tr. __." References to other transcripts that are included among the exhibits are cited to the exhibit number followed by the witness's name, a proceeding identifier, the transcript page number, and the transcript date. For example, a citation to John Leighton's on-the-record interview testimony in this proceeding would be cited as "CX-144, John Leighton NASD Tr. __ (Jan. 23, 2004)."

[2] Hr'g Tr. 2821-22.

known as Knight/Trimark Group, Inc., but it shortly changed its name to Knight Trading Group, Inc. ("KTG").[3]

KTG grew rapidly. By 2001, it had six subsidiaries, earned approximately $1.26 billion in annual revenues, and employed approximately 1,300 people.[4] Knight was one of KTG's subsidiaries. During 1999 and 2000, Knight employed approximately 400 people and processed approximately 500,000 trades per day—as many as 700 trades per second.[5] Knight only did business as a wholesale market maker. It held no customer accounts.[6] By 1999, Knight had become one of the largest NASDAQ market makers.[7]

Pasternak was actively engaged in the Firm's trading operations; he traded stocks in his own account alongside the Firm's other traders. Even after he became KTG's CEO and Chairman when KTG went public in 1998, Pasternak continued to function as the Firm's Trading Room Manager, with responsibility for its trading and market making activity.[8] He also was responsible for supervising the Institutional Sales Department in John Leighton's absence.[9]

In addition to his duties at KTG, between 1999 and 2003, Pasternak devoted substantial time to activities aside from the Firm's management. Among those activities, Pasternak served as a member of the NASD Board of Directors, the NASDAQ Board of Directors, the NASDAQ

---

[3] Hr'g Tr. 2822-24. Knight/Trimark Group, Inc. was founded through the purchase of Trimark Securities, Inc. in 1995. Knight/Trimark Group, Inc. subsequently changed its name to Knight Trading Group, Inc. *See* RX-449 at 025577; RX-450.

[4] Hr'g Tr. 2825-26, 2831-32, 2834.

[5] *See* RX-449; RX-450; Hr'g Tr. 2823; 2825-26.

[6] Hr'g Tr. 361.

[7] Hr'g Tr. 2313-14.

[8] Hr'g Tr. 2591, 2830-34; RX-298, at PA 010827 (Compliance and Supervisory Manual); CX-209, Stellato NASD Tr. 111-12 (June 26, 2002).

[9] RX-298, at PA 010827 (Compliance and Supervisory Manual).

Europe (EASDAQ) Board of Directors, the International Securities Exchange, Inc. Board of Directors, and the Advisory Committee of BRASS Utility, LLC, which operated BRUT ECN.[10]

In January 2002, Pasternak retired from Knight; he has not been associated with a member firm since that time. His last registration with NASD terminated on March 7, 2002.[11]

Pasternak did not have a disciplinary record before the Department instituted this proceeding.

B. John Patrick Leighton

John Leighton began his career in the securities industry in 1987. Thereafter, he worked at a number of NASD member firms before he joined Knight in July 1995.[12] Upon joining Knight, John Leighton assumed responsibility for its worldwide institutional sales activities. He remained the head of the Institutional Sales Department until approximately September 2000.[13] In addition, John Leighton had responsibility for Knight's e-commerce activities. During his entire tenure at Knight, John Leighton reported directly to Pasternak.[14]

John Leighton left Knight in November 2000. Except for a short stint with another NASD member firm in 2002,[15] John Leighton was unemployed between November 2000 and January 2003 when he became President and CEO of Crown Financial Group, Inc.[16] John Leighton left Crown Financial in October 2005 after it filed to withdraw its broker-dealer registration. John

[10] Hr'g Tr. 2834-35; RX-186, at PA 008016 n.2. BRUT ECN was an alternative trading system that operated an electronic communications network for the trading of NASDAQ and exchange-listed securities. The International Securities Exchange is an electronic options exchange founded in May 2000.

[11] CX-2.

[12] CX-1; CX-146, Pasternak NASD Tr. 30-31 (Feb. 9, 2004).

[13] CX-146, Pasternak NASD Tr. 30-31 (Feb. 9, 2004).

[14] Hr'g Tr. 2591, 2601.

[15] John Leighton left that member firm in 2002 because he received an offer to become the President of Knight. That offer was retracted after the media ran stories about possible improper institutional trading at Knight. *See* Hr'g Tr. 2693-97.

[16] Hr'g Tr. 2693-94, 2700-01.

Leighton is no longer associated with an NASD member firm.[17] His last NASD registration terminated in October 2005.[18]

John Leighton did not have a disciplinary record before the Department instituted this proceeding.

C. Knight's Institutional Sales Department

1. Nature of Knight's Institutional Business

In 1999 and 2000, most of Knight's institutional business was performed on a "not-held" basis, which was the predominant manner in which institutional customers chose to execute large orders in NASDAQ securities during 1999 and 2000.[19] The same was true generally for the business Joseph Leighton conducted, and, in fact, each of the 64 trades[20] the Department analyzed in connection with this proceeding were placed as "not-held" or "working" orders. In addition, the trades that Knight executed for its institutional customers were priced on a "net basis," meaning that Knight's compensation was embedded in the net prices it provided its customers.[21] Knight's institutional customers preferred to place their large, difficult-to-execute orders with broker-dealers on a not-held basis to retain greater control over the manner in which their trades interacted with the marketplace and to take advantage of the skill, knowledge, and experience of the sales traders with whom they dealt.

NASD has defined a "not-held" order as "an order voluntarily categorized by the customer as permitting the member to trade at any price without being required to execute the

---

[17] CX-1, at 4.

[18] CX-1, at 2.

[19] *See* RX-1226, Expert Report of Michael D. Wolk at 6.

[20] The Department provided an analysis of 64 trades out of the 23,475 institutional trades Joseph Leighton handled in 1999 and 2000.

[21] *See* NASD Notice to Members 01-85.

customer order."[22] In other words, a "not-held" order gives a broker-dealer discretion as to the time and price of execution of an order for the purchase or sale of securities.[23]

A broker-dealer must use its judgment with not-held orders to provide executions that are fair and reasonable and that best meet the instructions provided by its customers, given the prevailing market conditions.[24] If such judgment is exercised properly, the broker is relieved of his normal best-execution responsibilities with respect to both the time and price of execution.[25] Nonetheless, the broker working a not-held order retains the obligation to provide a fair price[26] and to deal honestly and fairly with his customer.[27] And, consistent with the customer's specific objectives and instructions, the broker must use reasonable diligence to secure a price that is as favorable as possible under the prevailing market conditions.[28]

2. Structure and Supervision

John Leighton started in 1995 as the only trader on Knight's Institutional Sales Desk with not more than approximately ten customers.[29] However, like the Market Making Department, the Institutional Sales Department grew rapidly. As a result, by 1998, the Firm organized the

---

[22] NASD Notice to Members 97-57, 1997 NASD LEXIS 75, at *13 (Sept. 1997).

[23] *See. e.g,* RX-386, William H. Perry SEC Tr. 262-63 (Jan. 17, 2006); RX-400, William C. Schubert SEC Tr. 48 (Feb. 22, 2006).

[24] NASD Notice to Members 97-57; RX-1226, Expert Report of Michael D. Wolk at 7.

[25] *Id*.

[26] NASD Conduct Rule 2440 provides in relevant part:

> In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall 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 he is entitled to a profit ….

[27] Hr'g Tr. 2112-13.

[28] Payment for Order Flow, Exchange Act Release No. 33,026 (Oct. 13, 1993); NASD Conduct Rule 2320. *See also* RX-1226, Expert Report of Michael D. Wolk at 14.

[29] Hr'g Tr. 2660-61.

Institutional Sales Department into teams headed by Team Captains who reported directly to John Leighton.[30] Eventually, there were 5 Team Captains and between 50 and 70 sales traders and assistant sales traders on the Institutional Sales Desk.[31]

Under the Firm's Compliance and Supervisory Manual, John Leighton was responsible for supervising the Institutional Sales Department and its personnel. Among other duties, he was specifically required to perform the following tasks on a daily basis:

1. Review and approve all institutional new account forms and order tickets for suitability, completeness, and accuracy of information.

2. Review the previous day's institutional trading activity and trade allocation reports.

3. Interact with institutional customers and sales personnel as needed to insure timely reporting and handling of institutional account transactions.[32]

John Leighton admitted that he personally did not perform most of the supervisory responsibilities required of him by Knight's Compliance and Supervisory manual. Rather, he claimed that he delegated most of his supervisory responsibilities to the institutional Team Captains in 1998 and thereafter relied on the teams to "act with their own internal supervision."[33] John Leighton stated that he expected the Team Captains to supervise the sales traders and to

---

[30] Hr'g Tr. 2366, 2605-06; RX-154, at PA004119 (Compliance and Supervisory Manual (Feb. 25, 1998)).

[31] CX-5, at 11 (Compliance and Supervisory Manual Apr. 2000)). Under Knight's system, the sales traders did not execute any trades. The traders on the Market Making Desk handled all trading. The sales traders acted as intermediaries between the institutions and the Market Making Desk. *See* CX-209, Stellato NASD Tr. 10 (June 26, 2002).

[32] *See* RX-154, at PA 004399 (Compliance and Supervisory Manual (Feb. 25, 1998)).

[33] Hr'g Tr. 2617-18, 2621.

cross-supervise each other.[34] He described this as a system of self-supervision with the legal and compliance departments providing supervisory oversight.[35]

However, there is no evidence that John Leighton properly and effectively delegated his supervisory responsibilities to the Team Captains. Knight's Compliance and Supervisory Manual did not reflect John Leighton's claim. Although the Compliance and Supervisory Manual denominated the Team Captains as supervisors on the organizational chart for the Institutional Sales Department, there is no evidence the Team Captains were ever assigned any supervisory responsibility or authority.[36] Furthermore, John Leighton testified that he did not document the delegation of his supervisory responsibilities to the Team Captains.[37] Nor could he identify any other documentation implementing delegation of his supervisory responsibilities to the Team Captains.

In addition, the Team Captains did not consider themselves to be supervisors.[38] In their view, and as Joseph Leighton testified at his on-the-record interview, the Team Captains had been selected as some of the more seasoned sales traders to assist and mentor the more junior traders and assistants.[39] They also had been assigned to assist with any capital commitment issues, but not supervision.[40] But the Team Captains had neither any supervisory authority nor any designated compliance responsibilities.

---

[34] CX-145, John Leighton SEC Tr. 25-26, 27-29 (Dec. 17, 2003). (The foregoing transcript references can be found on exhibit pages 13 and 14. The Department submitted a draft version of the SEC deposition transcript, which lacks internal pagination.)

[35] CX-238, John Leighton NASD Arbitration Tr. 3792-93 (Dec. 9, 2003) ("The team captains would, effectively, oversee themselves.").

[36] *See* RX-154, at PA 004119 (Compliance and Supervisory Manual (Feb. 25, 1998)); CX-5, at 11 (Compliance and Supervisory Manual (Apr. 2000)).

[37] Hr'g Tr. 2619.

[38] *See* CX-186, David G. Scialabba NASD Tr. 33-34 (Feb. 3, 2003); CX-187, John Peri NASD Tr. 17 (Jan. 30, 2003).

[39] CX-148, Joseph Leighton NASD Tr. 21 (Dec. 4, 2003).

[40] *Id.*

Knight's Chief Compliance Officer also contradicted John Leighton's claim that the Compliance Department supervised the Institutional Sales Department. Knight's Chief Compliance Officer testified that the Compliance Department had no supervisory responsibilities whatsoever.[41] In fact, no one reviewed the sales credits earned by the institutional sales traders, nor could they because there were no systems that monitored not-held executions.[42] And there was absolutely no review of execution quality on institutional orders. In this regard, Joseph Leighton and the other institutional sales traders were unsupervised.

D. Joseph Leighton

In 1996, John Leighton hired his brother Joseph Leighton as Senior Vice President, Institutional Sales. Joseph Leighton also assumed the position of Assistant Institutional Sales Desk Manager.[43] John Leighton was his brother's immediate supervisor.

Before joining Knight, Joseph Leighton had extensive experience with institutional sales. He was Senior Vice President of Institutional Sales at Dillon, Read & Co. from 1991 to 1996, and he was Vice President of Institutional Sales at Smith Barney, Harris Upham & Co. from 1989 to 1991.[44]

Joseph Leighton left Knight in September 2000 and joined another broker-dealer. In April 2005, Joseph Leighton settled regulatory charges relating to the facts underlying this proceeding and was barred from the securities industry.

Upon joining Knight, Joseph Leighton took over primary responsibility for John Leighton's accounts, which were the majority of Knight's larger and more lucrative institutional accounts. Because John Leighton had developed these customers, he proposed that he and his

---

[41] Hr'g Tr. 2481.

[42] Hr'g Tr. 2466, 2483.

[43] Hr'g Tr. 2661; RX-298, at PA 010823.

[44] CX-159, Joseph Leighton SEC Tr. 6 (Dec. 3, 2003).

brother split their compensation equally.[45] Joseph Leighton agreed, and Pasternak approved the arrangement under which they pooled all of their earnings and then divided the pool between them equally. As a result, a significant portion of John Leighton's compensation was tied to his brother's sales credits on trades John Leighton supervised. Their joint compensation plan remained in effect until April 2000.[46]

As the Institutional Sales Department grew, John Leighton consistently allocated the largest institutional customers to his brother, which enhanced the amount John Leighton earned under their joint compensation scheme. As a result, in 1999 and 2000, Joseph Leighton had the largest and most lucrative of the Firm's institutional accounts, which meant that he earned far more than any of the other sales traders in the Institutional Sales Department.[47] Indeed, Joseph Leighton's trading profits were extraordinary. Knight's records show that his sales credits were more than 300% greater than the Firm's second most profitable institutional sales trader between January 1999 and September 2000.[48] Joseph Leighton generated more than $50 million in sales credits in 1999, and more than $84 million during the first three quarters of 2000.[49] Joseph Leighton's profits also comprised a disproportionate share of the total sales credits generated by the Institutional Sales Department. For the 21 months in question, Joseph Leighton's production exceeded 25% of the entire sales credits for the Institutional Sales Department. And in two months, his gross sales credits exceeded 37% of the total for the Institutional Sales Department.[50] His sales credits also comprised a significant portion of Knight's total trading profits. Routinely,

---

[45] *See* Hr'g Tr. 1683, 1724, 2662-63, 2665-66; CX-37; CX-38; CX-39; CX-148, Joseph Leighton NASD Tr. 25-30 (Dec. 4, 2003).

[46] Hr'g Tr. 1765-66; CX-41.

[47] Hr'g Tr. 216, 2881-82.

[48] CX-25; CX-27 (Institutional Group Performance records).

[49] CX-25; CX-27 (Institutional Group Performance records). *See also* CX-150, Jan. 14, 2004 Joseph Leighton NASD Tr. 294-95.

[50] CX-25; CX-27 (Institutional Group Performance records); CX-323; Hr'g Tr. 674-76. NASD staff testified that Joseph Leighton consistently accounted for approximately 30% of the Institutional Sales Desk's total profits.

he made 8% to 13% of the Firm's total trading profits, reaching a high of more than 25% of the Firm's total in May 2000.[51]

Joseph Leighton's profits also stood out on a cents per share basis.[52] In ten months, January 1999 through September 1999, Joseph Leighton's average sales credits exceeded $.20 per share.[53] And he averaged more than $.40 per share in March and April 2000 on a combined volume of more than 80.3 million shares traded.[54]

Joseph Leighton's extraordinary profits were known throughout the Firm. Pasternak knew the size of Joseph Leighton's profits because Pasternak received and reviewed month-end summary reports that indicated how much gross revenue each institutional sales trader generated, as well as each trader's profit per share.[55] John Leighton knew how much his brother made because he had access to his brother's profit and loss blotter, and he shared in his brother's profits under their joint compensation scheme. Moreover, since the Leightons treated the accounts as joint accounts, John Leighton had direct, ongoing involvement with the trading for these institutions.[56] Indeed, John Leighton testified that he believed that his brother was responsible for about 25% of the total profitability of the Institutional Sales Department.[57] And the other sales traders knew about Joseph Leighton's extraordinary profits because he often bragged about his largest and most profitable trades. Indeed, Joseph Leighton's profits and practices were the subject of a significant amount of discussion and speculation throughout the

---

[51] CX-339.

[52] Other traders sometimes had higher average sales credits on much smaller volume. *See* RX-1215; CX-25; CX-27.

[53] CX-327.

[54] *Id.*

[55] Hr'g Tr. 2646.

[56] CX-193, Davis A. Miller, Jr. NASD Tr. 38-39 (Jan. 6, 2003).

[57] CX-144, John Leighton NASD Tr. 49 (Jan. 23, 2004).

Firm.[58] As one former trader described it, questions about the propriety of Joseph Leighton's profits had become "[water] cooler talk."[59]

Knight's records indicate that between January 1999 and April 2000 Knight paid Joseph Leighton approximately $7.8 million and John Leighton approximately $8.1 million.[60]

E. Joseph Leighton's Pricing of Not-Held orders

Joseph Leighton was able to make the amount he did by disregarding Knight's costs when pricing executions to his customers.[61] Rather than basing the price of the shares on their actual cost, Joseph Leighton priced the stock he acquired pursuant to a customer's order at or near the volume-weighted-average price he selected without regard to whether he could give the customer a better price.[62] As a result, the price reported to the customer often bore little relation to the actual cost of the shares he acquired to fill the customer's order. In short, Joseph Leighton gave no consideration at all to whether he had obtained the best price for the customer.

Joseph Leighton did not inform his customers that he priced their orders in this manner, nor did he disclose Knight's actual costs.[63] He also did not discuss his pricing practices with any of Knight's senior management team. Nonetheless, Joseph Leighton defended his actions by claiming that he consistently met his customers' expectations. In his view, his obligation was to make sure that he gave his customers at the end of the day a price that would not look foolish

---

[58] Hr'g Tr. 1784, 1790, 1792; CX-209 Stellato NASD Tr. 19, 32 (June 26, 2002).

[59] Hr'g Tr. 1790; CX-205, Ackerman NASD Tr. 128, 137 (Feb. 19, 2003).

[60] CX-37; CX-38; CX-39. Joseph Leighton claimed to have made more. Joseph Leighton told Knight's new President that he and his brother split $20 million in 1998. *See* Hr'g Tr. 197, 421.

[61] CX-148, Joseph Leighton NASD Tr. 97 (Dec. 4, 2003); CX-149, Joseph Leighton NASD Tr. 91, 198 (Jan. 13, 2004).

[62] CX-149, Joseph Leighton NASD Tr. 140 (Jan. 13, 2004).

[63] CX-149, Joseph Leighton NASD Tr. 107 (Jan. 13, 2004); CX-148, Joseph Leighton NASD Tr. 167-68 (Dec. 4, 2003).

when compared to the prices the stock had traded during the day away from Knight.[64] Joseph Leighton never explained to his customers that the strategy he employed meant that they regularly paid many times more than was necessary.

In his defense, Joseph Leighton claimed that his customers understood that he worked their orders to a volume-average price formula although there is no evidence supporting his contention.[65] Joseph Leighton testified at his on-the-record interviews that he guaranteed his customers that if they gave Knight their business he would get them the liquidity they desired with price protection benchmarked to an average price.[66] Joseph Leighton further testified that he made these guarantees to entice customers to do business with Knight unrelated to specific orders.[67] Joseph Leighton argued that this guarantee was in essence the only "product" he had to offer large institutional customers, and that it is the central reason they did business with Knight.

Joseph Leighton's customers uniformly disavowed any such understanding. Indeed, the customers who testified at the hearing all said that they would not have accepted such a pricing formula if Joseph Leighton had disclosed that he intended to work their orders in this manner. They all believed that their brokers, including Joseph Leighton, were obligated to use their best efforts to obtain the best possible prices when working a not-held order on their behalf. For example, WL, the manager of the trading desk at Davis Select Advisors for more than seven years, testified that he did not give Knight volume-participation orders except in one or two instances where the volatility of the stock required it.[68] To the contrary, WL testified that his

---

[64] CX-149, Joseph Leighton NASD Tr. 206 (Jan. 13, 2004); CX-150, Joseph Leighton NASD Tr. 433 (Jan. 14, 2004).

[65] CX-148, Joseph Leighton NASD Tr. 47-49 (Dec. 4, 2003).

[66] *See* CX-148, Joseph Leighton NASD Tr. 56 (Dec. 4, 2003); CX-149, Joseph Leighton NASD Tr. 57 (Jan. 13, 2004).

[67] CX-149, Joseph Leighton NASD Tr. 57 (Jan. 13, 2004).

[68] Hr'g Tr. 1032, 1038-39.

objective was to obtain best price execution, not an average price.[69] WL viewed working to a volume-weighted-average price as striving for mediocrity, which was not acceptable.[70] WL further testified, based on conversations he had with Joseph Leighton, that the prices he received at Knight were competitive with what he received at other firms—which was the broker-dealers' cost, plus a mark up of between $.03 and $.06 per share.[71] WL considered any higher profit unwarranted given the low risk associated with his orders.[72] WL did not request Knight, or any other broker-dealers with which he did business in 1999 and 2000, to make a capital commitment to fill the not-held orders he placed with the firms.[73]

SG, head of equity trading at Delaware Investments, testified similarly. He stated that his trading objective was to get the best possible price and that he therefore did not employ a volume weighted trading strategy.[74] With regard to price, SG testified that he understood that he would get stock at Knight's cost plus a mark up of not more than $.125 per share, which was in line with the industry norm in 1998 and 1999.[75] SG further stated that Joseph Leighton never disclosed that he priced SG's orders without regard to Knight's costs.[76]

WS, the former head of equity trading at Trust Company of the West, testified that he placed his trust in Joseph Leighton to fill orders at Knight's cost plus a mark up in most cases of between $.05 and $.06 per share, which he considered in line with the industry norm in 1999 and 2000, and in no case above $.12 per share.[77] WS considered a mark up in this range to be

[69] Hr'g Tr. 1030, 1038.

[70] Hr'g Tr. 1038.

[71] Hr'g Tr. 1036-37.

[72] Hr'g Tr. 1035-36.

[73] Hr'g Tr. 1036.

[74] Hr'g Tr. 1414, 1421.

[75] Hr'g Tr. 1419, 1422.

[76] Hr'g Tr. 1422.

[77] Hr'g Tr. 1486, 1488-89, 1491-92.

appropriate because Knight did not assume any appreciable risk with these orders.[78] WS analogized his not-held orders to agency trades for the purpose of assessing the degree of risk involved. Even in cases where he asked Knight to commit capital to fill a portion of an order, WS considered an appropriate mark up to be in the same range.[79] WS did not utilize a volume-weighted-average-price trading strategy, and he did not expect his orders to be priced to a market average price.[80]

RM, senior equity trader at T. Rowe Price, testified that he considered his brokers to function as T. Rowe Price's agents, representing the company's interests in the marketplace.[81] He considered it the broker's obligation to obtain the best possible execution, which included obtaining the most favorable price.[82] And, consistent with his understanding of industry standards, he believed that the brokers, including Joseph Leighton, priced the stock to T. Rowe Price at the brokers' cost, plus a mark up of between $.06 and $.125 per share.[83] RM did not consider a higher mark up warranted because Knight and the other brokers T. Rowe Price employed did not assume risk on these orders.[84] RM never requested a volume-weighted-average price or used a volume-weighted-average-price strategy.[85]

The Respondents did not present any credible testimony to refute their customers' testimony. There is no support in the record for Joseph Leighton's assertion that his institutional

---

[78] Hr'g Tr. 1490.

[79] Hr'g Tr. 1493.

[80] Hr'g Tr. 1494-95.

[81] Hr'g Tr. 1577.

[82] Hr'g Tr. 1577.

[83] Hr'g Tr. 1581, 1584.

[84] Hr'g Tr. 1581.

[85] Hr'g Tr. 1583.

customers knew that he was pricing their orders with reference to the stock’s volume-weighted-average price.

The Panel majority credits the customers’ testimony that Joseph Leighton led them to conclude that he priced their orders in a manner consistent with general industry practice by adding a mark up of $.06 to $.125 per share to Knight’s acquisition cost. Their testimony was forthright and consistent. The institutional traders exhibited no animosity or other bias against the Respondents or Knight. Moreover, they did not stand to benefit from their testimony. In sum, none of the customers had a motive to provide false testimony.[86]

In contrast, the Panel majority found Joseph Leighton’s recorded testimony to be argumentative, evasive, inconsistent, and oblique. Importantly, Joseph Leighton could not identify any evidence to support his pivotal contention that his customers had long-standing understandings that he would execute their trades using volume-weighted-average prices, which were totally unrelated to Knight’s actual costs. Nor did Joseph Leighton or the Respondents otherwise demonstrate that Knight incurred a degree of risk on the orders at issue that justified the pricing scheme Joseph Leighton employed. In short, Joseph Leighton’s testimony lacked credibility on key points; the Panel majority therefore rejected his testimony that conflicted with the customers’ testimony.

In addition, the Panel majority rejected the Respondents’ contention that Joseph Leighton’s profits were justified by the degree of risk Knight assumed on the orders. As Robert Stellato (“Stellato”), who eventually replaced John Leighton as head of the Institutional Sales Department, and a couple of customers observed, the working orders at issue in this case did not involve significant risk.[87] Joseph Leighton only accumulated a position in a stock after he had an

[86] In this regard, the Panel notes that one of the witnesses was retired and had no continuing association with his former employer.

[87] CX-209, Stellato NASD Tr. 101 (June 26, 2002).

order in hand. Moreover, since he priced the stock with reference to the volume-weighted-average price of those shares that traded away from Knight, and since he often waited until late in the day to select those prices, he typically was in a position to assure a profit on each trade. Furthermore, Joseph Leighton knew that his customers were incapable of determining Knight's acquisition costs; thus, as long as he selected prices that were at or near the volume-weighted-average price, he knew that his customers would not question the executions they received. The customers could only gage Joseph Leighton's performance by reference to the volume-weighted-average price of the stock. Thus, contrary to Joseph Leighton's claim, there was little or no risk that customers would cancel an order since they lacked sufficient information to determine if Joseph Leighton actually had gotten the most favorable price possible.[88] Indeed, the Respondents did not point to a single instance where a customer canceled an order and then refused to take the stock Joseph Leighton had acquired on the customer's behalf. As one customer stated, the relationship was not adversarial.[89] If a customer did cancel an order, the customer took the stock Knight had acquired up to that point.

In sum, the Panel majority finds that the prices Joseph Leighton charged on the not-held orders in question were neither in accord with the customers' expectations nor justified under the circumstances.

F. No Supervision of Pricing of Institutional Not-Held orders

The Respondents argued that Joseph Leighton and the Institutional Sales Department in general were properly supervised because all of the orders from the Institutional Sales Desk were routed through the Market Making Desk. Thus, they contended, the sales traders were subject to supervisory oversight by the managers in the Market Making Department, as well as by John Leighton and Pasternak. However, the evidence does not support the Respondents' argument.

---

[88] *See* CX-149, Joseph Leighton NASD Tr. 220, 226 (Jan. 13, 2004).

[89] *See* Hr'g Tr. 1577-78.

No one in the Market Making Department had been designated to supervise the sales traders, and there is no evidence that anyone in the Market Making Department ever did so. Further, the supervisors in the Market Making Department lacked the authority to alter the sales traders' conduct. For example, they did not have the power to hire and fire any of the institutional sales traders. In addition, as a practical matter, the supervisors in the Market Making Department lacked the ability to alter the Leightons' conduct because of their special relationship with Pasternak. The prevailing view was that Pasternak had approved the manner in which the Leightons ran the Institutional Sales Department and that his judgment in this regard was not open to review. In any event, there were no procedures in place for the Market Making Department to supervise the Institutional Sales Department. The two departments were entirely separate when it came to supervision.

In summary, the Panel majority finds that Knight's systems and procedures failed to address the prices charged by the Institutional Sales Department and that Pasternak and John Leighton failed to supervise Joseph Leighton's trading activities. Despite the extraordinary size of Joseph Leighton's sales credits, neither Pasternak nor John Leighton investigated whether Joseph Leighton provided his customers the best quality of execution that they were entitled to under the relevant facts and circumstances. Instead, Pasternak and John Leighton allowed Joseph Leighton to supervise himself. For all intents and purposes, Joseph Leighton ran the Institutional Sales Department as he saw fit. Pasternak, John Leighton, and Joseph Leighton each concluded that as long as the customers did not learn of the extraordinary profits Knight earned on their orders, there was no limit to the amount the Firm could make on an institutional order. Thus, no effort was made to monitor the execution quality the Institutional Sales Department provided its customers.

G. Pasternak and John Leighton Failed to Respond with Appropriate Follow-Up to Red Flags of Potential Irregularities

By 1999, Pasternak had decided to bring in someone to become the President of Knight and someone else to replace John Leighton as head of the Institutional Sales Department. At the time, Knight was expanding globally, and Pasternak believed that Knight needed a management team with the appropriate background to broaden the Firm's business and to deal with the increasing complexity of its operations. In particular, Pasternak was concerned about John Leighton's management style and his inability to communicate effectively with other managers at the Firm.[90] As a result, Pasternak had formed a committee to review John Leighton's performance and evaluate whether he could be channeled to work more cooperatively with business leaders at the Firm.[91] In the end, Pasternak determined that the better course of action was to replace John Leighton.

1. Red Flags Raised by John Hewitt, Knight's New President

In June 1999, Knight hired John Hewitt ("Hewitt") as Knight's new President. Hewitt came from Goldman Sachs where he had held a variety of management positions over the previous 13 years.[92] Pasternak wanted Hewitt to focus on new product development, international operations, and technology.[93] Hewitt did not assume responsibility for the Institutional Sales Department, which remained under John Leighton's and Pasternak's supervision. Hewitt reported directly to Pasternak.

Shortly after joining Knight, Hewitt met with the Leightons to familiarize himself with Knight's institutional business. Hewitt testified that he was "astonished" to learn from those meetings that Joseph Leighton was making in excess of $.25 per share and that the Institutional

[90] CX-222, Stellato Arbitration Tr. 167-68 (Apr. 24, 2003).

[91] CX-146, Pasternak NASD Tr. 86-87 (Feb. 9, 2004).

[92] Hr'g Tr. 192.

[93] Hr'g Tr. 194.

Sales Department overall was making "double digit" returns.[94] When Hewitt questioned John Leighton about how much he and his brother made, John Leighton said their joint income was approximately $20 million per year.[95] Hewitt questioned John Leighton about how they made so much and how they conducted their business. But Hewitt could not get a clear answer. The most he could understand was that Joseph Leighton justified his high profits by the degree of risk he assumed. John Leighton's explanation made no sense to Hewitt given the nature of Knight's institutional business.[96]

Concerned about the extraordinary profits Joseph Leighton was making, as well as John Leighton's inability to provide a satisfactory explanation of Knight's institutional business, Hewitt immediately reported to Pasternak. Hewitt told Pasternak that he found John Leighton's explanation unclear and misleading.[97] Hewitt surmised that the only way the Leightons could make so much was if they were taking advantage of the Firm's customers by "front running" their orders.[98] Hewitt further stated that he could not work with John Leighton under these circumstances.[99]

In the same general period, Hewitt told Pasternak that a trusted business associate had called to warn that Knight had a front running problem in its Institutional Sales Department.[100]

---

[94] Hr'g Tr. 197-99.

[95] Hr'g Tr. 197.

[96] Hr'g Tr. 199-200.

[97] Hr'g Tr. 200-01.

[98] Hr'g Tr. 201. In general, NASD's Front Running Policy, IM-2110-3, prohibits members or persons associated with members from taking a position in a stock to capitalize on advance material, non-public market information concerning imminent transactions of block size expected to influence the market price of the security. However, securities professionals also use the term to describe in broader terms the practice of members or persons associated with a member trading ahead of market orders or limit orders although such activity would not fall under the definition of front running in IM-2110-3. *Cf.* IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Conduct Rule 2111 (Trading Ahead of Customer Market Orders).

[99] Hr'g Tr. 201.

[100] Hr'g Tr. 210-13.

Pasternak dismissed the report without meaningful consideration. Pasternak told Hewitt that the caller did not understand Knight's business and that the Firm did not have such a problem.[101]

Pasternak disregarded Hewitt's concerns about possible misconduct. Pasternak told Hewitt that Knight was able to make such high profits because it employed a "unique trading methodology."[102] Pasternak attributed Hewitt's concern to his lack of understanding of Knight's methodology. Nonetheless, Pasternak agreed that they should begin a search for a new head of institutional sales to spearhead the Firm's international expansion. Hewitt and Pasternak had concluded that John Leighton lacked the qualifications to develop a global institutional business.

Hewitt also took his concerns to the Firm's management committee and the Firm's General Counsel. However, following Pasternak's lead, no one on the committee requested a review of Joseph Leighton's trading. And the Firm's General Counsel stated that he was aware of the "pre-positioning techniques" Joseph Leighton used, which he thought were "perfectly acceptable."[103]

Ultimately, Hewitt concluded that Knight's institutional trading methodology was not unique. The Panel majority agrees with Hewitt's assessment. Knight's institutional trading methodology for not-held orders was not unique, and, therefore, the Leightons could not justify the higher sales credits with that argument. Nonetheless, Pasternak did not follow up on Hewitt's concerns regarding Joseph Leighton's trading and profits.

2. Red Flags Raised by Stellato, Knight's New Head of Institutional Sales

Shortly after joining Knight, Hewitt recruited Stellato to take over Knight's Institutional Sales Department and build a global institutional business.[104] Stellato had more than 30 years of

---

[101] Hr'g Tr. 213.

[102] Hr'g Tr. 201-02.

[103] Hr'g Tr. 207-08.

[104] Hr'g Tr. 222; CX-222, Stellato Arbitration Tr. 142 (Apr. 24, 2003).

experience in the securities industry, which included managing Goldman Sachs' institutional business for approximately 25 years.

Between August and December 1999, Stellato met with a number of representatives from the Firm who voiced their concerns about John Leighton's ineffective management style. They confided that they wanted Stellato to join Knight and reorganize the department. Pasternak voiced the same concerns about John Leighton's management style at a meeting with Stellato in October 1999.[105]

Following this series of meetings, and with Pasternak's approval, Hewitt hired Stellato in December 1999 to head Knight's Institutional Sales Department.[106] However, Stellato could not start until August 2000 because of a non-compete agreement with Goldman Sachs. Nonetheless, Stellato used the intervening time to learn about Knight's operations and personnel.[107] Over the course of those visits and his first two weeks at Knight, a number of the sales traders spoke to Stellato about their general concerns with how the Leightons were running the Institutional Sales Department.[108] In addition, Greg Cavallo, a sales trader, and Phil Rapp, Senior Vice President in Marketing and Sales, brought to Stellato's attention a trade that Joseph Leighton had done for Davis Select Advisors involving shares of Costco Wholesale Corporation stock. They told Stellato that Joseph Leighton had made close to $2 million on the trade and questioned how this was legally possible.[109]

---

[105] CX-222, Stellato Arbitration Tr. 167 (Apr. 24, 2003).

[106] Hr'g Tr. 267, 2842-43.

[107] CX-222, Stellato Arbitration Tr. 223-24 (Apr. 24, 2003).

[108] CX-209, Stellato NASD Tr. 17 (June 26, 2002).

[109] CX-222, Stellato Arbitration Tr. 225-26, 230-31 (Apr. 24, 2003). Knight's records show that the Costco trade on May 24, 2000, involved the sale of 8 million shares of stock at $29.32 per share. The recorded profit on the trade was $2.904 million. CX-55, at 1.

Alarmed by the allegations of possible improper conduct, including Hewitt's comments that he suspected that Joseph Leighton was "front running"[110] customer orders, Stellato looked into Joseph Leighton's sales credits and found the spreads extraordinarily large.[111] Stellato concluded that Joseph Leighton could not make such high profits legally, which Stellato told Pasternak.[112]

Pasternak however dismissed Stellato's concern. At first Pasternak told Stellato that he had incorrect data. But after Pasternak verified the numbers, he told Stellato that he was not concerned because the Leightons inflated Joseph Leighton's sales credits to increase their payout. Pasternak said he was not concerned because Knight was only paying them 10% of the Institutional Sales Department's profit.[113] Pasternak implied that he considered their payout to be low considering the amount Joseph Leighton made for the Firm. Pasternak gave no indication that he would follow up on Stellato's allegations.

Stellato also questioned John Leighton about his brother's profits. But John Leighton also disregarded Stellato's concern. John Leighton indicated that he knew the profit numbers and that he did not see anything wrong with his brother making profits of $.35 to $.50 per share.[114] John Leighton did not consider Knight's profits on not-held orders to be any of the customers' business. John Leighton saw no limit to the amount Knight could make on not-held orders.

On or about August 10, 2000, Cavallo came to Stellato quite upset over two recent trades made by Joseph Leighton.[115] Cavallo told Stellato that he thought that Joseph Leighton's trading

[110] By "front running," John Hewitt meant that the sales traders were taking economic advantage of their knowledge of the size of the not-held orders placed by their institutional customers.

[111] CX-210, Stellato SEC Tr. 42-45, 52 (May 6, 2002); CX-223, Stellato Arbitration Tr. 409-11 (Apr. 25, 2003).

[112] Hr'g Tr. 427-28, 2418. CX-209, Stellato NASD Tr. 58-59 (June 26, 2002); CX-210, Stellato SEC Tr. 60-61 (May 6, 2002). Stellato reported directly to Pasternak. Hr'g Tr. 222-23.

[113] CX-210, Stellato SEC Tr. 62 (May 6, 2002); CX-223, Stellato Arbitration Tr. 411-12 (Apr. 25, 2003).

[114] CX-210, Stellato SEC Tr. 98 (May 6, 2002).

[115] CX-209, Stellato NASD Tr. 19 (June 26, 2002); CX-222, Stellato Arbitration Tr. 34-35 (Apr. 24, 2003).

involved illegal practices. The first was a trade of approximately 500,000 shares of Synopsis, Inc. Cavallo stated that Joseph Leighton had bragged loudly that he had made a large profit on the trade.[116] Cavallo took particular notice of this trade because Joseph Leighton had announced that he had a large order to purchase Synopsis before the market opened and had yelled out to the other sales traders to "find the other side."[117] The second was a trade of Tut Systems, Inc.[118]

Stellato knew and respected Cavallo. Cavallo had been a trader with US Trust for more than 28 years, during which time he had been one of Stellato's customers.[119] Accordingly, Stellato took Cavallo's alarm seriously. Stellato asked Cavallo to get details about the two trades and examples of any other questionable trades.[120] The following day Cavallo supplied the requested information for the Synopsis and Tut Systems trades, as well as for a third trade involving Juniper Networks, Inc.[121]

Stellato obtained documentation relating to these three trades from Knight's trading system and presented it to Knight's Chief Compliance Officer.[122] Stellato went over the trades with Knight's Chief Compliance Officer and explained why he believed the trade records showed that Joseph Leighton had engaged in front running.[123] At first, Knight's Chief Compliance Officer agreed. But after he reviewed the documents further, he concluded that

---

[116] CX-222, Stellato Arbitration Tr. 235 (Apr. 24, 2003). Knight's records show that on August 9, 2000, Joseph Leighton traded 537,500 shares of Synopsis (trade symbol "SNPS") for Fidelity at $29.65 per share. The recorded profit on the trade was $390,010. CX-55, at 1.

[117] CX-222, Stellato Arbitration Tr. 236 (Apr. 24, 2003); CX-209, Stellato NASD Tr. 32 (June 26, 2002).

[118] CX-222, Stellato Arbitration Tr. 167 (Apr. 24, 2003). Knight's records show that on August 10, 2000, Joseph Leighton traded 213,400 shares of Tut Systems (trade symbol "TUTS") for Delaware Trust at $107.81 per share. The recorded profit on the trade was $371,316. CX-55, at 1.

[119] Hr'g Tr. 1789; CX-222, Stellato Arbitration Tr. 238-39 (Apr. 24, 2003).

[120] CX-222, Stellato Arbitration Tr. 237 (Apr. 24, 2003).

[121] CX-222, Stellato Arbitration Tr. 237, 241 (Apr. 24, 2003).

[122] In addition, Stellato told John Hewitt that he had found trade records that confirmed their suspicion that Joseph Leighton was front running customer orders.

[123] CX-209, Stellato NASD Tr. 34-35 (June 26, 2002).

Joseph Leighton's conduct did not fit the technical definition of front running.[124] Knight's Chief Compliance Officer testified that front running "typically contemplates trading with an equity position in front of an option position or trading an option position in front of an equity position."[125] Since none of the three trades fit either pattern, Knight's Chief Compliance Officer concluded that Joseph Leighton had not engaged in front running.[126] Thus, the Chief Compliance Officer saw no need for further inquiry.

Stellato strongly disagreed with Knight's Chief Compliance Officer's conclusion. Stellato tried to demonstrate that the records for each of the three trades showed that Joseph Leighton had established a large proprietary position in the stock while the price of the stock rose throughout the day.[127] Joseph Leighton then gave the customers incremental executions at prices significantly higher than Knight's acquisition costs. Stellato further argued that Joseph Leighton would not have taken such substantial positions without first having the customers' orders.[128] For example, on the Synopsis trade for Fidelity, at one point Knight was long as many as 232,000 shares, which shares had a market value of approximately $6.9 million.[129] Stellato noted that Knight had never been long or short more than approximately 8,000 shares of Synopsis over the prior two months.[130] Therefore, Stellato disagreed with Knight's Chief Compliance Officer's speculation that the trading pattern and profits reflected on the documentation for the three trades could be attributed to the impact of Knight's market-making activities. Stellato told Knight's Chief Compliance Officer that the only plausible explanation for

---

[124] CX-209, Stellato NASD Tr. 35-36 (June 26, 2002).

[125] Hr'g Tr. 2423.

[126] CX-209, Stellato NASD Tr. 21-22 (June 26, 2002).

[127] CX-210, Stellato SEC Tr. 101-03 (May 6, 2002); CX-223, Stellato Arbitration Tr. 421 (Apr. 25, 2003).

[128] CX-209, Stellato NASD Tr. 48 (June 26, 2002); CX-223, Stellato Arbitration Tr. 378 (Apr. 25, 2003).

[129] CX-209, Stellato NASD Tr. 39 (June 26, 2002); CX-55, at 1.

[130] CX-209, Stellato NASD Tr. 43 (June 26, 2002).

Joseph Leighton's trading practices was that he had deliberately held the stock in inventory waiting for the price to rise before executing the orders for the customers.[131]

Additionally, Stellato observed that Joseph Leighton could count on the market moving in his favor because Knight was such a dominant market maker at the time. When Joseph Leighton had a large order, such as he had with the Synopsis trade from Fidelity, Knight's aggressive buying would attract day-traders' attention and push the price of the stock upward.[132] Hence, by delaying the execution of a large order, Joseph Leighton could ride the price up and retain most of the price appreciation as profit.

Knight's Chief Compliance Officer gave the trade records for the three trades to Knight's General Counsel who told Stellato not to be concerned. Knight's General Counsel reasoned that institutional customers are well equipped to take care of themselves and that it was their responsibility, not Knight's, to monitor their trades.[133] Like Knight's Chief Compliance Officer, the General Counsel saw no need for further inquiry.

Stellato, unsatisfied by the response he received from both Knight's Chief Compliance Officer and its General Counsel, then confronted Pasternak. But Pasternak disregarded Stellato's concerns. Pasternak insisted that Joseph Leighton was a terrific trader and refused to consider that he had done anything illegal.[134] Rather, Pasternak viewed Joseph Leighton's profits as a potential "marketing problem" should Knight's institutional customers discover how much Knight was making on their orders.[135] For that reason, Pasternak agreed that Stellato could replace the Leightons.[136] The Leightons resigned on September 7, 2000.

[131] CX-210, Stellato SEC Tr. 101, 134 (May 6, 2002).

[132] CX-210, Stellato SEC Tr. 105-06 (May 6, 2002).

[133] CX-210, Stellato SEC Tr. 109 (May 6, 2002); CX-223, Stellato Arbitration Tr. 422 (Apr. 25, 2003).

[134] CX-146, Pasternak NASD Tr. 240-44 (Feb. 9, 2004).

[135] CX-146, Pasternak NASD Tr. 240-44 (Feb. 9, 2004).

[136] CX-210, Stellato SEC Tr. 125-26, 128, 134-42 (May 6, 2002).

Contrary to the Respondents' assertions, no one investigated Stellato's and Hewitt's allegations that Joseph Leighton had unfairly and improperly priced trades. Even though Stellato had received complaints from many of the Firm's sales traders, Pasternak saw Stellato's and Hewitt's complaints as part of their transparent "agenda" to oust the Leightons.[137] As a result, Pasternak did not take Stellato's allegations seriously. Pasternak's lack of follow-up is disturbing given his acknowledgement that Knight's customers might conclude that the prices were unreasonable if they learned the amount Knight made on their orders. Unquestionably, Pasternak knew that Joseph Leighton's pricing stratagem did not meet the customers' expectations.

The Respondents contended that Pasternak, the Chief Compliance Officer, and the General Counsel appropriately responded to any red flags. Their contention is wholly unsupported by the evidence. First and foremost, no one ever spoke to Joseph Leighton about his trading and profits.[138] Nor did anyone speak to any of the traders in the Market Making Department.[139] Moreover, the General Counsel stated that he never reviewed the profit and loss on institutional trades, and he did not know whether anybody else ever did.[140] The same was true for the three trades Stellato questioned.[141] Second, no one followed up with any of the institutional customers about the three trades Stellato identified to confirm that they were priced in accordance with the customers' directions and understandings.[142] The General Counsel stated that he did not talk to the customers because he concluded that they were sophisticated and they

---

[137] *See* CX-146, Pasternak NASD Tr. 279 (Feb. 9, 2004).

[138] CX-164, Dorsey NASD Tr. 98 (Jan. 26, 2005); CX-160, Dorsey NASD Tr. 207 (Nov. 21, 2005); CX-177, Amoruso NASD Tr. 645 (July 29, 2003).

[139] CX-161, Dorsey NASD Tr. 320-24 (Nov. 22, 2005).

[140] CX-164, Dorsey NASD Tr. 46-47 (Jan. 26, 2005); CX-160, Dorsey NASD Tr. 166 (Nov. 21, 2005).

[141] CX-161, Dorsey NASD Tr. 306-07 (Nov. 22, 2005).

[142] CX-164, Dorsey NASD Tr. 98 (Jan. 26, 2005); CX-161, Dorsey NASD Tr. 291 (Nov. 22, 2005); CX-160, Dorsey NASD Tr. 196-97 (Nov. 21, 2005).

had not complained.[143] In other words, he held the opinion that such customers could look out for themselves, and Knight had no obligation to protect their interests.

IV. Conclusions of Law

Conduct Rule 3010(a) requires each member to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and rules.[144] Under this Rule, members are required to "set forth the applicable rules and policies that must be adhered to and describe specific practices that are prohibited."[145] The supervisory system must be tailored specifically to the member's business and must address the activities of all of its registered representatives and associated persons.[146]

Conduct Rule 3010(b) requires each member to establish, maintain, and enforce written supervisory procedures that are reasonably designed to ensure such compliance.[147] A firm's written supervisory procedures memorialize a firm's supervisory system; they "describe the actual supervisory system established by the firm to achieve compliance with applicable rules and regulations."[148] Hence, the written supervisory procedures should include a description of the controls and procedures the firm uses to deter and detect improper activity.[149]

---

143 CX-160, Dorsey NASD Tr. 124-25 (Nov. 21, 2005).

144 *Castle Sec. Corp.*, Exchange Act Release No. 52,580, 2005 SEC LEXIS 2628, at *7 (Oct. 11, 2005).

145 NASD Notice to Members 99-45, 1999 NASD LEXIS 20, at *3 (June 1999).

146 *Id.* at *4.

147 *See La Jolla Capital Corp.*, Exchange Act Release No. 41755, 1999 SEC LEXIS 1642, at *13 (Aug. 18, 1999); *see also Department of Enforcement v. Lobb*, No. C07960105, 2000 NASD Discip. LEXIS 11, at *16 (Apr. 6, 2000) (citation omitted).

148 NASD Notice to Members 98-96, 1998 NASD LEXIS 121, at *6 (Dec. 1998).

149 *Id.*

A. Pasternak Failed to Reasonably Delegate Supervisory Responsibility and Authority to John Leighton

The Commission has "long maintained that 'final responsibility for supervision of the trading activities of a member firm of NASD rests with the firm's president, unless the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties.'"[150] The SEC has further stated:

> It is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention.… Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised.[151]

Here, the record demonstrates that Pasternak's delegation of supervisory authority for the Institutional Sales Department to John Leighton was unreasonable under the facts and circumstances of this case.[152] Pasternak failed to follow up and review John Leighton's performance to ensure that he was properly exercising his supervisory authority. Once Pasternak appointed John Leighton to manage the Institutional Sales Department, Pasternak failed to oversee his activities. Indeed, Pasternak only had a vague understanding of what John Leighton did to supervise the Institutional Sales Department.[153] Pasternak could not identify any reports or procedures John Leighton used to monitor institutional trading other than one report that listed institutional trades by date and time, nor could he identify any supervisory functions he performed with respect to the Institutional Sales Department.[154] The only specific areas in which

---

[150] *Robert J. Prager*, Exchange Act Release No. 51,974, 2005 SEC LEXIS 1558, at *43 n.45 (July 6, 2005) (citation omitted).

[151] *Rita H. Malm*, Exchange Act Release No. 35,000, 1994 SEC Lexis 3679, at *23 (Nov. 23, 1994), quoting *Stuart K. Patrick*, Exchange Act Release No. 32,314 (May 17, 1993), *aff'd sub nom. Patrick v. SEC*, 19 F.3d 66 (2d Cir. 1994).

[152] *Christopher J. Benz*, 52 S.E.C. 1280, 1284 (1997), *petition for review denied*, 168 F.3d 478 (3d Cir. 1998) (table) (holding that reasonable supervision is determined based on the particular circumstances of each case).

[153] CX-146, Pasternak NASD Tr. 83 (Feb. 9, 2004).

[154] Hr'g Tr. 2908-12; CX-63, at 2; CX-146, Pasternak NASD Tr. 69-70 (Feb. 9, 2004).

Pasternak recalled interacting with John Leighton involved capital commitment and hiring issues.[155]

In summary, the Panel majority finds that the totality of the evidence shows that Pasternak disowned supervision of the Institutional Sales Department once he delegated that responsibility to John Leighton. Pasternak failed to ensure that John Leighton carried out those responsibilities appropriately. In particular, Pasternak did not ensure that John Leighton reasonably supervised his brother's trading despite the fact that Pasternak knew: (1) John Leighton gave his brother the most lucrative institutional accounts; (2) the Leightons pooled their income, creating a conflict of interest for John Leighton to supervise his brother; (3) Joseph Leighton made inordinately high profits in general and on specific large trades; (4) Knight's automated systems did not monitor institutional trades; and (5) Joseph Leighton did not cooperate with Knight's other managers. Under these circumstances, Pasternak should have followed up regularly to verify whether John Leighton was performing reasonable supervision of his brother's trading practices and to ensure that Knight was providing its institutional customers with the best executions possible.

For the foregoing reasons, the Panel majority finds that Pasternak violated NASD Conduct Rules 2110 and 3010.[156]

---

[155] CX-146, Pasternak NASD Tr. 70-71 (Feb. 9, 2004). Pasternak's claimed lack of understanding of John Leighton's supervisory functions is particularly alarming in light of the fact that Pasternak was required to assume those functions when John Leighton was out of the office, which occurred often in 1999 and 2000.

[156] The entire Panel rejects the Department's argument that Knight's procedures were "inherently defective" because the Leightons pooled their income. The fact that the Leightons are brothers, or that they shared in Joseph Leighton's profits, does not mean that John Leighton could not be Joseph Leighton's designated supervisor. Rather, the failure in Knight's supervisory system was that Pasternak failed to carry out his responsibilities as John Leighton's supervisor.

B. John Leighton Failed to Supervise His Brother

John Leighton failed reasonably to supervise his brother with a view to preventing his violation of the federal securities laws and NASD's Conduct Rules. During the relevant period, John Leighton was assigned supervisory responsibility over his brother. Nonetheless, John Leighton made no effort to monitor his brother's trading to determine if he traded at fair prices. Rather, John Leighton claimed that others were responsible for supervising his brother and the other Team Captains. At one point, John Leighton claimed that the Compliance Department was responsible for monitoring execution quality in the Institutional Sales Department. But compliance officers do not become "supervisors" solely because they occupy the position of compliance officers. The standard is whether the compliance officer was given "the requisite degree of responsibility, ability or authority to affect the conduct of" the institutional sales traders.[157] They were not in this case. The Firm's Chief Compliance Officer testified that the Compliance Department never had such authority or responsibility. Moreover, John Leighton knew that there were no systems in place for the Compliance Department to monitor institutional trades.

At another point, John Leighton claimed that he relied upon the supervisors in the Market Making Department to monitor the trading activity in the Institutional Sales Department. However, as discussed above, the market making supervisors were not responsible for the Institutional Sales Desk. There were no procedures in place that called for the market making supervisors to monitor the activity of the Institutional Sales Department, nor were the market making supervisors authorized to supervise the institutional sales traders. For example, they did not have the power to hire and fire any of the institutional sales personnel.

[157] *John H. Gutfreund*, Exchange Act Release No. 31,554, 1992 SEC LEXIS 2939, at *46-47 & n.24 (1992) (settled case charging violation of Section 15(b)(4)(E) of the Exchange Act).

At yet another point, John Leighton claimed that he relied on the Firm's automated compliance system to monitor the trades, but, as he well knew, the Firm did not have such a system in place. There were no automated reports that monitored the execution quality of institutional trades.

Finally, John Leighton claimed that he delegated most of his supervisory responsibilities and authority to the Team Captains in 1998. Even if true, however, the Panel majority finds that the purported delegation was not reasonable. John Leighton did not provide any specific instructions on the nature of those delegated responsibilities or on how the Team Captains were to fulfill those responsibilities. In particular, John Leighton failed to instruct the Team Captains on how to monitor trading for unfair or fraudulent pricing schemes. But in any event, this argument is a red herring when it comes to the question of John Leighton's supervision of his brother. Joseph Leighton was himself one of the Team Captains in the Institutional Sales Department. As such, John Leighton could not have designated his brother as his own supervisor, and there is no evidence or claim that John Leighton designated any of the other Team Captains as his brother's supervisor.

In sum, the evidence shows conclusively that John Leighton permitted his brother to supervise himself,[158] which allowed Joseph Leighton to implement a pricing stratagem that deprived his customers of best execution although he represented that he provided them with such prices. As John Leighton candidly testified, Knight had only one product to sell during the relevant time period—execution quality.[159] Nevertheless, he paid no attention to his department's execution quality.

---

[158] The SEC has held that a registered representative cannot supervise himself. *Harry Glicksman*, Exchange Act Release No. 42,255, 1999 SEC LEXIS 2685, at *25 (Dec. 20, 1999), *aff'd* 24 Fed. Appx. 702 (9th Cir. 2001).

[159] Knight held itself out to the public as providing "best execution services to [its] institutional clients." RX-450, at PA 025637 (KTG Form 10-K, Dec. 31, 2000).

For the foregoing reasons, the Panel majority finds that John Leighton failed to supervise his brother in a reasonable manner and that he thereby violated NASD Conduct Rules 3010 and 2110.

C. Pasternak Failed to Respond to Red Flags of Potential Irregularities

NASD Procedural Rule 3010(a) requires that firms maintain a supervisory system "reasonably designed to achieve compliance with" securities laws and regulations and with NASD rules.[160] Under this system, supervisors have a duty, among other things, "to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation."[161] Consequently, a supervisor's failure to respond to such red flags constitutes a failure to supervise reasonably under NASD rules, as does a supervisor's inadequate and belated response.[162]

The SEC has emphasized repeatedly that "in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention."[163] A contrary rule "would encourage ethical irresponsibility by those who should be primarily responsible."[164] Here it is clear that Pasternak had far more than "a remote

[160] *Castle Sec. Corp*., Exchange Act Release No. 52,580, 2005 SEC LEXIS 2628, at *7 (Oct. 11, 2005).

[161] *Michael T. Studer*, Exchange Act Release No. 50,543A, 2004 SEC LEXIS 2828, at *23 (Nov. 30, 2004) (citation omitted); *accord George J. Kolar*, Exchange Act Release 46,127, 2002 SEC LEXIS 1647, at *11 (June 26, 2002) (stating that "[d]ecisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations."); *Quest Capital Strategies, Inc.*, Exchange Act Release No. 44,935, 2001 SEC LEXIS 2147, at *13-14 (Oct. 15, 2001) (stating that "supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention") (citation omitted); *Consolidated Inv. Servs., Inc.*, Exchange Act Release No. 36,687, 1996 SEC LEXIS 83, at *17 (Jan. 5, 1996) (stating that "any indication of irregularity brought to a supervisor's attention must be treated with the utmost vigilance") (citations omitted).

[162] *See Studer*, 2004 SEC LEXIS 2828, at *26 (citation omitted). *See also James H. Thornton*, Exchange Act Release No. 41,007, 1999 SEC LEXIS 220, at *11 (Feb. 1, 1999).

[163] *See, e.g., Wedbush Sec., Inc.*, Exchange Act Release No. 25,504, 1988 SEC LEXIS 568, at *10 (Mar. 24, 1988).

[164] *R.H. Johnson & Company v. S.E.C.*, 198 F.2d 690, 696-97 (2d Cir. 1952).

indication of irregularity” with respect to Joseph Leighton’s activities. Yet he did not take appropriate action.

Apart from Pasternak’s direct knowledge of Joseph Leighton’s activities and the extraordinarily high profits he generated, Pasternak received notice of several specific “red flags” that he was obligated to investigate. Immediately upon becoming the President of Knight, Hewitt twice went to Pasternak with specific concerns regarding the Leightons. In the first instance, Hewitt told Pasternak that John Leighton’s explanation of his brother’s trading and profits was “misleading” and that the only way Joseph Leighton could be generating such great profits was by front running his customers’ orders.[165] In the second instance, Hewitt told Pasternak that he had received a telephone call from a trusted business associate who had called to warn Hewitt that Knight was engaged in front running in its Institutional Sales Department.[166] Then, not long after Pasternak received both of these reports, Stellato came to him with specific examples of questionable activity and related that a number of traders had raised their concerns about improper trading in the Institutional Sales Department. Stellato told Pasternak that Joseph Leighton was taking unfair advantage of the Firm’s institutional customers.

Pasternak’s response did not fulfill his supervisory responsibilities. Hewitt and Stellato presented Pasternak with allegations and evidence of serious misconduct. They informed Pasternak of Joseph Leighton’s misconduct to obtain his guidance and to involve him in the response to the problem. They could not have relied on Joseph Leighton’s immediate supervisor, John Leighton, because it appeared to them that John Leighton was complicitous in the misconduct. Moreover, Stellato advised Pasternak that he did not consider the response he received from Knight’s Chief Compliance Officer and General Counsel to be adequate under the circumstances. Nonetheless, Pasternak did nothing more than confirm that the Chief Compliance

---

[165] Hr’g Tr. 200-01.

[166] Hr’g Tr. 210-13.

Officer and the General Counsel had reviewed the trades to determine if the records reflected that they were either illegal or improper.[167] Although the concerns Hewitt and Stellato raised about improper profit margins in the Institutional Sales Department also called into question the effectiveness of the entire supervisory system, including the effectiveness of the compliance and legal departments, Pasternak accepted without question or further inquiry the Chief Compliance Officer's and the General Counsel's conclusion that the three trading records did not reflect improper conduct. Instead, Pasternak focused on management issues and concluded that the Leightons could not co-exist with the new management team. Pasternak therefore concluded that the Leightons needed to leave Knight.[168] However, at no point did Pasternak follow up to determine whether John Leighton was properly supervising the Institutional Sales Department.

The Panel majority concludes that Pasternak's response to red flags of possible misconduct was woefully inadequate. The evidence as a whole demonstrates that Pasternak approached the allegations with the preconceived notion that Hewitt and Stellato's allegations were driven by their desire to have Pasternak dismiss the Leightons. Accordingly, Pasternak gave the allegations no credence. Far from responding with "utmost vigilance," Pasternak did nothing more than confer briefly with the Chief Compliance Officer and the General Counsel to satisfy himself that the three trades Stellato questioned did not evidence front running, which was only one aspect of the issues presented. Under these circumstances Pasternak should have directed a thorough investigation into the broader question Hewitt and Stellato raised—whether Joseph Leighton was taking unfair advantage of Knight's institutional customers.

[167] *See* Hr'g Tr. 2866-67.

[168] Hr'g Tr. 2868-69.

V. SANCTIONS

The Panel majority finds in accord with the principal considerations in the NASD Sanction Guidelines that the Respondents' violative conduct was egregious, involving systematic supervision failures, and therefore substantial sanctions are appropriate.

For failure to supervise, the Sanction Guidelines recommend a fine of $5,000 to $50,000, and a suspension of the responsible individual for up to 30 business days.[169] The fine amount may be increased by adding the amount of a respondent's financial benefit.[170] In egregious cases, the Guidelines recommend that the disciplinary hearing panel consider a suspension of up to two years or a bar. In addition, the Guidelines provide three specific factors to consider in cases involving supervisory deficiencies: (1) whether respondent ignored "red flag" warnings; (2) the nature, extent, size, and character of the underlying misconduct; and (3) the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls.[171]

The Panel majority concludes that the Respondents' failure to supervise Joseph Leighton and the Institutional Sales Department was egregious. While the record before the Panel shows that Knight, under Pasternak's leadership, made considerable effort to stay on top of the compliance and supervision requirements of its burgeoning market-making activities, Pasternak all but ignored the Institutional Sales Department even though he knew or should have known that Joseph Leighton was, in the words of Knight's General Counsel, using "pre-positioning techniques" to garner the highest possible sales credits on each trade.[172] Knight relied heavily on its automated compliance systems to monitor and supervise the Firm's market-making activities.

---

[169] NASD SANCTION GUIDELINES 108 (2006), http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf.

[170] *Id. See also* GUIDELINES at 5 (General Principles Applicable To All Sanction Determinations, No. 6), http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf.

[171] GUIDELINES at 108.

[172] *See* Hr'g Tr. 207-08.

But none of those systems addressed the activities of the sales traders in the Institutional Sales Department. Moreover, faced with remarkable growth in the Institutional Sales Department, Pasternak made little or no effort to determine John Leighton's effectiveness in carrying out his delegated supervisory duties. Furthermore, despite the presence of red flags of potential irregularities, Pasternak paid minimal attention to the issue of unfair pricing of not-held orders and failed to implement and enforce an adequate supervisory system. The Respondents allowed Joseph Leighton to operate without meaningful supervision. Neither Respondent ever questioned Joseph Leighton's activities or confirmed he was providing his customers with best execution and a fair price, as required by NASD Conduct Rule 2440.

This supervisory void allowed Joseph Leighton to take advantage of his customers over a 21-month period by filling orders at prices that netted Knight unreasonably high profits. Joseph Leighton was obligated to provide his customers with the best prices possible under the prevailing market conditions, consistent with his customers' instructions. When Joseph Leighton agreed to accept a not-held order, he assumed certain duties. Chief among them were the duty to deal fairly with his customer and to follow faithfully the customer's instructions. These duties were not abrogated by the fact that Knight acted as a "principal" when it sold stock to its customer pursuant to a not-held order. By the very nature of a not-held order, Joseph Leighton understood that the customer relied upon his judgment and expertise to work the order to meet the customer's objectives, one of which was to obtain the stock at the most favorable price consistent with market conditions and the customer's other instructions.

The Respondents argued that Joseph Leighton and Knight assumed no fiduciary duties because not-held orders are not executed as "agency" trades. This argument oversimplifies the issue by ignoring the fact that a broker handling a not-held order is obligated to exercise properly his judgment to obtain an execution satisfactory to the customer.[173] In other words, such an order

[173] NASD Notice to Members 97-57, 1997 NASD LEXIS 75, at *13 (Sept. 1997).

does not grant unchecked discretion to the broker to operate solely in his own interest. "Because the customer has granted discretion to work the order, the [broker], as agent, has a clear responsibility to work to obtain the best fill considering all of the terms agreed to with the customer and the market conditions surrounding the order."[174]

The Respondents' argument also incorrectly ignores the parties' unequal positions. Joseph Leighton's customers did not have—and could not get—information regarding Knight's costs. Joseph Leighton knowingly exploited this inequality for his own benefit and to his customers' detriment. Thus, although he was not obligated under NASD rules to provide his customers with Knight's costs, by withholding this information to take advantage of the customers' ignorance, Joseph Leighton violated his obligation to observe high standards of commercial honor and just and equitable principles of trade, as required by NASD Conduct Rule 2110.

The Panel majority further concludes under the specific facts of this case that Joseph Leighton misled his customers into believing that they received best execution services at least as good as, if not superior to, the generally prevailing industry practice. Knight represented in its public filings with the SEC that it provided superior execution services when in fact Joseph Leighton routinely executed trades at prices intentionally selected to maximize his profits. Joseph Leighton made no effort to conform to industry practice. Instead, he took advantage of the customers' inability to verify that they received the best possible prices. Joseph Leighton realized that institutions monitored the volume-weighted-average price of a stock to rate the performance of their broker-dealers. Hence, he knew that if he gave them prices that compared favorably to the volume weighted average over the period he worked their orders, the customers would be unable to complain that they did not receive the best possible price. Joseph Leighton then took advantage of Knight's dominant position as the largest NASDAQ market maker and

[174] *Id*. at *14.

timed trades and prints to his customers in a way that allowed Knight to trade at his customers' expense. With a not-held order in hand, Joseph Leighton often purchased stock and then waited to fill anything more than small amounts of the order while the price of the stock to rose. As it did, Joseph Leighton unfairly and improperly selected prices based on the volume-weighted-average price the stock traded away from Knight to fill the customer's order, keeping the larger spread as a profit. Joseph Leighton's customers did not agree to this pricing scheme. Indeed, they had no knowledge that Joseph Leighton was pricing their not-held orders in this manner.

Although the exact amount of Joseph Leighton's excess sales credits cannot be calculated from the evidence before the Panel,[175] Knight's records show that, between January 1999 and September 2000, Joseph Leighton generated approximately $21.7 million in sales credits above $.20 per share. Although this does not represent the amount of the customers' losses, the magnitude of the sales credits demonstrates the significance of Joseph Leighton's actions in depriving his customers of the opportunity to negotiate different terms for their not-held orders. Accordingly, the Panel majority concludes that substantial sanctions are appropriate and necessary under the facts of this case. Therefore, taking into consideration all of the foregoing aggravating factors, the Panel majority will fine each Respondent $100,000. In addition, the Panel majority will bar John Leighton in all supervisory capacities and will suspend Pasternak in all supervisory capacities for two years.

VI. ORDER

For the reasons set forth above, John Patrick Leighton and Kenneth D. Pasternak are each fined $100,000. In addition, John Patrick Leighton is barred in all supervisory capacities, and Kenneth D. Pasternak is suspended in all supervisory capacities for two years, which suspension

[175] The Panel cannot determine what terms the customers might have agreed upon had Joseph Leighton disclosed his trading strategy.

shall begin at the opening of business on June 4, 2007, and end at the close of business on June 3, 2009.[176]

The remaining sanctions shall become effective on a date set by NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of NASD.

In addition, the Respondents are jointly and severally ordered to pay $26,189.70 in costs.[177]

Andrew H. Perkins
Hearing Officer
For the Majority of the
Extended Hearing Panel

[176] The Hearing Panel has considered all of the parties' arguments. They are rejected or sustained to the extent that they are inconsistent with the views expressed herein.

[177] The costs are composed of an administrative fee of $750 and transcript costs of $25,439.70.

Statement of Dissenting Panelist

For the reasons discussed below, I would dismiss the Complaint.

A. The Department Failed to Prove That Joseph Leighton's Trading Activity Was Improper

1. No Evidence of Fraud

The Department failed to prove that there was anything improper about Joseph Leighton's trading activity. The Department's central theory was that Joseph Leighton defrauded his institutional customers by filling their not-held orders at prices exceeding Knight's cost plus $.06 to $.12 per share. But the Department failed to produce any evidence that Joseph Leighton's former institutional clients ever directed him to provide "cost-plus" executions. Indeed, all of the evidence undermines the Department's theory.

All of the institutional traders who testified stated that they never requested any information regarding the profits Knight made on their orders.[178] They furthermore confirmed that it was not customary in 1999 and 2000 for institutional customers to request such information and that neither Knight nor any other broker-dealer with which the customers did business voluntarily disclosed its costs or profits.[179] In fact, the customers testified that they were not concerned with Joseph Leighton's profits. Rather, each of Knight's customers testified at the hearing that their objective was to obtain the best price, time, and volume possible for their orders, and each testified that Joseph Leighton consistently met those objectives.[180] Although they testified that they assumed they received pricing at "cost plus," none ever discussed this assumption with Joseph Leighton or anyone else at Knight. There is not a scintilla of evidence

[178] *See* Hr'g Tr. 507, 521, 1068-69, 1425, 1452-56, 1497, 1508-09, 1531, 1587, 1606; RX-1219, Perry SEC Tr. 195-96 (Jan. 17, 2006); RX-1220, Mace SEC Tr. 211-12 (Feb. 6, 2006).

[179] *See* Hr'g Tr. 320, 520-21, 1068-69, 1613-14.

[180] Hr'g Tr. 496-97, 520, 529-30, 1030, 1047, 1053, 1062, 1414, 1442, 1444-46, 1484-85, 1501, 1527, 1534-35, 1577, 1587-89, 1600, 1602.

that any of Joseph Leighton's customers had a mutual understanding with Joseph Leighton that he would provide them with "cost plus" pricing.

All of the customers stated that Joseph Leighton provided good-quality executions in accord with their instructions. Joseph Leighton's customers were some of the largest and most sophisticated institutional investors, which constantly monitored and evaluated the quality of executions they received from their broker-dealers. Each of Knight's institutional customers employed sophisticated market surveillance tools and closely monitored in real time the price and volume of the stocks in which they were trading.[181] Knight's institutional customers regularly monitored NASDAQ Time and Sales, which showed in real time the prices and volumes that traded in a particular stock.[182] In addition, Knight's institutional customers retained outside consultants to generate reports that compared the execution quality amongst the various broker-dealers to which they routed order flow, and these reports indicated that Knight provided them with high-quality executions.[183] Using this information, these customers continuously evaluated the quality of executions that they received from Knight.[184] Yet, despite their sophistication and diligence, not one ever questioned, or expressed any dissatisfaction with, the prices they received. Indeed, the uncontested evidence established conclusively that Joseph Leighton provided more liquidity at superior prices than the sales traders at other broker-dealers in the NASDAQ market in 1999 and 2000.[185]

---

[181] Hr'g Tr. 516-17, 1055, 1428, 1510-11, 1591; RX-1220, Mace SEC Tr. 137-38 (Feb. 6, 2006); RX-1219, Perry Tr. 96 (Jan. 17, 2006). The customers measured the prices that they received from Knight against certain benchmarks, including the volume-weighted-average price, which was generally available to them through Bridge and Bloomberg. Hr'g Tr. Hearing Tr. 1040-41, 1056-58, 1447, 1501-02, 1512.

[182] *See* Hr'g Tr. 506, 517, 1056, 1429, 1497, 1591-92.

[183] *See* Hr'g Tr. 1423, 1447-50, 1496, 1512-13.

[184] Hr'g Tr. 506. *See also* RX-1220, Mace SEC Tr. 40-41 (Feb. 6, 2006).

[185] Hr'g Tr. 523, 1051-52, 1446-47, 1487, 1501, 1522-23, 1603; 1219, Perry SEC Tr. 210 (Jan. 17, 2006).

In addition, the evidence established that Joseph Leighton provided his institutional customers with regular updates regarding the progress of their orders, including how their orders performed in the market and the average price of shares bought or sold pursuant to each order.[186] For example, one customer testified that while Joseph Leighton was working his orders, there would be "numerous conversations back and forth" regarding "how the order was going."[187] Knight's institutional customers often reacted to their orders' performance in the marketplace by modifying the instructions that they had given to Joseph Leighton, increasing or decreasing the quantity of shares ordered or the pace at which they expected these shares to be bought or sold.[188]

Furthermore, the Department introduced no evidence at the hearing in support of its claim that Joseph Leighton increased his profits by secretly delaying executions to take advantage of movements in the market price of the stock. To the contrary, Knight's customers testified that they expected Joseph Leighton to accumulate positions pursuant to their orders without immediately reporting each buy or sell transaction.[189] The evidence also showed that these customers controlled the pace of the execution and determined the life of the order.[190] The Department's claim that Joseph Leighton was able to hold customers' orders without their knowledge is thus contrary to the evidence. Therefore, in many instances the customers actually dictated the timing of the executions on their orders.

In summary, the Department did not present any evidence that Joseph Leighton misrepresented the manner in which he priced the stock purchased for institutional customers

---

[186] Hr'g Tr. 507-08, 1042, 1045-46, 1424; RX-1220, Mace SEC Tr. 127-28 (Feb. 6, 2006); RX-1219, Perry SEC Tr. 12-13, 218 (Jan. 17, 2006).

[187] Hr'g Tr. 1045-46.

[188] Hr'g Tr. 518, 1046-47, 1418-19, 1436, 1503, 1595-96. Several of Knight's customers testified at the hearing that their participation in the execution of their orders often had a substantial impact upon the quality of execution that they received from Knight and other broker dealers. Hr'g Tr. 1518-19, 1596-97.

[189] Hr'g Tr. 1440, 1526-27, 1899-1901.

[190] Hr'g Tr. 1440, 1596.

pursuant to their not-held orders. Nor did the Department show that Joseph Leighton ever disregarded any customer instruction. Accordingly, I cannot find that the Department proved by a preponderance of the evidence that Joseph Leighton defrauded his customers by executing not-held orders at an average market price rather than at Knight's cost plus a mark up of less than $.125 per share, as the Department argued.

2. The Department's Profit Analysis Was Unreliable

The Department failed to present any reliable evidence of Joseph Leighton's alleged excessive profits. The Department's schedules of Joseph Leighton's trading activity were so arbitrarily drawn that they must be disregarded. In addition, the Department improperly withheld information underlying its analysis, thereby rendering the analysis and supporting schedules unreliable.

During 1999 and 2000, Knight's trading systems lacked the ability to isolate the profits and losses earned on particular institutional orders from those earned on the retail order flow that was simultaneously processed through Knight's market making accounts.[191] Rather, Knight's system recorded all of Knight's profits and losses in a particular security—which included the profit and loss generated by institutional, retail, and proprietary trades—on a cumulative running basis.[192] The Department therefore attempted to calculate the actual profits and losses on a limited number of the approximately 23,375 trades Joseph Leighton handled during the period at issue.[193] However, in doing so, the Department admittedly failed to apply any uniform methodology to its analysis, and it failed to take into account the market conditions at the time—

---

[191] Hr'g Tr. 2002.

[192] Hr'g Tr. 2004.

[193] These trades were selected because the Department considered them to be Joseph Leighton's most profitable trades. Hr'g Tr. Hearing Tr. 553, 697. The Department did not analyze trades it thought might have smaller profits or trades where Joseph Leighton might have incurred a loss.

including volume, volatility, and the bid to ask spread on the subject stocks.[194] These omissions fundamentally flaw the Department's analysis.

The Department's staff witness, the Director of the Department's Fixed Income Group, ("Staff Analyst") conceded at the hearing a number of methodological errors and inconsistencies that render his schedules and conclusions completely unreliable. Rather than using a standardized mathematical formula to generate Knight's profit and loss calculations from the data, the Staff Analyst testified that he made subjective line-by-line determinations as to which transactions he believed were effected pursuant to the institutional orders in question and therefore which transactions to include or omit from his calculations of Knight's profits.[195] For example, the Staff Analyst omitted from his analysis certain purchases and sales which occurred within a close proximity to each other, as he assumed that these trades were triggered by Manning obligations.[196] In addition, in situations where he concluded that Knight committed capital (e.g., accumulating a net short inventory position to accommodate a customer buy order), he made contradictory subjective determinations as to whether to include or omit these positions from his analysis.[197] The Staff Analyst also admitted to arbitrarily removing from his analysis all trades which occurred on the opposite side of the institutional order he was analyzing (i.e., when examining a buy order, the Staff Analyst removed all sell transactions from his profit calculations).[198] Ultimately, the Staff Analyst conceded under cross-examination that he failed to

[194] Hr'g Tr. 833-34. Such market conditions are factors considered necessary to any fair price evaluation under NASD Conduct Rule 2440.

[195] Hr'g Tr. 714, 917-18.

[196] Hr'g Tr. 574-75, 715-18. A firm's Manning obligation refers to NASD's limit order protection rules. *See* IM-2110-2.

[197] Hr'g Tr. 897-98, 918-19, 2018-19.

[198] Hr'g Tr. 723-25.

employ a standardized methodology as to which trades should be included or excluded from his analysis.[199] And he could not reconstruct which criteria he used as to any particular trade.

The Staff Analyst also could not take into account the customers' instructions regarding the manner in which they expected their orders to be handled because the instructions were not documented. Thus, he could not reconstruct the history of the trades.[200] Instead, he disregarded the impact these instructions had on the execution of the orders in question.

More troubling, however, was the Department's withholding of material evidence concerning Knight's trade with Fidelity in Synopsis, the trade the Department showcased to demonstrate the alleged egregiousness of Joseph Leighton's activities. The Staff Analyst testified that he relied on an internal Fidelity document to perform his analysis because he did not have a legible copy of the corresponding order ticket.[201] His story proved inaccurate. Contrary to the Staff Analyst's testimony, the Department did have a legible copy of the order ticket, which the Department eventually produced during the Staff Analyst's cross-examination.[202] Although the order ticket contradicted the Staff Analyst's assumptions about the Synopsis trade, the Department offered no explanation for its decision to use the Fidelity document or for the Staff Analyst's inaccurate testimony that the Department did not have a legible copy of the order ticket. Nor did the Department offer an explanation for its failure to produce the document earlier, as it was required to do by Procedural Rule 9252 and by order of the Hearing Officer.

For the foregoing reasons, I found the Department's profit analysis to be wholly unreliable. The Department's conduct in suppressing relevant information that it was obligated

---

[199] Hr'g Tr. 918-19. The Staff Analyst admitted that by failing to consider retail trades in his analysis, all of the profits that Knight generated on its automated execution of these retail orders were arbitrarily allocated to the institutional orders in his analysis. Hr'g Tr. 1990, 1997, 2000, 2012.

[200] Hr'g Tr. 511-12, 519-20, 1045, 1436-37, 1518-19, 1984.

[201] Hr'g Tr. 848-50. The Department had not provided the defense with a copy of the Fidelity document, and the Staff Analyst had little knowledge of its content or origin.

[202] Hr'g Tr. 857-58. The order ticket was admitted into evidence as RX-1214.

to produce to the Respondents totally undermines the Staff Analyst's credibility. Accordingly, the Department's schedules and profit analysis must be disregarded.

B. Profits Are Not Red Flags of Potential Misconduct

The Department presented no authority in support of its argument that high profit is an indicium of wrongdoing. There are no rules or regulations that set a limit on the profit level firms may earn on not-held orders. Indeed, the Department's theory is directly at odds with NASD's published guidance relating to the execution of not-held orders on a net basis.[203] Accordingly, the Department cannot base supervisory liability on the Respondents' failure to follow up on Joseph Leighton's profits. Moreover, the period in question was the most volatile and profitable in NASDAQ history. Pasternak understood that the extremely volatile NASDAQ market conditions in 1999 and 2000 presented unique opportunities for market makers like Knight to earn higher profits.[204] In fact, Knight's market making revenues increased 152% between the first quarter of 1999 and the first quarter of 2000.[205] Knight's competitors, including Sherwood Securities and M.H. Meyerson, also reported increased market making revenues of 140% and 163%, respectively, during this time period.[206] Given these general conditions, Pasternak rightfully understood that Knight's traders would generate correspondingly higher sales credits during this period of market volatility.[207] Thus, it would be unreasonable in hindsight to hold the Respondents to a standard that required them to disregard these factors and conclude from Joseph Leighton's success that he was trading improperly.

I also note that the other sales traders at Knight often made significantly more than Joseph Leighton did on a per share basis. The Respondents produced evidence unchallenged by

---

[203] Hr'g Tr. 1979-80, 2080-85, 2091-92. *See also* NASD Notice to Members 01-85.

[204] Hr'g Tr. 2882-83.

[205] RX-421.

[206] RX-433; RX-444.

[207] Hr'g Tr. 2883-84.

the Department that other sales traders routinely earned sales credits far in excess of $.06 per share. In fact, Joseph Leighton usually did not post the highest monthly sales credits per share. Between January 1999 and September 2000, Joseph Leighton had the highest sales credits in just three months.[208] Moreover, the highest monthly average sales credit per share earned by Joseph Leighton during 1999 and 2000 was $.43, while another trader posted average sales credits as high as $1.83 per share.[209] Under these circumstances, it is unreasonable to conclude that the Respondents should have considered the amount of Joseph Leighton's sales credits to be a red flag of potential misconduct, as the Department argued.

Moreover, NASD Conduct Rule 3010 mandates that supervision must be reasonable under the particular facts and circumstances. "The duty to exercise reasonable, effective supervision has never been construed to be an absolute guarantee against every malfeasance by errant subordinates."[210] Accordingly, the burden is on the Department to show that the Respondent's conduct was unreasonable. It is not sufficient to demonstrate that they were not model supervisors or that the supervision could have been better.[211] The Department failed to meet this burden in this case.

As the Department concedes, the only published guidance that addresses the appropriate pricing of not-held orders executed on a net basis is NASD Rule 2440.[212] However, the Department did not allege, and made no effort to prove, that Joseph Leighton violated NASD Conduct Rule 2440. Indeed, the Department's analysis omitted any consideration of the quality

---

[208] RX-1215.

[209] RX-1215.

[210] *Dean Witter Reynolds, Inc.*, Admin. Proc. No. 179, 2001 SEC LEXIS 99, at *168 (Jan. 22, 2001) (noting prior decisions do not substitute knowledge gained in hindsight of actual wrongdoing by someone under the supervisor's control in assessing whether a supervisor's conduct is proper under the circumstances).

[211] *See, e.g., District Bus. Conduct Comm. v. Lobb*, 2000 NASD Discip. LEXIS 11, at *16 (N.A.C. Apr. 6, 2000) (citations omitted).

[212] Hr'g Tr. 2037-38; NASD Conduct Rule 2440.

of the prices in relation to the market conditions at the time of the trades, which are factors required for a proper analysis under NASD Conduct Rule 2440.[213] Therefore, it would violate the requirements of fundamental fairness to hold the Respondents liable for violating Conduct Rule 2440. Not only did all of the evidence support the conclusion that the prices did not violate Conduct Rule 2440, but also the Respondents had no notice of, or opportunity to defend, this charge. Accordingly, the Complaint should be dismissed.

C. Pasternak Responded Appropriately to Supervisory Concerns about Joseph Leighton's Trading

Under the facts and circumstances of this case, Pasternak responded appropriately to the concerns raised by Hewitt and Stellato.

In the fall of 1999, shortly after Hewitt arrived at Knight, he learned from John Leighton that his brother earned sales credits of approximately $0.25 per share.[214] Hewitt immediately concluded that the only possible explanation for these profits was "front running," and, shortly thereafter, he conveyed his conclusions to Knight's management committee, including Knight's General Counsel and Pasternak.[215] Hewitt testified that he defined "front running" as building an inventory position pursuant to a not-held order "without disclosing the economics of the buildup" to a customer although he admitted that broker-dealers did not disclose their acquisition costs to their customers during 1999 and 2000.[216]

Further, when asked to explain why he concluded that Joseph Leighton's trading was improper based upon the amount of profits he earned and why he was not concerned about the fact that other sales traders were earning sales credits that were similar to, or higher than, Joseph

[213] Hr'g Tr. 833-34.

[214] Hr'g Tr. 198-99.

[215] Hearing Tr. 204-06.

[216] Hr'g Tr. 311-14, 320.

Leighton's, Hewitt stated that he was suspicious only because he could not understand Knight's trading methodology, the Leightons were not his "type of guys," and he wanted someone else to run the Institutional Sales Department.[217] Hewitt further admitted that at the time he did not fully understand Joseph Leighton's trading activity or its relation to Knight's tremendous retail order flow.[218] Hewitt further admitted that Knight's wholesale business model, which included substantial automated retail order flow, and Knight's "eat what you kill" compensation model, were completely foreign to the products-based commission model with which he was familiar at Goldman Sachs.[219]

Hewitt's testimony is consistent with Pasternak's. Pasternak testified that he concluded that Hewitt was questioning John Leighton's business management qualifications to run the expanded international Institutional Sales Department Hewitt envisioned for Knight, not Joseph Leighton's trading practices.[220] Thus, there were no red flags of improper trading that Pasternak needed to address. And, although Pasternak disagreed with Hewitt's assessment of John Leighton's business qualifications, Pasternak readily agreed with his recommendation to replace John Leighton.[221] There was nothing more requested of Pasternak in the fall of 1999, and he diligently responded to Hewitt's non-regulatory concerns regarding the Institutional Sales Department. Furthermore, Pasternak's testimony is corroborated at least in part by the fact that Hewitt took no further action for the next eight months until Stellato replaced John Leighton as head of the Institutional Sales Department.

In early August 2000, shortly after Stellato arrived at Knight, he expressed concerns about the amount of money that Joseph Leighton had generated on three of his institutional

---

[217] Hr'g Tr. 347-48.

[218] Hr'g Tr. 201-02, 293-94.

[219] Hr'g Tr. 201, 219, 358-59.

[220] Hr'g Tr. 2839-40.

[221] Hearing Tr. 201, 220, 2840-41.

orders—Juniper, Synopsis, and Tut Systems. Pasternak responded promptly and appropriately to Stellato's concern.[222] The evidence shows that Pasternak performed an immediate review of the trading activity questioned by Stellato, pursuant to which Pasternak examined the BRASS runs as well as other market data for the three trades.[223] Pasternak observed that on the day of the Synopsis trade, Knight had received approximately 800-900 sell orders prior to the opening and was immediately long approximately 200,000 shares of Synopsis stock prior to the opening as a result of computer execution guarantees Knight provided its retail customers.[224] In the course of his review, Pasternak spoke to Joseph Leighton about the Synopsis trade; he informed Pasternak that Fidelity placed an initial buy order for 50,000 shares at the open based on Knight's advertisement in the Autex system. Pasternak confirmed that information by reviewing the order ticket.[225] From his review of the BRASS data, Pasternak concluded that Stellato had incorrectly assumed that the 200,000 share long position resulting from Knight's guarantee had been accumulated pursuant to Fidelity's order, and that Knight either made a marginal profit or actually lost money on the Synopsis trade.[226] As a result, Pasternak concluded that Stellato's allegations were based entirely on his misunderstanding of Knight's trading records and were perhaps politically motivated.[227] In Pasternak's view, Stellato and Hewitt wanted to replace John Leighton so that they could control the future direction of the Institutional Sales Department.

The evidence further established that Pasternak directed Knight's Legal and Compliance Departments to investigate Stellato's concerns, which they did.[228] The head of each department

---

[222] Hr'g Tr. 2847.

[223] Hrg Tr. 2851-54.

[224] Hr'g Tr. 2853-54.

[225] Hr'g Tr. 2857-58.

[226] Hr'g Tr. 2860-62.

[227] Hr'g Tr. 2860.

[228] Hr'g Tr. 2866.

performed an independent review of the three trades, and each concluded that the records did not reflect any improprieties.[229] The Firm's General Counsel reported those findings back to Pasternak.[230] In addition, the Chief Compliance Officer and General Counsel reported their findings to Stellato and invited him to make any changes to Knight's business practices as he saw fit.[231] Nonetheless, Stellato made no changes whatsoever.[232] The Institutional Sales Department continued to operate in the same manner after Stellato took over, further confirming Pasternak's conclusion that Stellato's real agenda was to secure complete control of Knight's Institutional Sales Department.

In sum, John Leighton and Pasternak fulfilled their supervisory obligations under the facts and circumstances of this case. John Leighton was not presented with any red flags. Joseph Leighton had the largest clients and no one at Knight raised any concerns to John Leighton about his brother's trading. Moreover, John Leighton had a long and close relationship with many of Joseph Leighton's clients because they had once been John Leighton's clients. None ever complained about Joseph Leighton's trading. Under these circumstances, there is no evidence that John Leighton's supervision was deficient. In addition, even if the issues Hewitt and Stellato raised with Pasternak can be categorized as red flags, Pasternak responded reasonably. Accordingly, the Complaint should be dismissed.

---

[229] Hr'g Tr. 2424; CX-162, Dorsey NASD Tr. 81-82 (Feb. 14, 2006).

[230] Hr'g Tr. 2868.

[231] Hr'g Tr. 2422-23; CX-162, Dorsey NASD Tr. 83 (Feb. 14, 2006), CX-163, Dorsey NASD Tr. 378-79 (Feb. 15, 2006).

[232] CX-162, Dorsey NASD Tr. 87 (Feb. 14, 2006), CX-163, Dorsey NASD Tr. 379 (Feb. 15, 2006).

Copies sent to:

John Patrick Leighton (*by FedEx and first-class mail*)
Kenneth D. Pasternak (*by FedEx and first-class mail*)
Joel E. Davidson, Esq. (*by electronic and first-class mail*)
Howard Schiffman, Esq. (*by electronic and first-class mail*)
James M. Wines, Esq. (*by electronic and first-class mail*)
Robert L. Furst, Esq. (*by electronic and first-class mail*)
Jeffrey K. Stith, Esq. (*by electronic and first-class mail*)
Michael R. Levy, Esq. (*by electronic and first-class mail*)
James J. Nixon, Esq. (*by electronic and first-class mail*)
Tina Salehi Gubb, Esq. (*by electronic and first-class mail*)