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U.S. Securities and Exchange Commission

UNITED STATES OF AMERICA BEFORE THE SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 49501 / March 30, 2004

ADMINISTRATIVE PROCEEDING
File No. 3-11448

In the Matter of :

Spear, Leeds & Kellogg Specialists LLC, :
Respondent. :

ORDER
INSTITUTING
ADMINISTRATIVE
AND CEASE-AND-
DESIST
PROCEEDINGS,
: MAKING
: FINDINGS, AND
: IMPOSING
: REMEDIAL
: SANCTIONS AND
: A CEASE-AND-
: DESIST ORDER
PURSUANT TO
SECTIONS 15(b)
(4) AND 21C OF
THE SECURITIES
EXCHANGE ACT
OF 1934

I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Spear, Leeds & Kellogg Specialists LLC ("SLKS" or "Respondent").

II.

In anticipation of the institution of these proceedings, SLKS has submitted an offer of settlement ("Offer"), which the Commission has determined to accept. Solely for the purposes of these proceedings, and any other proceeding brought by or on behalf of the Commission, or in which the Commission is a party, and prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. § 201.100 et seq., and without admitting or denying the findings set forth herein, except that SLKS admits the jurisdiction of the Commission over it and over the subject matter of these proceedings, SLKS consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Order"), as set forth below.

III.

On the basis of this Order and the Offer submitted by SLKS, the Commission finds¹ that:

A. RESPONDENT

1. **SLKS** is a broker-dealer registered with the Commission, pursuant to Section 15(b) of the Exchange Act, since December 1996. On October 31, 2000, SLKS was acquired by and became an indirect subsidiary of The Goldman Sachs Group, Inc.², the securities of which are registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange ("NYSE"), the American Stock Exchange ("AMEX"), and the Chicago Board Options Exchange. SLKS is a NYSE member organization and acts as the registered specialist for approximately 568 NYSE-listed securities, which, as of August 31, 2003, accounted for about 25% and 22%, respectively, of the dollar and share volume traded on the NYSE. SLKS's parent, Spear, Leeds & Kellogg L.P., also functions as a specialist on the AMEX. During the period relevant to this Order, SLKS acquired or merged with other specialist firms. Some of the conduct that is the basis of the findings herein took place at those predecessor entities. As used herein, SLKS refers to SLKS and its predecessor entities.

B. FACTS

Summary

2. This matter involves violations by SLKS of its basic obligation to serve public customer orders over its own proprietary interests. As a specialist firm on the NYSE, SLKS had a general duty to match executable public customer or "agency" buy and sell orders and not to fill customer orders through trades from the firm's own account when those customer orders

could be matched with other customer orders. Through various forms of improper conduct, SLKS violated this obligation by filling orders through proprietary trades rather than through other customer orders, thereby causing customer orders to be disadvantaged by approximately \$28.7 million from 1999 through 2003.

3. By effecting proprietary transactions that were not part of a course of dealings reasonably necessary to maintain a fair and orderly market, SLKS violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder. In addition, with certain transactions in six particular stocks, certain specialists at SLKS engaged in unlawful proprietary trades with *scienter*, violating their implied representations to public customers that they were limiting dealer transactions to those reasonably necessary to maintain a fair and orderly market. In those instances, individual specialists at SLKS violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Under Section 15(b)(4)(E) of the Exchange Act, SLKS failed reasonably to supervise those individual specialists with a view to preventing their violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. SLKS also violated NYSE Rules 92, 104, 123B, 342, 401 and 476.

Overview of Specialists' Obligations

4. In the NYSE's continuous two-way agency auction market, specialist firms are responsible for the quality of the markets in the securities in which individual specialists are registered. A specialist is expected to maintain, insofar as reasonably practicable, a "fair" and "orderly" market. A "fair" market is free from manipulative and deceptive practices, and affords no undue advantage to any participant. An "orderly" market is characterized by regular, reliable operation, with price continuity and depth, in which price movements are accompanied by appropriate volume, and unreasonable price variations between sales are avoided.

5. Specialists have two primary duties: performing their "negative obligation" to execute customer orders at the most advantageous price with minimal dealer intervention, and fulfilling their "affirmative obligation" to offset imbalances in supply and demand. Specialists participate as both broker (or agent), absenting themselves from the market to pair executable customer orders against each other, and as dealer (or principal), trading for the specialists' dealer or proprietary accounts when needed to facilitate price continuity and fill customer orders when there are no available contra parties to those orders.

6. Whether acting as brokers or dealers, specialists are required to hold the public's interests above their own and, as such, are prohibited from trading for their dealers' accounts ahead of pre-existing customer buy or sell orders that are executable against each other. When matchable customer buy and sell orders arrive at specialists' trading posts - generally either through the NYSE's Super Designated Order Turnaround System ("DOT")³ to an electronic display book (the "Display Book")⁴, or by floor brokers gathered in front of the specialists' trading posts ("the crowd") - specialists are required to act as agent and cross or pair off those orders and to abstain from participating as principal or dealer.

Unlawful Proprietary Trading by SLKS

7. During the period January 1999 through 2003, SLKS breached its duty to refrain from dealing for its own account while in possession of executable buy and sell customer orders. Instead, SLKS effected improper proprietary trades at the expense of customer orders.

8. Through the Display Book, the specialist reports trade executions electronically, and can view all the incoming DOT market and limit orders on both sides of the market.⁵ Executable buy and sell customer orders can appear on the Display Book at the same time. In such instances, specialists should simply "pair off" or cross the buy and sell orders. In numerous instances, however, SLKS specialists improperly chose not to "pair off" or cross these buy and sell orders with each other. Sometimes, SLKS specialists did this by effecting proprietary trades with orders that arrived electronically through the DOT system to the Display Book. At other times, SLKS specialists effected improper proprietary trades with orders that came in from the crowd. In either case, the disadvantaged order was a DOT order visible on the Display Book that the SLKS specialist should have paired with the other order, instead of filling that other order through a proprietary trade.

9. From 1999 through 2003, this conduct at SLKS resulted in customer disadvantage of \$28,776,072. The conduct basically fell within three categories, described in paragraphs 10 through 12 below.

10. *Interpositioning.*

- a. At times from January 1999 through 2003, certain SLKS specialists bought stock for the firm dealer account from the customer sell order, and then filled the customer buy order by selling from the dealer account at a higher price - thus realizing a profit for the firm account. To illustrate: if market orders were present on both sides of the market and simultaneously visible on the Display Book, and the quote constituted a bid for \$25.00 (purchase price) and an ask of \$25.01 (sale price), the specialist was obligated to pair the market orders at \$25.00 or \$25.01. Instead, the specialist improperly interpositioned SLKS's dealer account by buying from the sellers at \$25.00, and then selling to the buyers at \$25.01 and capturing the one-cent spread. Alternatively, certain SLKS specialists sometimes sold stock into the customer buy order, and then filled the customer sell order by buying for the dealer account at a lower price.
- b. In either case, SLKS specialists participated on both sides of trades, thereby capturing the spread between the purchase and sale prices, disadvantaging the other parties to the transaction. Also, in either case, the customer orders in question always came in through the DOT system, not the crowd. Between 1999 and 2003, interpositioning by SLKS disadvantaged customers in the amount of \$8,309,962 in a number of securities for which SLKS was the specialist.⁶
- c. Putting the SLKS dealer account between executable agency orders that arrived through the electronic DOT system and were capable of being crossed required several deliberate steps executed on the Display Book computer keyboard by the SLKS specialist or his clerk. The Display Book highlights in yellow marketable customer orders. To fill an agency order with a proprietary trade, the specialist or his clerk

must take the Display Book out of its "default mode" and input several other keyboard commands. Pairing off two matchable orders at the same price as the last sale requires only two keystrokes, whereas interpositioning usually requires several extra keystrokes. Interpositioning disadvantages a market buy order (*i.e.*, a purchaser) and/or a market sell order (*i.e.*, a seller) because the specialist sells to the purchaser at one price and then buys from the seller at a lower price (or, alternatively, the specialist buys from the seller at one price and then sells to the purchaser at a higher price) instead of matching the purchaser and seller at a better market price for each.

- d. For example, shortly after 11:04 am on January 8, 2003, a specialist at SLKS engaged in an unlawful interpositioning transaction in the stock of Verizon Communications Inc. ("VZ"). As depicted below (see white box, bottom left-hand corner of screen), at 11:04:22 am, the Display Book for the SLKS specialist showed, among other things, more than eight market orders to buy a total of 3,300 VZ shares (comprised of orders for 500, 100, 1,000, 300, 200, 400, 300 and 200, which add up to 3,000; orders for another 300 shares do not show up on the screen because the Display Book can only show a certain number of buy or sell orders at any given time, in this case the first eight buy orders) and two market orders to sell a total of 2,100 VZ shares (one for 2,000 and one for 100). At that very moment, the Display Book highlighted the market orders in yellow at the bottom middle of the white box as "33 MKT 21" - meaning 3,300 shares to buy at market and 2,100 shares to sell at market (see also "1, 20" to the right of that indicating the two market sell orders and "5, 1, 10, 3, 2, 4, 3, 2" to the left indicating eight market buy orders):

Display Book for the SLKS specialist

The SLKS specialist should have paired the market orders to buy 3,300 shares with the orders to sell 2,100 shares, and could have satisfied the remaining 1,200 shares of the buy market orders through a proprietary trade. Instead, at 11:04:25, the specialist stepped in front of the orders to sell 2,100 shares and sold 3,300 shares to the buy market orders in a proprietary trade at \$41.10 per share. Next, SLKS' specialist lowered the price to \$41.00 and, in a separate trade reported at 11:04:32, bought back 5,200 shares for the firm's dealer account, thereby filling several sell orders, including the market orders to sell 2,100 shares he had traded in front of as described above. By buying back, at \$41.00, all of the 3,300 VZ shares he had sold just moments earlier at \$41.10, the SLKS specialist made a profit of \$330 for SLKS' dealer account (3,300 shares x \$.10/share = \$330) through a riskless transaction.

11. *Trading Ahead.*

- a. SLKS specialists sometimes filled one agency order through a proprietary trade for the firm's account - and thereby improperly "traded ahead" of the other agency order. As a consequence, the customer order that was traded ahead of was disadvantaged by being executed at a price that was inferior to the price received by the dealer account. Unlike "interpositioning," the "trading ahead"

violations did not necessarily involve a second specialist proprietary trade into the opposite, disadvantaged agency order. From January 1999 through 2003, trading ahead by certain SLKS specialists resulted in customer disadvantage of \$19,430,004.

- b. For example, in a declining market, the SLKS specialist might engage in "trading ahead" when filling a market buy order by selling stock from the firm's dealer account in front of an agency market sell order. In so doing, the specialist would secure a higher price for its proprietary trade. To illustrate, if the specialist's Display Book showed an order to sell 3,000 shares and an order to buy 3,000 shares, the specialist was obligated to pair off the orders. Instead, the SLKS specialist might fill the 3,000 share market buy order from SLKS's dealer account. At some point *after* the proprietary trade, the specialist would then execute the agency market sell order, providing the agency market sell order a lower price as the price of the stock fell. SLKS specialists "traded ahead" by effecting such proprietary trades with both crowd orders and DOT orders. In either case, the disadvantaged agency order was always a DOT order.

12. *Unexecuted Limit Orders.*

- a. Sometimes, SLKS specialists traded ahead of executable limit orders - *i.e.*, they improperly effected proprietary trades with customer orders that they should have paired with marketable limit orders. Unlike the "trading ahead" violations described just above, in these instances the disadvantaged limit orders were never executed, but rather were cancelled by the customer before receiving an execution.
- b. Between 1999 and 2003, trading ahead of unexecuted limit orders by SLKS caused \$1,036,106 in customer disadvantage. This measurement is determined based on the difference between the price at which the order should have been executed and the price at the time of cancellation.

Interpositioning in Six Particular Stocks

13. SLKS' improper interpositioning transactions, in particular, were heavily concentrated in a few stocks traded by a small number of specialists. Specifically, from 1999 through 2003, 75.08% of SLKS' customer disadvantage from interpositioning occurred in just six stocks - AOL Time Warner ("AOL"), International Business Machines Corporation ("IBM"), Micron Technology, Inc. ("MU"), American International Group, Inc. ("AIG"), Teradyne, Inc. ("TER"), and VZ.⁷

14. The interpositioning violations with respect to certain transactions in the six stocks listed above were done by certain SLKS specialists with *scienter*. In such instances, certain SLKS specialists disadvantaged a market buy order (*i.e.*, a purchaser) and/or a sell order (*i.e.*, a seller) because the specialist sold to the purchaser at one price and then bought from the seller at a lower price (or, alternatively, the specialist bought from the seller at one price and then sold to the purchaser at a higher price) instead of matching the purchaser and seller at a better market price for each.

15. Certain senior executives at SLKS knew about the illicit trading because certain of the specialists who were engaged in some of the most egregious cases of violative conduct in the six stocks were among the most senior executives at SLKS, including managing directors and team captains.

16. In June 2002, the NYSE issued a \$1,000 summary fine against a predecessor firm of SLKS because 5 specialists at the predecessor firm, including the specialist in TER, traded ahead of agency orders, resulting in inferior price executions of such agency orders, during the period of March 2 through April 18, 2001. This action was an indication to SLKS of improper trading by specialists.

17. SLKS did not have in place reasonable systems or procedures to monitor, detect, or prevent interpositioning by certain individual specialists.

C. APPLICABLE LAW

Section 11(b) and Rule 11b-1 of the Exchange Act

18. Section 11(b) of the Exchange Act and Rule 11b-1 thereunder require various limitations on the operations of specialists, including limiting a specialist's dealer transactions to those "reasonably necessary to permit him to maintain a fair and orderly market." Section 11(b) and Rule 11b-1 require a national securities exchange to promulgate rules that allow a member to register as a specialist and to act as a dealer. Under Rule 11b-1 (b), if the Commission finds, after appropriate notice and opportunity for hearing, that a specialist has for any account in which he has an interest "effected transactions... which were not part of a course of dealings reasonably necessary to permit such specialist to maintain a fair and orderly market," the Commission may order the exchange to suspend or cancel the specialist's registration.

19. Where specialists effect trades for their accounts that are not "reasonably necessary to permit [such specialists] to maintain a fair and orderly market," they have violated Section 11(b) and Rule 11b-1 of the Exchange Act. *See In the Matter of Weiskopf, Silver & Co.*, 1980 WL 22091, SEC Release No. 34-17361 (Dec. 10, 1980); *In the Matter of Albert Fried & Co. and Albert Fried, Jr.*, 1978 WL 196046, S.E.C. Release No. 34-15293 (Nov. 3, 1978).⁸

20. Here, SLKS violated its negative obligation by engaging in the three types of conduct described in paragraphs 7 through 12 above. Accordingly, SLKS willfully⁹ violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

NYSE Rules

21. Several NYSE rules prohibit the same conduct as is prohibited by Section 11(b) and Rule 11b-1 thereunder. These NYSE rules effectively prohibit a specialist from trading ahead of a customer order, as well as from engaging in interpositioning, and require agency orders to be matched whenever possible.

22. NYSE Rule 104 (Dealings by Specialists) places a negative obligation on

specialists by prohibiting a specialist from trading for his own account unless it is reasonably necessary to maintain a fair and orderly market. Rule 104 states in relevant part: "No specialist shall effect... purchases or sales of any security in which such specialist is registered ..., unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market."¹⁰

23. NYSE Rule 92, as amended, provides that "no member or member organization shall cause the entry of an order to buy (sell) any Exchange-listed security for any account in which such member or member organization . . . is directly or indirectly interested (a 'proprietary order'), if the person responsible for the entry of such order has knowledge of any particular unexecuted customer's order to buy (sell) such security which could be executed at the same price."

24. Similarly, NYSE Rule 92 also applies to the specialist buying or selling a security while holding an unexecuted customer market buy or sell order, as well as to circumstances where the specialist holds unexecuted customer limit orders at a price that could be satisfied by the proprietary transaction effected by the specialist.

25. NYSE Rule 123B (Exchange Automated Order Routing Systems) requires specialists to cross orders received over the DOT system. Rule 123B(d) states in relevant part: "a specialist shall execute System orders in accordance with the Exchange auction market rules and procedures, including requirements to expose orders to buying and selling interest in the trading crowd and *to cross orders before buying or selling from his own account.*" (Emphasis added).

26. NYSE Rule 401 requires NYSE member organizations to "adhere to the principles of good business practice in the conduct of his or its business affairs." Similarly, NYSE Rule 476(a)(6) provides sanctions if NYSE member organizations engage in conduct "inconsistent with just and equitable principles of trade." Pursuant to NYSE Rule 476(a)(7), member organizations must also refrain from engaging in "acts detrimental to the interest or welfare of the Exchange."

27. NYSE Rule 342 provides that "[e]ach office, department or business activity of a member or member organization ... shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility."

28. SLKS violated each of the aforementioned NYSE rules by reason of the activities set forth in paragraphs 7 through 17 above.

SLKS's Failure Reasonably to Supervise Under Section 15(b)(4)(E) of the Exchange Act

29. Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to sanction a broker or dealer if that broker or dealer, or any "person associated with [the] broker or dealer,"¹¹ has "fail[ed] reasonably to supervise, with a view toward preventing securities law violations, a person subject to its supervision who commits [a violation of, among other statutes, any provision of the Exchange Act]." *In the Matter of Dean Witter*

Reynolds Inc., et al., Initial Decision, Admin. Proc. File No. 3-9686 (Jan. 22, 2001), Finality Order, SEC Release No. 34-44012 (February 27, 2001) . Such sanction must be in the public interest. To prove a failure to supervise claim against a broker or dealer, the Commission must establish: (i) an underlying securities law violation; (ii) association of the registered representative or person who committed the violation; (iii) supervisory jurisdiction over that person; and (iv) failure reasonably to supervise the person committing the violation. *See In re Philadelphia Investors, Ltd. and Clarence Z. Wurts*, Initial Decision, SEC Admin. Proc. File No. 3-9114 (March 20, 1998), Finality Order, SEC Release No. 34-40525 (October 6, 1998). Here, the conduct meets each of those elements.

30. Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit a person, in connection with the purchase or sale of any security, from employing any device, scheme or artifice to defraud, making false or misleading statements, or engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

31. To violate Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, one must have acted with *scienter*. *Aaron v. SEC*, 446 U.S. 680, 691 (1980). *Scienter* may be established by proof of conscious behavior or recklessness. *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74 (2d Cir. 2001); *SEC v. U.S. Environmental*, 155 F.3d 107, 111 (2d Cir. 1998).

32. Specialists impliedly represent to their customers that they are dealing fairly with the public in accordance with the standards and practices applicable to specialists, namely, that they are limiting their dealer transactions to those "reasonably necessary to maintain a fair and orderly market." A specialist's failure to comply with this implied representation, if done with *scienter*, can constitute a violation of the antifraud provisions of the securities laws. *See, e.g., Newton, et al. v. Merrill Lynch Pierce Fenner & Smith, et al.*, 135 F.3d 266 (3d Cir. 1998) (en banc); *see also Market Street Ltd. Partners v. Englander Capital Corp.*, 1993 WL 212817 (S.D.N.Y. June 14, 1993).

33. From January 1999 through 2003, 75.08% of SLKS's customer disadvantage from interpositioning occurred in the following NYSE-listed securities: AOL, IBM, MU, AIG, TER, and VZ. Moreover, interpositioning disadvantages a market buy order (*i.e.*, a purchaser) and/or a market sell order (*i.e.*, a seller) because the specialist sells to the purchaser at one price and then buys from the seller at a lower price (or, alternatively, the specialist buys from the seller at one price and then sells to the purchaser at a higher price) instead of matching the purchaser and seller at a better market price for each.

34. The interpositioning conduct by certain SLKS specialists with respect to certain transactions in the above six stocks evidences *scienter*. Accordingly, those SLKS specialists violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

35. Each of the specialists who violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder was associated with SLKS. Moreover, SLKS had supervisory jurisdiction over each of these individual specialists.

36. SLKS failed reasonably to supervise its specialists engaged in fraudulent trading with a view to preventing their violations of the Exchange Act. First, SLKS failed to establish policies or procedures, or a system to implement such policies or procedures, that would reasonably be expected to detect the individual specialist's fraudulent conduct. Second, senior executives at SLKS including managing directors and floor captains with supervisory responsibility were themselves engaged in some of the most egregious cases of violative conduct. Finally, the June 2002 summary fine by the NYSE was an indication of misconduct and should have prompted SLKS to inquire whether the improper trading was more widespread and serious. In large organizations such as SLKS, it is especially imperative that those in authority exercise particular vigilance when indications of irregularity reach their attention. *See Wedbush Securities, Inc.*, 48 S.E.C. 963, 967 (1988) (citations omitted). SLKS did not take adequate steps in response to the NYSE action. Accordingly, SLKS failed reasonably to supervise its specialists who, through certain transactions in six stocks identified above, committed willful violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, with a view toward preventing violations of the federal securities laws within the meaning of Section 15(b)(4)(E) of the Exchange Act.

D. CONCLUSIONS

37. SLKS willfully committed violations of Section 11(b) and Rule 11b-1 of the Exchange Act.

38. SLKS failed reasonably to supervise certain of its specialists who, through certain transactions in the six stocks identified above, committed willful violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, with a view toward preventing violations of the federal securities laws within the meaning of Section 15(b)(4)(E) of the Exchange Act.

E. UNDERTAKINGS

Respondent has undertaken to:

1. Implement systems and procedures to ensure appropriate follow up and review with regard to information provided to SLKS on a daily basis by the NYSE with regard to specialists' override of the Principal Inhibitor¹² function on the Display Book.
2. Create a committee, including SLKS's Chief Compliance Officer and at least two members of senior management, specifically charged with meeting periodically (no less frequently than monthly) to evaluate specialist rule compliance with respect to interpositioning, trading ahead, and unexecuted limit orders, and keep written minutes of such committee meetings in an easily accessible place for a period of at least three years.
3. Develop and/or enhance systems and procedures to track which individual was acting as specialist and clerk for each security at all times throughout the trading day and maintain such records in an easily accessible place for a period of at least three years.

4. Annually certify, through SLKS's Chief Executive Officer, that a review has been conducted by the Chief Compliance Officer of trading in SLKS's principal account for the purpose of detecting interpositioning, trading ahead, and unexecuted limit order violations.
5. Bi-annually assess the adequacy of the resources devoted to SLKS's compliance function, and devote adequate funds and staffing to the compliance department.
6. Retain, within four months of the issuance of this Order, an independent consultant ("Independent Consultant"), not unacceptable to the staff of the Commission, to review and evaluate SLKS's compliance systems, policies and procedures, including but not limited to those required by paragraphs E. 1. through E. 5. above, reasonably designed to ensure that SLKS is in compliance with federal securities laws and NYSE rules relating to (i) interpositioning and trading ahead (including unexecuted limit orders), and (ii) SLKS's supervisory responsibilities with respect to these activities. SLKS shall cooperate fully with the Independent Consultant and shall provide the Independent Consultant with access to its files, books, records, and personnel as reasonably requested for the review.
 - a. SLKS shall require the Independent Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, he/she shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with SLKS, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that he/she will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist him/her in performance of his/her duties under this Order shall not, without prior written consent of the Commission, enter into any employment, consultant, attorney-client, auditing or other professional relationship with SLKS, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the engagement and for a period of two years after the engagement.
 - b. SLKS shall require that the Independent Consultant issue a report within 240 days after being retained pursuant to paragraph E. 6. above, recommending (i) policies and procedures reasonably designed to ensure compliance with the federal securities laws and NYSE rules with respect to interpositioning, trading ahead, and unexecuted limit orders, and systems for the surveillance of such specialist trading activity, and (ii) reasonable procedures for implementing such policies, procedures, and systems. In formulating his recommendations, the Independent Consultant shall take steps to ensure that the firm's policies, procedures, and systems with respect to interpositioning, trading ahead, and unexecuted limit orders are reasonably designed to not compromise compliance with other federal or NYSE laws, rules and regulations. Simultaneously with providing that report to SLKS, SLKS shall

require that the Independent Consultant provide the report to the following officials at the Commission: (a) the Director of the Office of Compliance Inspections and Examinations; (b) the Director of the Division of Market Regulation; and (c) the Director of the Division of Enforcement.

- c. SLKS shall adopt all recommendations in the report of the Independent Consultant; provided, however, that within 60 days after the Independent Consultant serves that report, SLKS shall in writing advise the Independent Consultant, and the Commission officials identified in paragraph E. 6.b. above of any recommendations that it considers to be unnecessary, inappropriate, or unduly burdensome. With respect to any recommendation that SLKS considers unnecessary, inappropriate, or unduly burdensome, SLKS need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure or system designed to achieve the same objective or purpose.
- d. As to any recommendation on which SLKS and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement within 60 days after SLKS serves the written advice described in paragraph E. 6.c. above. In the event SLKS and the Independent Consultant are unable to agree on an alternative proposal, SLKS will abide by the determinations of the Independent Consultant.
- e. SLKS: (i) shall not have the authority to terminate the Independent Consultant without the prior written approval of the staff of the Commission; (ii) shall compensate the Independent Consultant, and persons engaged to assist the Independent Consultant, for services rendered pursuant to the Order at their reasonable and customary rates; and (iii) shall not be in, and shall not have, an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client privilege or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports, or documents to the directors identified in paragraph E. 6.b. above, or the Commission.
- f. The Commission staff shall have the authority, in its discretion, to extend, at the written request of SLKS or the Independent Consultant, the dates set forth in paragraphs E. 6.a. through E. 6.e. above.

IV.

In view of the foregoing, the Commission finds that it is appropriate and in the public interest to impose the sanctions specified in the Offer submitted by SLKS.

Accordingly, it is ORDERED that:

- A. Pursuant to Section 21C of the Exchange Act, SLKS cease and desist

from committing or causing any violations and any future violations of Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

- B. Pursuant to Section 15(b)(4)(E) of the Exchange Act, SLKS is hereby censured.
- C. SLKS shall, within ten days of the entry of the Order, pay disgorgement in the total amount of \$28,776,072. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Alexandria, Stop 0-3, VA 22312; and (D) submitted under cover letter that identifies SLKS as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Rosenfeld, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 233 Broadway, New York, New York, 10279.
- D. SLKS shall, within ten days of the entry of the Order, pay a civil money penalty in the amount of \$16,496,406.¹³ Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies SLKS as a Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Rosenfeld, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 233 Broadway, New York, New York, 10279. Such civil money penalty shall be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002 ("Fair Fund distribution"). Regardless of any such Fair Fund distribution, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that it shall not, in any Related Investor Action, benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor in this proceeding that is proportionately attributable to the civil penalty paid by Respondent ("Penalty Offset"). If the court in any Related Investor Action grants such an offset or reduction, Respondent agrees that it shall, within 30 days after entry of a final order granting the offset or reduction, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed against Respondent in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order in this proceeding.

- E. The disgorgement and the civil penalties which shall be added to a Fair Fund (the "Distribution Fund") shall be maintained in an interest-bearing account and shall be distributed pursuant to a distribution plan (the "Plan") drawn up by an administrator (the "Administrator") to be chosen by the staff of the Commission and the NYSE. The Administrator shall identify the customers who were injured as a result of SLKS' trading violations as determined herein by the Commission staff and the NYSE. The Distribution Fund shall be used: (i) to pay the costs of administering the Plan; (ii) to reimburse injured customers for their loss; and (iii) to pay prejudgment interest to injured customers. The Commission shall determine the appropriate use for the benefit of investors of any funds left in the Distribution Fund following such payments. Under no circumstances shall any part of the Distribution Fund be returned to SLKS.
- F. SLKS shall comply with the undertakings enumerated in Section III. E. above.

By the Commission.

Jonathan G. Katz
Secretary

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- 1 The findings herein are made pursuant to SLKS's Offer and are not binding on any other person or entity in this or any other proceeding.
 - 2 Approximately 73% of the customer disadvantage resulting from the conduct alleged herein occurred before October 31, 2000.
 - 3 The DOT system is the NYSE's primary order processing system, supporting equity trading on the trading floor and providing the NYSE with the current status of any equity order. Customers can transmit orders through NYSE member organizations electronically to the floor through the DOT system.
 - 4 The Display Book is an electronic workstation provided by the NYSE to the firm for use by its specialists at their post panels, operated by means of a customized keyboard containing function, letter, number and arrow keys. The Display Book allows specialists to, among other things, receive and process orders, disseminate trade and quote information, report trade executions, research order and execution status, manage positions and view profit and loss in the dealer account.
 - 5 During the trading day, the specialist can cause the Display Book to be "frozen" in a particular security. During the time that the Display Book is frozen, no new DOT

orders in that security can be viewed on the Display Book's display screen, although they continue to queue in "order time" priority. When the Display Book is "unfrozen," DOT orders that queued during the freeze are immediately displayed and viewable on the Display Book's display screen.

- 6 Approximately 82% of the customer disadvantage from interpositioning occurred before October 31, 2000.
- 7 The customer disadvantage from interpositioning in these six stocks for 1999-2003, and the percentage that represents of all of the interpositioning disadvantage at SLKS during that five-year period, are as follows:

TABLE

TER was a specialty stock at a specialist firm that became part of SLKS in June 2002, and VZ was a specialty stock at a specialist firm that became part of SLKS in March 2001.

- 8 The obligation to maintain a fair and orderly market "has a broader reach than the prohibition of 'fraud' and, thereby, imposes stricter standards of integrity and performance on specialists." *Albert Fried & Co.*, 1978 WL 196046, at *5. A transaction not reasonably necessary to maintain a fair and orderly market has been defined as one "not reasonably calculated to contribute to the maintenance of price continuity [on the exchange] and to minimize the effects of temporary disparity between supply and demand." *Weiskopf*, 1980 WL 22091, at *2 fn5 (quoting SEC Release No. 1117 at 2 (March 30, 1937)).
- 9 "Willfully" as used in this Order means intentionally committing the act which constitutes the violation. See *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.
- 10 NYSE Rule 104.10(3) expands on this obligation:

Transactions on the Exchange for his own Account effected by a member acting as a specialist must constitute a course of dealings reasonably calculated to contribute to the maintenance of price continuity with reasonable

depth, and to minimizing of the effects of temporary disparity between supply and demand, immediate or reasonably to be anticipated. Transactions not part of such a course of dealings ... are not to be effected.

- [11](#) Section 3(a)(18) of the Exchange Act defines the term "person associated with a broker or dealer" as "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling, controlled by or under common control with such broker or dealer or any employee of such broker or dealer."
- [12](#) In October 2003, the NYSE modified the operation of the Display Book to include an automated "Principal Inhibitor" function, which is an electronic default that blocks certain specialist dealer trades unless the dealer overrides the default by inputting information representing that the trade is proper. The NYSE advises firms on a daily basis whenever one of its specialists has overridden the Principal Inhibitor.
- [13](#) The disgorgement and civil penalties to be paid by SLKS in this proceeding are also made in satisfaction of payments ordered in a related proceeding being simultaneously instituted by the NYSE.

<http://www.sec.gov/litigation/admin/34-49501.htm>

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