BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Market Regulation, Complainant, vs. John Patrick Leighton Garden City, NY, and Kenneth D. Pasternak Saddle River, NJ, Respondents.	DECISION Complaint No. CLG050021 Dated: March 3, 2010

FINRA staff failed to satisfy their burden of proof with respect to allegations that the respondents failed to supervise reasonably the leading institutional sales trader of their firm. Held, the Extended Hearing Panel majority's findings are reversed, the sanctions imposed are hereby vacated, and the case is dismissed.

Appearances

For the Complainant: James J. Nixon, Esq., Tina S. Gubb, Esq., Michael R. Levy, Esq., Department of Market Regulation, Financial Industry Regulatory Authority

For the Respondents: Joel E. Davidson, Esq., on behalf of John Leighton; Howard Schiffman, Esq., James M. Wines, Esq., on behalf of Kenneth Pasternak

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I. Introduction

This case concerns allegations that Kenneth D. Pasternak ("Pasternak") and John Patrick Leighton ("John Leighton"), respectively the chief executive officer and institutional sales desk manager of Knight Securities, L.P. ("Knight"), a registered broker-dealer and market maker, failed to supervise reasonably Knight's leading institutional sales trader and thus permitted him to defraud institutional investors that bought and sold securities from and to Knight. After a lengthy airing of these claims, Pasternak and John Leighton appeal the Extended Hearing Panel majority's decision, which found that both of the respondents failed to fulfill their supervisory duties with respect to Knight's leading institutional sales trader, in violation of NASD Rules 3010 and 2110.[1]

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1 Following the consolidation of NASD and the member regulation, enforcement, and arbitration functions of NYSE Regulation into FINRA, FINRA began developing a new "Consolidated Rulebook" of FINRA Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See FINRA Regulatory Notice 08-57* (Oct. 2008). Because the complaint in this case was filed before December 15, 2008, the procedural rules that apply are the NASD Rule 9000 Series, as they existed on December 14, 2008. The conduct rules that apply are those that existed at the time of the conduct at issue.

At the outset, we highlight the unique posture with which this matter presents itself to this body. Though ostensibly a case concerning the reasonableness of the respondents' behavior as supervisors, it is the conduct of Knight's leading institutional sales trader, Joseph Leighton, that is the axis upon which the resolution of these proceedings largely pivots. Although he is not named as a respondent in this matter, the complainant, FINRA's Department of Market Regulation ("Market Regulation"), nonetheless alleged that Joseph Leighton engaged in deceptive trading practices in executing orders received from Knight's institutional customers. Market Regulation's complaint as to Pasternak and John Leighton is thus cast with Joseph Leighton as a central, leading character. Pasternak and John Leighton, the theory goes, aware of what Market Regulation has provocatively characterized as Joseph Leighton's "excessive" profits, failed to take steps to supervise reasonably Joseph Leighton's execution of institutional, not-held orders and prevent his deceit.

The majority, side-stepping allegations of fraud, found that Joseph Leighton's trading practices failed to adhere to just and equitable principles of trade in violation of NASD Rule 2110. Market Regulation thus cross appeals the majority's decision. Market Regulation requests that the NAC further examine Joseph Leighton's trading and find, as alleged in the complaint, that his practices amount to fraud under the federal securities laws and FINRA rules. Such a finding, Market Regulation argues, supports imposing sanctions upon Pasternak and John Leighton for their alleged supervisory failures that are stiffer than those levied by the majority's decision.

It is clear to us that Market Regulation's claims and the Extended Hearing Panel majority's findings that John Leighton and Pasternak failed as supervisors are informed and colored in this case by their faulty views of Joseph Leighton's conduct and a tenuous "industry standard" that they claim limited the "profits" he could garner for Knight from his trading. Having conducted a thorough review of the extensive record before us on appeal, and after a careful vetting of the legal theories upon which Market Regulation's complaint and arguments are premised, we conclude that Market Regulation did not prove its claims. We therefore reverse the Extended Hearing Panel majority's decision. In doing so, we dismiss the allegations set forth in Market Regulation's complaint and vacate the sanctions imposed.

II. Procedural Background

A review and understanding of the backdrop that sets these proceedings is necessary to resolve a number of issues before the NAC and to properly frame a discussion of the substantive legal issues that we are called upon by the parties to address through their respective appeals.

A. Market Regulation's Complaint

On March 4, 2005, Market Regulation filed a one-cause complaint initiating disciplinary proceedings against Pasternak and John Leighton. Market Regulation's claims are premised upon allegations that, from January 1999 through September 2000, Joseph Leighton improperly disadvantaged institutional orders to obtain "exorbitant," "extraordinary," and "excessive" trading "profits" for Knight, in which he personally shared.[2] Specifically, Market Regulation alleges that Joseph Leighton, John Leighton's brother, engaged in a pattern of misconduct whereby orders, executed for institutional investors on a "net" basis, were filled at prices that were contrary to industry "custom and expectation." These conventions, Market Regulation argues, required Joseph Leighton and Knight to sell (purchase) securities to (from) institutional customers at the market price or prices at which Knight acquired (sold) the stock necessary to fulfill their "not-held" orders, after accounting for some amount of "reasonable compensation." Market Regulation complains that Joseph Leighton instead ordered Knight to take positions in the ordered securities but deceitfully delayed the execution of the institutional orders, trading securities with the institutions at unfavorable prices that reflected changes in the market and allowed him to manufacture greater "profits." Market Regulation asserts that, by failing to disclose Knight's cost (sales) basis in the securities sold to (bought from) institutions and deviating from what has been termed in these proceedings as "cost-plus" pricing, Joseph Leighton deceived Knight's institutional customers, hid from them the extent of Knight's compensation, and obscured the quality of the prices at which their orders were executed. Joseph Leighton's conduct, Market Regulation contends, thus violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110.[3]

The first and only cause of Market Regulation's complaint alleged that Pasternak and John Leighton failed as supervisors of Joseph Leighton's trading activities, in violation of NASD Rules 3010 and 2110. With respect to these claims, Market Regulation's overriding grievance is that Pasternak and John Leighton, knowing of Joseph Leighton's "extraordinary" "profits" and his status as Knight's leading institutional sales trader, failed to implement and take steps designed to supervise reasonably Joseph Leighton's trading and prevent his alleged fraud. Market Regulation declares that John Leighton, Joseph Leighton's immediate supervisor, was an inherently conflicted supervisor and did not conduct any meaningful supervisory review of Joseph Leighton's trading. Market Regulation further claims that Pasternak sanctioned an inherently defective supervisory system, did not ensure that John Leighton adequately supervised his brother, and failed to himself reasonably supervise Joseph Leighton's trading.[4]

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2 Like Joseph Leighton, Knight was not named as a respondent in Market Regulation's complaint.

3 Market Regulation does not claim that Joseph Leighton's trading practices violated any other provision of the federal securities laws or FINRA rules.

4 In its complaint, Market Regulation further alleged that Joseph Leighton engaged in fraudulent proprietary, "back-book" trading opposite Knight's institutional customers and that Pasternak failed to supervise reasonably "back-book" trading activities. The Extended Hearing Panel made no findings concerning these allegations and Market Regulation does not address the Extended Hearing Panel's silence on these issues in its cross appeal or in its appellate briefs. We therefore do not address issues of alleged improper "back-book" trading in our decision and deem the issues waived. *See* NASD Rule 9311(e).

B. The Hearing and the State of the Record

John Leighton and Pasternak each timely answered the complaint, denied any wrongdoing, and requested a hearing. A disciplinary hearing before the Extended Hearing Panel commenced on May 1, 2006, and lasted 12 days.

1. Witness Testimony

At the hearing, the parties tendered the testimony of 14 witnesses that appeared before the Extended Hearing Panel. During the presentation of its evidence, Market Regulation directly examined 10 witnesses. These witnesses included five "buy-side" traders from the institutions allegedly defrauded by Joseph Leighton; John Hewitt ("Hewitt"), Pasternak's successor as president of Knight effective as of June 1999; Alan Levinson, a former Knight market maker; John Howard, a member of Knight's financial staff who authenticated certain documents; Gregory Cavallo ("Cavallo"), a former Knight institutional sales trader; and, lastly, a member of Market Regulation's staff who provided summaries of Joseph Leighton's institutional trading and estimations of his trading "profits."

John Leighton and Pasternak each testified before the Extended Hearing Panel during the respondents' presentations of evidence. The respondents also proffered the live testimony of an expert witness, Michael Wolk ("Wolk"), and of Knight's chief compliance officer, Leonard Amoruso ("Amoruso").

2. Documentary Evidence

As to documentary evidence, the parties presented 118 exhibits to the Extended Hearing Panel at the disciplinary hearing. These exhibits included designated and counter-designated excerpts from a small portion of the recorded testimony of six individuals, including that of Joseph Leighton and Michael Dorsey ("Dorsey"), Knight's general counsel at the time of the events at issue.

The testimony and documentary evidence presented to and discussed by the parties and their witnesses before the Extended Hearing Panel, however, represents a small fraction of the evidentiary record now before the NAC on appeal. During the final pre-hearing conference, the parties orally informed the Hearing Officer that the parties had agreed that "all the exhibits and demonstratives [listed on the parties' pre-hearing exhibit lists] are admitted into evidence and can be used at the hearing." Thus, "as to all identifying exhibits, demonstratives, et cetera . . . there won't be any quarrel with regard to authenticity or admissibility or use." As a result of the foregoing stipulation, the record before us on appeal includes over 1,500 exhibits, the vast preponderance of which were never presented to or discussed before the Extended Hearing Panel during the disciplinary hearing. This evidence includes 107 days' worth of transcripts and video recordings of sworn testimony given by 42 individuals in: FINRA's investigation of this matter; a parallel investigation undertaken by the Commission; a civil lawsuit filed by the Commission against John Leighton and Pasternak in federal court; and an arbitration proceeding brought against Knight and Pasternak by Robert Stellato ("Stellato"), John Leighton's successor as head of Knight's institutional sales department effective as of August 2000.[5]

3. Disputes Over the Use of Recorded Testimony

Despite this stipulation concerning the admissibility of all exhibits identified on the parties' pre-hearing exhibit lists, the parties proceeded to the hearing with different views concerning the use of recorded testimony to argue in support of their claims and defenses. Market Regulation staff did not view the presentation of designated and counter-designated testimony as preventing them, at any time after the hearing, from making arguments about or drawing inferences from any of the recorded testimony that had been identified as exhibits on the parties' pre-hearing filings. Respondents, on the other hand, viewed the designation and counter-designation of recorded testimony as a process of "adding to the record" and objected that permitting the use of recorded testimony, without limit, would be akin to "trial by ambush" and prejudiced them because they would not know the full extent of the evidence upon which Market Regulation intended to support its claims until after the hearing had been completed.

The Hearing Officer resolved this dispute by ruling that the parties had agreed to admit into evidence all of their proposed exhibits, including recorded testimony. The Hearing Officer stated that if the parties wished to designate recorded testimony and present that testimony to the Extended Hearing Panel to "enhance the clarity of presentation," fairness required that the other parties be permitted to counter-designate other portions of the offered testimony to ensure completeness. The Hearing Officer further ruled, however, that the parties were free to draw upon any recorded testimony that was part of the record in their post-hearing arguments and briefs.

4. Admission of Stipulated Evidence Was Proper

On appeal, Pasternak avers that the respondents were denied the fair process to which they were entitled under the Exchange Act as a result of the Hearing Officer's ruling. Pasternak asserts that by allowing the unfettered use of recorded testimony, the respondents were confronted "with substantial elements of surprise and haste." We disagree. Evidentiary stipulations are a "valuable and integral" part of everyday litigation practice. *United States v.*

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[5] In his arbitration filing, Stellato sought $25 million in damages based, among other things, upon claims of breach of contract, fraud, and wrongful termination. Stellato claimed that Knight terminated him because he objected to illegal trading practices being undertaken by Joseph Leighton. On September 20, 2004, a FINRA arbitration panel awarded Stellato $19,101 on his breach of contract claim. This sum represented immaterial underpayments of agreed-upon compensation. The arbitration panel otherwise dismissed Stellato's remaining claims, noting that although Stellato averred that Joseph Leighton was engaged in wrongdoing Stellato never sought to leave Knight, continued to express "unbridled optimism about Knight's future," and failed to establish that he was the victim of any retaliatory action because of his alleged disclosures.

Mezzanatto, 513 U.S. 196, 203 (1995). Parties frequently agree to the admission of otherwise objectionable evidence for various strategic reasons and such stipulations are routinely honored. *Id.* FINRA procedural rules clearly contemplate that the parties litigating FINRA disciplinary claims will enter into evidentiary agreements during the pre-hearing conference. *See* NASD Rule 9241(c)(3). Absent evidence that the parties' stipulation was entered into unknowingly or involuntarily, we conclude that the Hearing Officer was well within his authority to accept and enforce the evidentiary stipulation put forth by the parties.[6] *See Mezzanatto*, 513 U.S. at 210; *see also* NASD Rule 9235(a) (outlining a Hearing Officer's broad authority to regulate the course of a hearing).

C. The Extended Hearing Panel's Majority Decision and Dissenting Opinion

1. Majority Decision

On April 11, 2007, the Extended Hearing Panel issued the majority's decision and the opinion of a dissenting panelist. The panel's majority focused upon Joseph Leighton's trading and concluded that, "by disregarding Knight's costs when pricing executions to his customers," "Joseph Leighton gave no consideration at all to whether he had obtained the best price" for the institutions with which he traded. Instead, the majority found, Joseph Leighton priced the stock he sold to (purchased from) institutions at or near the "volume-weighted average price," a price that was "intentionally selected to maximize his profits" after secretly delaying the execution of trades. The panel further concluded that Joseph Leighton did not disclose to Knight's institutional clients that he priced their "not-held" orders without regard to Knight's cost. The majority stated that Joseph Leighton "led [institutions] to conclude that he priced their order in a manner consistent with general industry practice by adding a mark up of $.06 to $.125 per share to Knight's acquisition cost" and "misled [them] into believing that they received best execution services at least as good as, if not superior to, the generally prevailing industry practice." Although, in an apparent contradiction, the majority concluded that Joseph Leighton was under no "obligation" to provide institutions with "cost-plus" pricing, it nevertheless found that Joseph Leighton violated NASD Rule 2110 by withholding information concerning Knight's costs "to take advantage of the customers' ignorance" and "inability to verify that they received the best

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6 The admissibility of such evidence, of course, does not determine the weight to be given to any evidence admitted as a result of the parties' stipulation. Furthermore, although we find no error in the Hearing Officer's ruling, we encourage the parties to FINRA disciplinary proceedings, as well as FINRA adjudicators, to consider in the future the efficacy of such stipulations from both the perspective of the parties' advocacy and the interests of justice, especially where such a large volume of evidence is in play. Finally, we note that FINRA Hearing Officers at all times retain the discretion to reject the enforcement of evidentiary stipulations that call for the admission of irrelevant, immaterial, unduly repetitious, or unduly prejudicial evidence. *See* NASD Rule 9263(a); *cf. Noel Shows, Inc. v. United States*, 721 F.2d 327, 330 (11th Cir. 1983) (finding that the fact that parties have stipulated to the admission of evidence does not deprive a trial judge of the power to exclude evidence under Rule 403 of the Federal Rules of Evidence).

possible prices." The panel's majority decision does not analyze or discuss whether Joseph Leighton's conduct, as alleged in Market Regulation's complaint, constituted fraud under the federal securities laws and FINRA rules.

Turning to the alleged misconduct of the respondents, the majority found that Pasternak and John Leighton each failed in their roles as supervisors of Joseph Leighton's trading activities. The majority concluded that Pasternak "disowned" supervision of Knight's institutional sales trading and failed to ensure that John Leighton fulfilled the supervisory duties that had been delegated to him, particularly given the fact that Joseph Leighton made "inordinately high profits" and that Knight's systems did not automatically monitor the profits earned from the execution of individual institutional, not-held orders. As to John Leighton, the panel's majority found that John Leighton failed reasonably to supervise his brother's trading. In this respect, the majority concluded that John Leighton "allowed Joseph Leighton to implement a pricing stratagem that deprived his customers of best execution." In sum, the majority concluded 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 John Leighton's trading activities." "Despite the extraordinary size of Joseph Leighton's sales credits," the majority stated, neither Pasternak nor John Leighton made an effort to monitor the executions that Joseph Leighton provided to institutional clients.

The majority further found that Pasternak failed to respond to certain "red flags" of potential irregularities surrounding Joseph Leighton's institutional trading. The majority concluded that Pasternak received notice of several red flags from Hewitt and Stellato that he was obligated to, but did not, investigate to determine whether Joseph Leighton was taking advantage of Knight's institutional clients. As a result of the foregoing, the majority concluded that the respondents violated NASD Rules 3010 and 2110. For this misconduct, the majority fined each respondent $100,000. The majority also barred John Leighton in all supervisory capacities and suspended Pasternak in all supervisory capacities for two years.

2. Dissenting Opinion

The Extended Hearing Panel's dissenting panelist issued an opinion calling for the dismissal of Market Regulation's complaint. The dissent concluded that Market Regulation failed to meet its evidentiary burden of proof and, in fact, that the evidentiary record undermined Market Regulation's central theory that Joseph Leighton committed fraud by failing to disclose his pricing practices to institutions. In the dissent's view, the evidence conclusively showed that neither Joseph Leighton nor the institutions with which he traded ever discussed the use of cost-plus pricing and Joseph Leighton did not in any way misrepresent to the institutions the manner in which he priced their stock. The dissent further found the record devoid of any evidence that Joseph Leighton increased his profits by secretly delaying executions and taking advantage of movements in a stock's price to the detriment of the institutions with which Knight traded. Plainly stated, the dissent concluded that Market Regulation failed to prove that there was anything improper about the manner in which Joseph Leighton executed not-held orders, on a net basis, for institutions.

The dissent further avowed that John Leighton and Pasternak reasonably fulfilled their supervisory obligations under the facts and circumstances of this case. Market Regulation's supervision charges, the dissent declared, rested upon nothing more than hindsight that disregarded historic levels of market volatility and trading profitability. With respect to allegations that Pasternak failed to respond appropriately to red flags, the dissent concluded that the record did not support this assertion. Instead, the dissent found that Pasternak responded reasonably to concerns, if any, raised by Hewitt and Stellato about Joseph Leighton's trading.

D. Appeals Before the NAC

1. Respondents' Appeal

In accordance with NASD Rule 9311(a), John Leighton and Pasternak each appealed timely the Extended Hearing Panel's majority decision. The respondents take exception with the panel's majority conclusion that Market Regulation proved the existence of irregularities in Joseph Leighton's trading practices. In their view, the majority's conclusion is based upon an unsupported theory that a standard industry practice existed for the execution of institutional "not-held" orders by market makers using cost-plus pricing. The evidence, they argue, clearly established that it was not customary during 1999 and 2000 for institutional clients to request or be concerned about information concerning Knight's costs or trading profits. Instead, they aver, the uniform, unrebutted evidence presented at hearing established that Joseph Leighton provided Knight's institutional clients with executions that accorded with their instructions and met customer objectives.

The respondents also contest the Extended Hearing Panel's majority conclusion that they each violated NASD Rules 3010 and 2110. They argue that Leighton and Pasternak each reasonably fulfilled their supervisory duties. They further assert that they reasonably relied upon Knight's robust and multi-faceted supervisory systems, which, in their view, Market Regulation failed to prove were in any manner deficient. Finally, Pasternak avers that, contrary to the majority's decision, he responded appropriately to concerns raised about Joseph Leighton's trading practices.

2. Market Regulation's Cross Appeal

Market Regulation timely cross appealed the majority's decision under NASD Rule 9311(d). Market Regulation requests that the NAC specifically find that Joseph Leighton's trading was deceptive and in violation of the antifraud provisions of the federal securities laws and FINRA rules. Market Regulation further claims that, given the egregious nature of Joseph Leighton's alleged misconduct, the sanctions imposed upon Pasternak and John Leighton by the Extended Hearing Panel's majority decision are insufficient. It therefore requests that the NAC impose higher fines upon the respondents and further bar Pasternak from acting in any supervisory capacity in the securities industry.

E. Respondents' Motion for Leave to Introduce Additional Evidence and for Preclusion

On August 8, 2005, Commission attorneys commenced a parallel civil enforcement action against Pasternak and John Leighton in the United States District Court for the District of New Jersey. In that action, the Commission sought injunctive relief, disgorgement, and penalties against the respondents, alleging that, as supervisors and senior executives of Knight, they violated provisions of the Securities Act of 1933 and the Exchange Act and aided and abetted frauds committed by Knight through Joseph Leighton.[7]

The core of the Commission's case was that "Joseph Leighton, Knight's most prolific sales trader, engaged in a pattern of fraud by trading for Knight's institutional customers using a method that concealed from the customer the manner in which not held orders were worked, including the use of a delayed execution scheme . . ., which obscured the quality of the execution price, resulting in profits above the industry norm at effectively no risk to Knight."[8] *See SEC v. Pasternak*, 561 F. Supp. 2d 459, 467 (D.N.J. 2008). Joseph Leighton, the Commission averred, thus "failed to make full and appropriate disclosures and failed to provide best execution for orders placed by the institutional customers." *Id.* Commission attorneys alleged that Joseph Leighton's trading amounted to "front-running" that sought to generate profits that the Commission deemed improper. *Id.*

As to Pasternak and John Leighton, the Commission alleged that they knew the manner in which Joseph Leighton was working institutional customer orders and the "extraordinary" profits that Knight was generating from these institutional orders. Thus, the Commission alleged, the respondents knew, or were reckless in not knowing, of Joseph Leighton's alleged frauds. *Id.* The Commission also averred that, by failing to disclose the manner in which Joseph Leighton priced executions to Knight's institutional customers, Pasternak and John Leighton participated in the fraud and misled customers into believing that they were receiving best execution services. *Id.* Finally, the Commission claimed that Pasternak and John Leighton each had a fiduciary duty to disclose Joseph Leighton's trading profits to customers, which they breached. *Id.*

On June 24, 2008, after a trial on the merits, the district court dismissed the Commission's claims. The court found that the "SEC failed to prove by a preponderance of the evidence that Joseph [Leighton] made a misrepresentation, an omission where he had a duty to speak, or used a fraudulent device." *Id.* at 510. "Joseph [Leighton] did not commit securities fraud by earning 'excessive' profits, failing to disclose a hypothetical mark-up . . . engaging in a manipulative device, or improperly using ACT modifiers." *Id.* at 510-11. Because the Commission had not proven that Joseph Leighton committed fraud, the district court concluded,

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7 The Commission also alleged that Pasternak was liable as a "control person" of the firm.

8 This industry norm, the Commission claimed, was to execute institutional not-held, net-priced orders, at Knight's cost, "plus some reasonable amount of compensation."

the Commission's claims against Pasternak and John Leighton, "both on theories of primary and secondary liability, must fail." *Id.* at 511.

1. Respondents' Motion to Adduce Additional Evidence

On July 18, 2008, Pasternak filed a motion, joined by John Leighton, seeking leave to add to the record of these proceedings the record developed in the district court trial.[9] The respondents also request that we admit as "evidence" here the district court's opinion and give the opinion a preclusive effect warranting the dismissal of the claims now before us. The Subcommittee empanelled to consider this matter before the NAC has decided to deny the respondents' motion. We accept the Subcommittee's decision as our own.

NASD Rule 9346(a) permits us to amend the record with new evidence only under the "extraordinary circumstances" enumerated under NASD Rule 9346(b). These conditions require those seeking to introduce additional evidence to describe each item of new evidence proposed, to demonstrate good cause excusing the failure to introduce the evidence below, and to establish the materiality of the evidence to the issues before the NAC. NASD Rule 9346(b). Leave to introduce new evidence must be sought from the NAC not later than 30 days after the Office of Hearing Officers transmits to the NAC the index to the record. *Id.* Parties may request an extension of this period by demonstrating that there was good cause for the failure to introduce the additional evidence during the prescribed period. *Id.*

With respect to the trial record before the district court, the respondents' motion (filed more than one year after the deadline set forth in NASD Rule 9346(b)) does not describe each item of proposed new evidence, explain why the respondents failed to introduce the evidence below, or assert why each piece of new evidence is material to the issues before us. Rather, the respondents' motion only generally depicts the district court's trial record as containing evidence that "is virtually identical to that presented to the Hearing Panel in the FINRA disciplinary proceeding," including testimonial evidence "substantially similar" to that given by virtually the same roster of witnesses that appeared before the Extended Hearing Panel. Assuming that the evidence within the court's trial record is material to the issues we address here, respondents' motion puts forward evidence that is admittedly duplicative and cumulative of the evidence offered by the parties and admitted before the Extended Hearing Panel. Respondents do not claim that they did not possess this evidence at the time of their disciplinary hearing, and there is no indication that they were prevented from adducing the relevant testimony of any witness during the proceedings below. We therefore reject the respondents' contention that good cause exists to excuse either their failure to introduce such evidence to the Extended Hearing Panel or to seek the NAC's leave to introduce the additional evidence within the time period prescribed

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[9] The Commission did not appeal the district court's decision, and it therefore represents a final adjudication on the merits of the Commission's complaint.

under NASD Rule 9346(b).[10] *Cf.* NASD Rule 9263(a) (citing undue repetition as criteria for excluding evidence).

2. Preclusion

We also reject the respondents' request that we give the district court's opinion preclusive effect in this proceeding. As an initial matter, we decline to receive the court's opinion as "evidence."[11] More directly, the principles of res judicata and collateral estoppel do not warrant that we favor the district court's opinion with preclusion of Market Regulation's claims in FINRA's disciplinary proceedings.[12]

a. Res Judicata

The principle of res judicata, or *claim* preclusion, bars a cause of action adjudicated between the same parties or their privies in a prior case. *Jones v. SEC*, 115 F.3d 1173, 1178 (4th Cir. 1997), *cert. denied*, 523 U.S. 1072 (1998). Respondents principally argue that FINRA may no longer consider sanctioning them for violations of FINRA rules when the district court dismissed the Commission's civil lawsuit covering the same or similar alleged misconduct. We disagree.

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10 That the district court reviewed evidence that is the same as or substantially similar to the evidence considered by the Extended Hearing Panel, and reached a decision on the merits of issues similar to those we face in this proceeding, does not in our view warrant expansion of the voluminous record we find before us.

11 Although the formal rules of evidence do not apply here, we conclude that substantial authority weighs against admitting the district court's opinion as a matter of sound adjudicatory policy due to the danger of undue prejudice and the potential to disrupt the orderly administration of FINRA disciplinary proceedings. *See* 2 McCormick on Evidence § 298 (6th ed. 2009) ("[I]f prior judgments are admissible parties offering them will rely heavily on them and not introduce significant other evidence with the result that the evidence available in the second case does not support a reliable decision."); *see also Herrick v. Garvey*, 298 F.3d 1184, 1192 (10th Cir. 2002) ("[F]indings of fact in a prior judgment could result because of default by an opposing party, stipulations between the parties, or a strategic choice by a party to not contest certain factual claims."); *United States v. Jones*, 29 F.3d 1549, 1553 (11th Cir. 1994) ("If it were permissible for a court to take judicial notice of a fact merely because it has been found to be true in some other action, the doctrine of collateral estoppel would be superfluous."); *Nipper v. Snipes*, 7 F.3d 415, 418 (4th Cir. 1993) ("[O]ur decision [to exclude judicial findings of fact] comports with sound judicial policy.").

12 The respondents also invoke the notion of "double jeopardy" to oppose further litigation of Market Regulation's claims before us on appeal. The concept of double jeopardy, however, does not apply to FINRA disciplinary proceedings, which are remedial in nature. *See Kirk A. Knapp*, 51 S.E.C. 115, 130-31 & n.69 (1992).

To establish a res judicata defense, a party must establish three elements: a final judgment upon the merits in a prior action, an identity of the cause of action in both the earlier and later action, and an identity of the parties or their privies in the two actions. *Jones*, 115 F.3d at 1178; *Dep't of Enforcement v. Robert Tretiak*, Complaint Nos. C02990042, C02980085, 2001 NASD Discip. LEXIS 1, at *52 (NASD NAC Jan. 23, 2001), *aff'd*, Exchange Act Rel. No. 47534, 2003 SEC LEXIS 653 (Mar. 19, 2003). Although the district court's opinion represents a final judgment upon the merits of the Commission's claims, respondents have not met the final two conditions necessary to preclude Market Regulation's claims before FINRA adjudicators.

First, the two causes of action are not the same. *See Jones*, 115 F.3d at 1178 ("[T]he nature of the statutory scheme and the relationships between the parties under it reveal that NASD's enforcement action is not the same cause of action as the SEC's own later enforcement action."). The Commission's civil injunctive action, although also premised upon allegations that Joseph Leighton defrauded Knight's institutional customers using deceptive pricing practices, represented a claim that Pasternak and John Leighton violated provisions of the federal securities laws and aided and abetted Joseph Leighton's fraud. Market Regulation, on the other hand, requests disciplinary sanctions for the respondents' alleged failure to supervise, in violation of FINRA rules, Joseph Leighton's allegedly deceptive misconduct.

Second, the Commission and FINRA are not the same party nor are they privies. While the Commission and FINRA both seek to protect investors and preserve the integrity of the markets, their respective roles, while sometimes overlapping and coordinated, represent distinct legal interests. *Id.* at 1180-81. Their disciplinary authority reflects a considered statutory decision to permit enforcement actions brought from two separate vantage points. *Id.* The dismissal of the Commission's civil action in federal court thus does not preclude our review of Market Regulation's FINRA-based disciplinary action. *See Knapp*, 51 S.E.C. at 131 ("The NASD has an independent statutory mandate to enforce the provisions of the Exchange Act, as well as its own rules."). Res judicata considerations do not apply here.

b. Collateral Estoppel

The principle of collateral estoppel is a narrower variety of preclusion. *Walzer v. Muriel, Siebert & Co.*, 2007 U.S. App. LEXIS 7859, at *7 (3d Cir. Apr. 4, 2007). Collateral estoppel refers to the preclusive effect of a judgment that bars a party or his privy from litigating a second time an issue of fact or law that has been decided against the party or privy in a prior proceeding. *Parklane Hosiery Co., Inc., v. Shore*, 439 U.S. 322, 326 (1979). "Collateral estoppel, or issue preclusion, deals with the relitigation of issues previously decided, when those issues arise in a subsequent litigation on a claim not barred by claim preclusion (res judicata)." 18 Moore's Federal Practice § 132.01 [2] (Matthew Bender 3d ed. 2009). The second cause of action is thus upon different claims or causes and a judgment in the first action precludes revisiting issues actually litigated and necessary to the outcome of the first. *Parklane*, 439 U.S. at 327.

Similar to claim preclusion requirements, issue preclusion will not be applied against a party that was neither a party nor a party's privy in the prior adjudication. As we conclude above, there exists no identity of the parties in the Commission's civil lawsuit and Market Regulation's disciplinary action. Market Regulation was neither a party to the Commission's federal court action nor is it the Commission's privy.[13] We therefore find that the principle of collateral estoppel also is not applicable here.[14]

III. Facts[15]

A. Pasternak and Knight's Market Making

Pasternak is a securities industry veteran. He started his career with Troster Singer, a subsidiary of Spear, Leeds & Kellogg, in 1979, where he eventually became that firm's trading room manager. During his tenure, Troster Singer was the leading market maker, measured by trading volume, in securities listed on The Nasdaq Stock Market, Inc ("Nasdaq").[16]

Pasternak left Troster Singer in 1994 to co-found what was envisioned as a "next-generation," technologically advanced firm that would serve the burgeoning order execution needs of self-directed retail investors trading online through discount and other brokerage firms.

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13 We are cognizant of the fact that, on February 28, 2006, prior to the commencement of the respondent's FINRA-based disciplinary hearing, Market Regulation moved to stay the proceedings against Pasternak and John Leighton, citing the existence of the then-pending civil enforcement matter initiated against the respondents by the Commission in federal court. Market Regulation asserted that good cause existed for its motion because the Commission's "prosecution of [r]espondents on the same facts and broader, overlapping charges may obviate the need for [sic] hearing in this matter." Market Regulation's motion, although denied, highlights the overlapping nature of some issues that exists between the two causes of action, particularly as it relates to Joseph Leighton's alleged misconduct. Therefore, although it is not binding upon this body, we do not, as Market Regulation now requests, turn a blind eye to the district court's opinion. We have looked to the court's opinion with special attention to certain issues, as we would any other decision issued by a court with jurisdiction over claims involving the federal securities laws, and cite it where appropriate.

14 Leighton and Pasternak argue that it is "manifestly unfair" to require them to endure an appellate process before the NAC, and possibly the Commission, when a federal court has considered and rendered a decision on issues that are presently under review by the NAC. While actions by both the Commission and FINRA for arguably the same conduct may, "in the abstract, offend a certain sense of fairness, our system tolerates it and, at times, even requires it. . . . While both levels may be sanctioning the same conduct, they are serving separate interests." *Jones*, 115 F.3d at 1181.

15 All of the findings set forth herein are based upon our view of the preponderance of the evidence. *See David M. Levine*, Exchange Act Rel. No. 48760, 2003 SEC LEXIS 2678, at *36 n.42 (Nov. 7, 2003) (holding that preponderance of the evidence is the standard of proof in self-regulatory organization disciplinary proceedings).

16 At the time of the events at issue in this matter, Nasdaq was an electronic interdealer quotation system used by broker-dealers to make markets in securities and execute trades.

Knight was formed in 1995 to give birth to this idea and for the purpose of making markets in Nasdaq securities and securities quoted on the Over-the-Counter Bulletin Board ("OTCBB").[17]

Knight, at all times relevant to Market Regulation's claims, was a "wholesale" market maker, meaning that the firm held no accounts for customers and therefore did not conduct any direct retail trading.[18] Rather, Knight provided trade executions by offering to buy securities from (or sell to) other broker-dealers and institutional investors. All of the trading conducted by Knight was therefore done on a principal basis.[19]

Knight experienced rapid growth after its formation. By 1998, Knight was the leading market maker, in terms of volume, in Nasdaq securities. The volume of Nasdaq securities traded by Knight increased from 1.4 billion shares in the month of January 1998 to 6.4 billion shares traded in the month of December 2000. By December 31, 2000, Knight was making markets in approximately 9,100 Nasdaq and OTCBB equity securities and had, for the calendar year, enjoyed trading volume totaling 90.8 billion shares.

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17 In 1995, Pasternak and the other co-founders of Knight also acquired Trimark Securities, Inc. ("Trimark"), a broker-dealer that made markets in the over-the-counter market for certain exchange listed stocks. Knight and Trimark were subsidiaries of Roundtable Partners, LLC. Roundtable Partners, LLC, was succeeded by Knight/Trimark Group, Inc. ("Knight/Trimark"), in April 1998. Knight/Trimark was succeeded by Knight Trading Group, Inc. ("Knight Trading Group"), in January 2000. In addition to its broker-dealer subsidiaries, Knight Trading Group operated several asset management businesses and was a party to a number of joint ventures with international equity trading firms. For ease of mention, any reference in this decision to Knight's parent company will be to Knight Trading Group.

18 A "market maker" is defined under Exchange Act Section 3(a)(38) as meaning "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who with respect to a security, holds himself out . . . as being willing to buy and sell such security for his own account on a regular or continuous basis." 15 U.S.C. § 78c(a)(38).

19 A "principal" trade is a trade in which a broker-dealer buys or sells for an account in which the broker-dealer has a beneficial interest. *NASD Notice to Members 01-85* (Dec. 2001). Knight in this case thus accumulated positions and executed trades with other broker-dealers and institutions as one principal to another using its proprietary market-making accounts. Market makers, like Knight, are primarily compensated and profit from the differences or "spread" between the prices at which they buy and sell securities for their proprietary accounts.

In contrast, an "agency" trade is a trade that does not pass through the broker-dealer's proprietary account, but is instead executed by the broker-dealer as an intermediary with third parties for the account of its customer. *Id.* When executing an agency trade, the broker-dealer generally is compensated by charging a commission for its execution services. *Id.*

As the firm's chief executive officer and, until June 1999, its president, Pasternak was responsible for the overall supervision of Knight and its employees.[20] Until August 2000, Pasternak also acted as Knight's trading room manager, responsible for supervising the firm's proprietary trading and market-making activities. While associated with Knight, he was registered as a general securities principal, general securities representative, and limited representative - equity trader of the firm. Pasternak's association with Knight ended in January 2002, at which time his registrations with the firm were terminated.[21] Pasternak has not been associated with a FINRA member broker-dealer since leaving Knight.

B. John Leighton and Knight's Institutional Sales Department

John Leighton first registered as a securities industry professional in 1987 and thereafter worked as an institutional sales trader for several years with several firms. At its inception in 1995, John Leighton joined Knight and immediately assumed responsibility for hiring other institutional sales traders and building Knight's institutional sales department. At all relevant times, John Leighton acted as Knight's institutional sales desk manager and was responsible for supervising the firm's institutional sales department.[22] As a senior vice-president of the firm, John Leighton reported directly to and was supervised by Pasternak.[23]

Knight's institutional sales department, which received orders from institutional customers, including mutual funds, investment advisors, pension plans, trusts, and endowments, was organized by teams. Each team was headed by a team captain that reported directly to John Leighton and consisted of institutional sales traders, assistant traders, and clerks. By 1999, John Leighton was responsible for the supervision of approximately five institutional sales teams and 100 individuals.

Institutional investors represented the fastest growing component of Knight Trading Group's revenues and accounted for a large portion of its equity order flow. Knight's institutional sales traders and assistant traders acted, in effect, as intermediaries between

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[20] By December 31, 2000, Knight employed 672 individuals, of which 387 were engaged in market making and institutional sales trading. At all relevant times, Pasternak also served as the chief executive officer and president of Knight Trading Group and spent a substantial portion of his time on issues related to the business activities of Knight's publicly traded holding company. As of December 31, 2000, Knight Trading Group had 1,364 full-time employees.

[21] Pasternak retired at the same time from Knight Trading Group.

[22] In addition to his responsibilities for Knight's institutional sales department, John Leighton also guided the firm's "e-commerce" initiatives and Boston branch office.

[23] In John Leighton's absence, Pasternak was responsible for the supervision of Knight's institutional sales department. There is no evidence, however, that Pasternak was ever required to assume direct supervisory responsibility over the institutional sales department for this purpose.

institutions and Knight's market-making department. Knight's institutional sales department received orders from institutions and worked with Knight's market makers to fill the orders. All dialogue with the institutions was handled by the institutional sales traders and assistant traders. Knight's market-making department, however, was ultimately responsible for purchasing (selling) the securities necessary to fulfill the orders received from Knight's institutional customers. Transaction executions were reported to the institutions by Knight's institutional sales traders and assistant traders and reported to the market by Knight's trade reporting systems.

While associated with Knight, John Leighton was registered with the firm as a general securities principal, general securities representative, and limited representative - equity trader. John Leighton's association with Knight ended in December 2000, at which time his registrations with the firm were terminated.

C. Joseph Leighton's Position as Knight's Leading Institutional Sales Trader

Joseph Leighton was the first institutional sales trader hired by John Leighton at Knight, joining the firm as a senior vice-president in 1996.[24] Joseph Leighton acted as the assistant institutional sales department manager and as a team captain responsible for other institutional sales traders, assistant traders, and clerks. Joseph Leighton thus reported to and was supervised directly by John Leighton. While associated with Knight, Joseph Leighton was registered with the firm as a general securities principal, general securities representative, and limited representative – equity trader. Joseph Leighton also separated from Knight in December 2000, and his registrations with the firm were terminated at that time. Joseph Leighton is no longer a securities industry registrant.

Upon joining Knight, Joseph Leighton assumed responsibility for the institutional sales trading previously performed by John Leighton.[25] Joseph Leighton also cultivated new relationships with several large institutional customers. The roster of institutions with which Joseph Leighton traded represented a concentration of the largest institutions with which Knight enjoyed a relationship, including Putnam Investment Management, Inc., Fidelity, T. Rowe Price Associates, Trust Company of the West, and Delaware Investment Advisors, Inc. These institutions were conducting significant trading through Knight in highly volatile, high-volume, high-priced Nasdaq securities.[26] As a result, Joseph Leighton became the institutional sales

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24 Before associating with Knight, Joseph Leighton acquired several years of experience working in institutional sales for other broker-dealers.

25 From the time he joined Knight in 1995, until Joseph Leighton joined the firm in 1996, John Leighton conducted all institutional sales trading for the firm. Thereafter, John Leighton did not himself regularly trade with institutions unless called upon to do so because of staff absences or heavy order flow.

26 The years 1999 and 2000 reflected an historical period of large trading volume and high volatility for Nasdaq securities. It was not uncommon for the prices of certain high-priced biotechnology and internet-related stocks to increase or decrease substantially during a single day. The Nasdaq market experienced its most extreme intra-day volatility during the early part

[Footnote continued on next page]

department's largest producer and Knight's leading institutional sales trader. In addition to the coveted list of institutions with which he traded, Joseph Leighton possessed a reputation as being a talented, professional sales trader, utilizing his understanding of the market to realize opportunities that generated profit opportunities for Knight, while providing institutions with quality trade executions. Joseph Leighton also possessed a reputation within Knight as a trader that took big risks by committing the firm's capital.

From 1996 through March 2000, in an arrangement endorsed by Pasternak, Joseph Leighton and John Leighton shared equally certain compensation, other than John Leighton's salary and certain management pool bonuses, that each earned from Knight. This included 10 percent of the gross "sales credits" attributed to Joseph Leighton for his institutional sales trading and overrides that John Leighton earned on all of Knight's institutional sales trading.[27]

D. Joseph Leighton's Execution of Not-Held Orders

This case is concerned solely with "not-held" orders placed by institutions with Knight's institutional sales department and executed by Joseph Leighton. Not-held orders were the common vehicle through which institutions placed large-volume orders for Nasdaq securities with market makers during the volatile period in which the trading at issue in this case occurred.[28] A not-held or "working" order is an order voluntarily categorized to permit a broker-dealer to trade with others as principal at any price without being required or "held" to execute the order with the immediacy and price requirements of a market or limit order.[29] *NASD Notice to Members 97-57* (Sept. 1997). A customer placing a not-held order instead grants the broker-dealer discretion as to the price and time at which the trade is executed. *Id*; *see also* NASD Rule 2510(d)(1). A broker-dealer receiving a not-held order agrees to use its judgment to obtain an execution for the volume of stock sought to be purchased (sold) by the customer that is

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of 2000. In this environment, top Nasdaq market makers, including Knight, experienced significantly higher trading revenues.

27 The Leightons' joint compensation structure changed beginning on April 1, 2000. At that time, Joseph Leighton and John Leighton ceased sharing compensation and Pasternak increased Joseph Leighton's sales credit payout rate to 15 percent. John Leighton continued to earn a percentage of the total "payouts" made to the entire institutional sales department.

28 These orders generally involved the buying or selling of 100,000 shares or greater of a particular Nasdaq security.

29 A "market" order is an order to buy (sell) a stated amount of a security at the best possible price at the time the order is received in the marketplace. *See FINRA Glossary*, http://www.finra.org/Glossary/index.htm. A "limit" order, by contrast, is an order to buy (sell) a security at a customer-specified price. *Id.*

satisfactory to the customer, given the customer's instructions, any agreed upon terms, and market conditions.[30] *NASD Notice to Members 97-57.*

By using not-held orders for their trading, institutions requested that Joseph Leighton utilize his skill, knowledge, and experience to determine the prices and volumes at which to purchase (sell) securities to satisfy their orders. As the testimony and evidence marshaled by the parties makes clear, not-held orders afforded Joseph Leighton the discretion to "work" orders at prices and volumes that best represented the institutions' trading objectives, while providing institutions market anonymity. Rather than executing entire orders at once, not-held orders permitted Joseph Leighton and Knight's market makers to accumulate small portions of each order in an orderly fashion over a period of time and to execute or "print" those shares to the institutions at a subsequent time.

Joseph Leighton and his assistant traders received not-held orders from institutions primarily by phone. "Buy-side" traders, who represented institutions and their portfolio managers, provided Joseph Leighton with instructions concerning how to execute their orders, including any price parameters and the volume of stock to be traded. Order tickets were subsequently written documenting Knight's receipt of each order. Joseph Leighton testified that although he or his assistant traders noted any "special instructions" concerning an order and attached the instructions to the order ticket, not-held orders were generally traded pursuant to standard instructions or common understandings gleaned from long-standing trading relationships with the institutions he served.[31] Joseph Leighton further testified that he discussed and understood the goals and expectations of each of the institutions with which he traded. From his perspective, institutions wanted generally to buy (sell) substantial amounts of stock, and they wished to do so at prices that were reflective of all trading in the security during the period in which their orders were being traded by Knight.[32]

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30 Agreed upon terms will include the terms under which the order will be worked and the compensation the broker-dealer is to receive. *NASD Notice to Members 97-57.*

31 Neither Joseph Leighton nor the institutional buy-side traders that testified could recall any specific instructions given by the institutions concerning the trades at issue in this case and no documentary or other evidence of any such instructions exists.

32 The Extended Hearing Panel's majority found that Joseph Leighton's testimony in this case "lacked credibility" and "conflicted with the customers' testimony." We conclude that this credibility determination, because it is based solely upon the majority's review of Joseph Leighton's previously recorded testimony, is not due our deference. *Cf. Keith Springer*, Exchange Act Rel. No. 45439, 2002 SEC LEXIS 364, at *20 (Feb. 13, 2002) ("It is well settled that credibility determinations of an initial fact-finder are entitled to considerable weight and deference, since they are based on hearing the witnesses' testimony and observing their demeanor."). Joseph Leighton's recorded testimony, taken both by FINRA and Commission staff, is hearsay. In determining whether to rely upon hearsay evidence, it is necessary to evaluate its probative value, reliability, and fairness of use. *Charles D. Tom*, 50 S.E.C. 1142, 1145 (1992). Factors to consider in this respect include, among other things, the type of hearsay

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After completing an order ticket, Joseph Leighton or his assistant traders contacted Knight's market-making department. They provided the relevant market maker with instructions concerning each order and advised the market maker how to trade the security at issue. Upon receiving instructions from the institutional sales trader, Knight's market-making department proceeded, if necessary, to accumulate a proprietary position in the security necessary to fulfill an institution's order.[33] Joseph Leighton stated that it was his practice to instruct Knight's market makers to actively engage the market, to "find spots" where Knight could buy (sell) stock for its proprietary account, while remaining consistent with the desires of institutions to obtain a level of volume "participation" or "representation" that ultimately embodied a certain percentage of the total volume of trading in that stock both at and away from Knight.

Joseph Leighton and his assistant traders continually monitored the trading being conducted by Knight's market makers. Joseph Leighton testified that he maintained a constant dialogue with Knight's market makers concerning the securities for which he was working orders and advised them of continuing institutional interest, or the lack thereof, for the securities they were trading. Knight's systems provided institutional sales traders with a summary of Knight's total long or short proprietary position in each security for which Knight made a market, as well as the average cost (sales price) per share and the daily and monthly profit or loss associated with the securities that made up each proprietary position.[34]

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at issue, whether the evidence is signed or sworn, whether the evidence is contradicted by direct testimony, and whether the evidence is corroborated. *Id.*; *see also Springer*, 2002 SEC LEXIS 364, at *21-22. Applying these factors, we find Joseph Leighton's recorded testimony to be reliable. Joseph Leighton testified consistently on several occasions, in several different forums, and attested under oath to certain facts that gave rise to this action. Contrary to the majority's conclusion that Joseph Leighton's recorded testimony was argumentative and inconsistent with customer testimony, we find, based upon our review of the entire record, that the testimony provided by Joseph Leighton was largely corroborated by the institutional, buy-side traders and other witnesses that directly testified at the FINRA disciplinary hearing and was not otherwise marked by any meaningful quarrel. We therefore give Joseph Leighton's testimony significantly more weight than did the panel's majority.

33 Buy-side traders testified that they expected Knight to commit its capital to facilitate the completion of institutional orders, for example by shorting its inventory to facilitate an institution's purchase of a security. A market maker working to fulfill a not-held order could, at Joseph Leighton's discretion, commit Knight's capital to facilitate a trade, resulting in the firm being at risk. Although institutions sometimes requested Knight to commit capital, for example where the institution sought an immediate print to start its order, the testimony of buy-side traders established that they were largely unaware of and indifferent to those instances where Knight would commit its capital to fulfill their orders.

34 As we discuss in further detail below, *infra* Part III.F, Knight's systems did not segregate trading conducted by Knight's market makers to fulfill a particular institutional order from any other institutional, retail, or proprietary trading being conducted by the market maker in the

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Joseph Leighton also testified that, while working not-held orders, he maintained a regular dialogue with the institutions whose orders he was handling. He provided frequent updates to the institutions concerning the volume of securities that had been acquired (sold) by Knight to fulfill their orders and a running average of the prices at which Knight would ultimately print those shares to the institutions.

Consistent with the discretion imparted with the trading of a not-held order, Joseph Leighton could determine the times and prices at which to execute the transactions that filled institutional orders and report the order executions to the market. When doing so, Joseph Leighton admitted, he did not necessarily execute an institutional not-held order contemporaneous with Knight's accumulation of a proprietary position in the security being traded. Instead, he avoided large prints to the market and, consistent with the expectations of institutions, executed smaller fills or partial fills at such times that he was comfortable that Knight had accumulated a quantity of stock that was reflective of the representation sought by institutions in the total trading volume for each particular security and minimized the "footprint" of an institution's trading upon the market.[35]

Joseph Leighton testified that he executed institutional, not-held orders without regard for the prices at which Knight's market makers acquired (sold) the securities that filled the order. He instead priced the stock sold to (bought from) institutions using as a "benchmark" an "average price" or a "volume-weighted average price" that reflected the volume and prices at which the security had traded both at and away from Knight during the life of the institution's order. Joseph Leighton's objectives, which he believed were consistent with those of Knight's customers, were to obtain a final report that "would be satisfactory" to each institution at the end of the trading day, utilizing his "best efforts" to trade the volume of stock that the institution wished to buy (sell) at prices that the institution determined to be acceptable and representative of where the market, as a whole, had traded.

Joseph Leighton therefore viewed Knight as providing institutions "price participation" or a price commitment when executing their not-held orders. If the average price of a particular security traded down substantially, for example when handling an institution's order to purchase stock, the institutions expected, and Joseph Leighton felt obliged to provide, executions reflective of those lower prices. Joseph Leighton testified that he provided such executions

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firm's proprietary account. Knight's institutional sales traders, therefore, could not discern from Knight's systems the profit (loss) associated with any particular institutional trade.

35 When an execution did not occur at a price that was consistent with the inside market for the security being traded, Knight utilized ACT reporting modifiers to indicate that the orders were executed at prices from a previous period of time.

irrespective of Knight's cost basis, just as he would print at higher average prices if the market traded up while the institution's order remained active.[36]

At the end of the day, institutions received reports from Knight summarizing the executions that filled their not-held orders and confirmations reflecting that the trades were principal transactions.[37] All of the trades at issue in this case were executed on a "net" basis. A net trade occurs when a market maker purchases (sells) stock necessary to fulfill an order as a principal at one price and then executes the offsetting sale (purchase) of stock to (from) a customer at a different price, without any mark-up, mark-down, commission, or other fee being imposed.[38] *See NASD Notice to Members 99-65* (Aug. 1999). The difference between the price of the market maker's principal transaction and the price of the offsetting transaction with its customer represents the market maker's compensation, which, as a matter of custom, was not disclosed on the customer's confirmation.[39] *See Notice to Members 01-85*. Institutions thus

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[36] Testimony given by Cavallo and Joseph Leighton indicates that they viewed Knight's trading to fulfill institutional not-held orders as constantly subjecting Knight to "risk," particularly given the volatile nature of the Nasdaq securities being traded at the time.

[37] These reports showed that Knight allocated to an institution's various portfolios all of the securities purchased (sold) by the institution from a particular order at a single price, which reflected the volume-weighted average of the prices at which the institutional order had been filled or partially filled throughout the day.

[38] FINRA has long-recognized that market makers typically trade with institutions on a net basis and that a market maker thus is not precluded from accumulating a position at one price and executing an offsetting trade with a customer at another price, provided that the customer requested net pricing and such arrangement satisfies the market maker's best execution and other obligations under FINRA rules. *See NASD Notice to Members 99-65; see also Notice of Filing of Proposed Rule Change by NASD Relating to Disclosure and Consent Requirements when Trading on a Net Basis with Customers*, Exchange Act Rel. No. 51457, 2005 SEC LEXIS 750, at *7-9 (March 31, 2005) ("[I]t has been the NASD staff's understanding that net trading typically only occurs at the request of institutional customers . . . ."). In November of 2000, Nasdaq issued an interpretation concerning the use of net trading and concluded that firms could use negative consent letters to evidence a customer's agreement to trade on a net basis. *See NASD Notice to Members* 00-79 (Nov. 2000). Knight thereafter used negative consent letters to evidence the agreement of institutional customers to the use of net pricing for their orders and to document the fact that such pricing was consistent with their past dealings and agreements. FINRA codified the use of negative consent letters and other methods to evidence net trading agreements with institutional customers when it adopted NASD Rule 2441. *See NASD Notice to Members* 06-47 (Sept. 2006).

[39] Exchange Act Rule 10b-10(a)(2)(ii)(B) does not require that a market maker disclose compensation that it has earned on a net priced trade on the customer confirmation. 17 C.F.R. § 240.10b-10(a)(2)(ii)(B); *see also Notice of Filing of Proposed Rule Change by NASD Relating to Disclosure and Consent Requirements when Trading on a Net Basis with Customers*, 2005 SEC LEXIS 750, at *6 n.9.

were not privy to the prices at which Knight acquired (sold) for its proprietary accounts the securities necessary to fulfill their orders and, consequently, could not discern the amount of Knight's compensation.

E. The "Expectations" and Understandings of Institutions

The testimony of buy-side traders makes clear that institutions turned to Knight to execute their orders because Knight provided superior liquidity in the volatile markets for the difficult-to-trade Nasdaq securities they were buying (selling) in 1999 and 2000. Institutions placed not-held orders with Joseph Leighton in particular to ensure greater control over the manner in which their trades interacted with the market and to take advantage of his brokerage judgment. Institutions sought both to lessen the market impact of their trading and to avoid pegging the market for a security by looking to the average prices at which securities traded during the period of time their orders were active.

By placing not-held orders, institutions voluntarily substituted generic order handling instructions with their own instructions that Joseph Leighton work to obtain fills that were consistent with their expressed instructions and goals and market conditions. Institutions thus requested that Knight accumulate the securities necessary to fulfill their orders in an orderly fashion and within the framework of the market. Consistent with Joseph Leighton's testimony, buy-side traders testified that institutions sought through their trading with Knight to participate in, and obtain some predetermined portion or "fair share" of, a security's total trading volume.

Although institutions granted Joseph Leighton limited time and price discretion to work their orders, buy-side traders testified that they nevertheless carefully monitored, controlled, and "quarterbacked" his trading to ensure that their orders were being executed in conformity with their instructions. Buy-side traders could not see at what time or price Knight was acquiring or selling securities for its proprietary accounts, but they carefully followed the prices and volumes at which those securities traded in the market during the lives of their orders by watching Nasdaq time and sales data. Among other things, institutions monitored the prices of the securities, the volume traded, and the impact, if any, their orders were having upon the market. Institutions also were involved in determining when and how they wanted their transactions printed. Institutions fully expected, and saw, the execution of their not-held orders occurring over a period of time and including multiple, piecemeal prints.

The buy-side traders also frequently conversed with Joseph Leighton, who provided them with information concerning the execution of their orders throughout the trading day. During these conversations, Joseph Leighton would inform the buy-side traders how their orders were performing in the market, whether any portion of their orders had been completed, and the average price to the institution of any shares executed. Buy-side traders therefore worked closely with Joseph Leighton to ensure that they received the volume participation and execution prices that met their trading objectives and frequently altered, amended, or cancelled their orders to buy or sell more or less stock in response to the information that they received from Joseph Leighton and the market.[40]

Buy-side traders testified that, ultimately, it was their responsibility to ensure that orders were executed in accordance with their interests and that they received the best price they could receive for a security within the confines of the market. The record evidence establishes that the relationship between Joseph Leighton and the buy-side traders was therefore a collaborative one, marked by ongoing discussions and negotiations that sought to culminate in a final execution report that satisfied the trading objectives of the institutions.

At the hearing below, Market Regulation elicited testimony from buy-side traders that they "assumed" or "expected" that the execution prices that they received from Joseph Leighton were reflective of the prices at which Knight bought (sold) the securities necessary to satisfy their orders, after imputing an assumed mark-up, mark-down, or commission equivalent of anywhere from three to 12 cents per share. The expectation that they would receive such cost-plus pricing for their trades, the buy-side traders asserted, was an "industry standard."

Even accepting this testimony as true, we find that the buy-side traders' claims, that "cost-plus" pricing represented a binding market standard for the pricing of not-held, net-priced orders, rings hollow when considered in the context of the entirety of their testimony and the record as a whole.[41] First, the record is devoid of proof that the buy-side traders ever communicated their expectations to Joseph Leighton or reached any mutual understanding with

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40 If a customer cancelled an existing not-held order, the customer would accept whatever securities had been printed to the institution at that time. Knight, however, would be at risk for any securities purchased (sold) to work the institution's order that had not yet been sold to (bought from) the institution to fill its order. Institutions also often "backed away" or "walked away" from orders, temporarily suspending further trading until they determined the direction of the market. In this case too, Knight would be at risk for any securities in its inventory that had not yet been sold to (bought from) the customer.

41 The Extended Hearing Panel majority found the buy-side traders to be credible and free from bias. Absent substantial evidence to the contrary, these credibility determinations, which are based upon the testimony and demeanor of the buy-side traders at the disciplinary hearing, are entitled to deference. *Springer*, 2002 SEC LEXIS 364, at *20. We note, however, that in reaching its credibility determinations the majority found the buy-side traders free of "a motive to provide false testimony." We disagree. These buy-side traders had no independent recollection of the not-held orders discussed or examined in this case and exhibited no concern over Joseph Leighton's trading until they were shown, during investigative interviews, unverified, one-sided analyses prepared by Market Regulation staff that purported to show that Joseph Leighton enjoyed inflated "profits" executing their orders. With the benefit of hindsight, these traders could be either upset or embarrassed that they could have executed trades at costs lower than the prices they received. Despite this potential motive to color or shade testimony, we nevertheless cannot conclude that there exists substantial evidence that warrants overturning the majority's credibility determinations as to the buy-side traders that testified at the hearing.

Knight that Joseph Leighton would execute their orders using cost-plus pricing. Rather, it is clear that, other than agreeing to the use of net pricing, Joseph Leighton and the buy-side traders discussed neither the manner in which order executions would be priced by Knight nor the extent of the profits (losses) that Joseph Leighton could garner for Knight from those executions. Institutional "expectations," therefore, were nothing other than unilateral.

Second, buy-side traders testified that they understood that their institutional, not-held orders would be executed by Knight, acting as a principal, on a net basis. The buy-side traders therefore employed a "don't ask, don't tell" approach under which the institutions did not ask, and Knight did not disclose, the prices at which Knight purchased (sold) securities for its proprietary accounts or the level of the profit (loss) it incurred from executing not-held orders. Indeed, it was generally not the practice of institutions to request, or of wholesale market makers to disclose, the market maker's cost basis for stock sold to (bought from) institutions or the profits (losses) experienced from executing institutional not-held orders during the relevant period of time. Institutions instead understood and expected that Knight would profit based upon the difference between the price at which Knight accumulated a proprietary position and the execution price received by the institution, without any additional mark-up, mark-down, commission or other fee being imposed. *See NASD Notice to Members 01-85.*

Finally, the evidence, on balance, shows that institutions were largely indifferent to the immediate prices at which Knight purchased or sold the securities necessary to satisfy their orders and monitored instead the net prices at which their orders were executed. The record further indicates that, given the volatile nature of the Nasdaq markets at the time, buy-side traders wanted their not-held orders executed not at prices that were reflective of Knight's cost, but rather were reflective of where the market for a particular security, as a whole, traded in volume. The completion and execution of their not-held orders within the confines of the market's volume and liquidity for a particular Nasdaq security was, in the view of institutions, an important factor for determining execution quality. In this respect, institutions balanced the execution prices received from Joseph Leighton against certain benchmarks, including the volume-weighted average price for a security, to determine whether the prices they received from Knight met their expectations.

F. Market Regulation's Summaries and Analyses of Joseph Leighton's "Excessive Profits"

Market Regulation's pleadings, briefs, and arguments are in this case replete with characterizations that Joseph Leighton and Knight earned "exorbitant," "outrageous," and "excessive" "profits" executing institutional not-held orders. To support these claims, Market Regulation offered the testimony of a Market Regulation staff member to proffer summary calculations and analyses of the trading "profits" that Joseph Leighton purportedly garnered on Knight's behalf from the execution of not-held orders. Neither the Extended Hearing Panel's majority nor the dissent credited staff's estimations and summaries. We too grant them limited weight.

As an initial matter, the evidence reflects the fact that it is extremely difficult, and perhaps impracticable, to determine an institution's participation in any of the trading conducted by Knight in its proprietary accounts. All trades executed by Knight in a particular security, whether it be for an institution, retail customers of other broker-dealers, or for proprietary purposes, were completed through a single market-making account whose total inventory of securities was constantly increasing or decreasing.[42] Significant retail order flow, in particular, which in part came from automatic execution protocols that Knight provided as a market maker, alone had a large impact on Knight's inventory of a security. Knight's systems did not and could not segregate the trading conducted to fulfill a specific institutional sales order from any other trading being conducted by the market maker in the particular security.[43] Furthermore, all purchases and sales for securities traded through Knight's proprietary accounts were aggregated only to produce running total daily and monthly profits and losses per security. Knight's systems therefore also did not and could not calculate the profit or loss associated with the execution of any individual institutional order by the firm's institutional sales traders. Any effort to recreate either the manner in which an institutional order was worked and executed, or the profits associated with such an order, thus represents an inherently suspect endeavor.

1. "Sales Credit" Summaries

Market Regulation staff nevertheless examined and analyzed certain institutional sales department performance data and "trade blotters" produced by Knight for 1999 and the first nine months of 2000. This performance data purported to illustrate, among other things, the "average profit per share" and the total shares attributed to each institutional sales trader, including Joseph Leighton, for all trading that the sales trader conducted each month and on individual institutional trades. Parsing this data, staff prepared a number of summary exhibits that purported to show the gross "profits" or "average profit per share" that Knight enjoyed from Joseph Leighton's institutional trading during the review period.

These summaries illustrate that Joseph Leighton was a large contributor to the institutional sales department's revenues, generating greater than $134 million in "profits" over the 21-month period reviewed. Looking at each month and each quarter during that period, the summaries of Knight's institutional sales department performance data also show that a large percentage of the institutional sales department's total "profits" was attributable to trading conducted by Joseph Leighton. In the first and second quarters of 2000, for example, Joseph Leighton's institutional trading generated $35.69 million and $33.08 million, respectively, in "profits." These figures represented greater than 32 percent of the institutional sales department's total "profits" in each of those two quarters.[44]

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42 Market makers often engaged in hundreds, and sometimes thousands, of trades for the securities in which they made markets throughout the course of a single day.

43 This appears to have been the norm for market makers conducting institutional trading at the time of the trades at issue in this case. *See NASD Notice to Members 99-65*.

44 The summaries prepared by Market Regulation staff also show that while a large percentage of the institutional sales department's profits was attributable to Joseph Leighton's trading, his trading nevertheless generally constituted a much smaller percentage of the total shares traded by the institutional sales department.

Market Regulation's summary exhibits also show the "average profit per share" attributable to Joseph Leighton's institutional sales trading during 1999 and the first nine months of 2000. These summaries reveal that Joseph Leighton's monthly "average profit per share" figures during the review period ranged from a low of 11 cents per share in February 1999 to a high of 43 cents per share in March 2000. Joseph Leighton, however, was not the leading sales trader in terms of average profit per share each month. In fact, between January 1999 and September 2000, Joseph Leighton had the highest average profit per share figures in just three months.[45] Other institutional sales traders at Knight often made more than Joseph Leighton on a per share basis. For example, in January 2000, Joseph Leighton had a reported average profit per share of 18 cents. The leading institutional sales trader that month, on an average profit per share basis, was reported at 68 cents. Likewise, in August 2000, Joseph Leighton had an average profit per share reported of 16 cents. That same month, however, another institutional sales trader had a reported average profit per share of $1.80.[46]

Market Regulation staff estimated that Joseph Leighton generated $98,924,633 in "profits" from 3,377 trades where his "average profit per share" exceeded 25 cents during the period of January 1999 to September 2000. In other words, Market Regulation claims that greater than 73 percent of the total profits generated by Joseph Leighton during this period came from trades from which Joseph Leighton and Knight earned more than 25 cents per share in compensation.[47]

These "profits" and "average profit per share" figures, however, are not true reflections of the actual profits or average profit per share attributable to Joseph Leighton's institutional sales trading. They instead are based upon and reflective of "sales credits" that were calculated for purposes of compensating Knight's institutional sales traders and market makers for the institutional orders they executed.

Because Knight's systems reflected the position held by Knight in a particular security and did not differentiate between types of trades, Knight's market makers and institutional sales traders negotiated sales credits that attempted to allocate a percentage of the total daily trading profit (or loss) associated with Knight's trading in a particular security to individual institutional trades. The calculations of these sales credits were not performed by Knight's systems, but rather represented subjective, manual, back-of-the-envelope estimations of the profits attributed

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45 Market Regulation nevertheless has not alleged that there was anything improper about the sales practices of any of these other institutional sales traders.

46 Indeed, even after Joseph Leighton's departure from the firm, many of Knight's institutional sales traders continued to report monthly average profit per share figures well beyond the three-to-12 cents per share range that Market Regulation claims represented an "industry standard."

47 The summaries prepared by Market Regulation show that the bulk of these "profits" was attributable to trading conducted by Joseph Leighton during the volatile first months of 2000.

to particular institutional trades, for which there existed no set methodology or guidance. The calculation of sales credits thus represented, at best, an inexact science.

Moreover, because these figures represented the culmination of a negotiated effort, they were prone to the influence of the relative bargaining power of the market maker and sales trader. Given Joseph Leighton's stable of institutional clients, and the trading volume that they produced for Knight, Joseph Leighton possessed noteworthy negotiating power over Knight's market makers concerning the sales credits to be attributed to his institutional trading.

As result of the inherent limitations associated with Knight's sales credit figures, which were captured by the performance data and trade blotters that form the bases of staff's estimations, we conclude that the foregoing summaries prepared and proffered by Market Regulation staff are in this case of limited analytical value and usefulness. The sales credits allocated to Joseph Leighton's institutional trades provide a glimpse of a general notion of profitability only. We rely upon them solely for this purpose.

2. "Profit" Estimations for Specific Trades

In further support of Market Regulation's claims that Knight gained outsized profits from Joseph Leighton's institutional trading, Market Regulation also examined 144 allegedly troublesome trades executed by Joseph Leighton for institutions from January 1999 through September 2000. At the disciplinary hearing, Market Regulation presented numerous additional summary exhibits in the form of detailed spreadsheets that purported to replicate Joseph Leighton's execution of 56 of these not-held orders using historical audit trail sources.[48]

In these summary spreadsheets, Market Regulation estimated the profit per share incurred by Joseph Leighton and Knight for each of the 56 trades examined in detail.[49] For each trade,

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48 The trades selected for review by Market Regulation represented a small portion of the greater than 23,000 institutional orders that Joseph Leighton executed from January 1999 until September 2000 and were chosen in large part because of the sizable sales credit figures attributed to each of the trades by Knight's trade blotters. A review of Knight's trade blotters, however, shows a large number of institutional trades that also resulted in Joseph Leighton and Knight either claiming no "profit" or losing money during the review period. No trades that appear to be "profit" neutral or to have resulted in a loss to Knight were examined further by staff.

49 A review of these additional summary exhibits also shows that Knight's market maker who traded the security that was the subject of the institution's order generally began accumulating a proprietary position necessary to satisfy the order. Consistent with Joseph Leighton's testimony and the institution's desire that he limit the market impact of its trading, Market Regulation's exhibits also illustrate that Joseph Leighton did not execute the institution's order all at once or provide any large partial fills of the order despite Knight's market maker often possessing a sizeable proprietary position that would have allowed Joseph Leighton to do

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staff first sought to estimate the weighted average cost basis (sales price) of the inventory of securities acquired (sold) by Knight's market maker. Staff then compared this static weighted average cost (sales price) to the prices at which Knight actually sold securities to (bought from) the institution, repeating this exercise until the order was completed to arrive at an estimated profit per share for each order as a whole. Using this methodology, Market Regulation estimates that Joseph Leighton's execution of the 56 institutional not-held orders reviewed produced profits for Knight ranging from a minimum of 43 cents per share to a maximum per share profit of $9.63.[50]

We conclude, however, that Market Regulation's profit estimations for each of the 56 trades examined are also unreliable. First, to overcome the limitations of Knight's systems, Market Regulation applied various assumptions to segregate and exclude from its analysis of each trade any purchases or sales of securities that were believed to be unrelated to the institutional order. The assumptions applied to arrive at these exclusions, however, were not documented and were not subject to a standard methodology. Indeed, staff's approach changed in a subjective fashion from one analyzed trade to another and cannot be reconstructed.

Second, staff relied upon order tickets and other trading records obtained from Knight and the institutions when conducting its analysis. These records, however, were shown to be less than clear, subject to different interpretations, and, in certain cases, contradicted staff's assumptions, further adding to the arbitrary and subjective characterization of its methodology.

Finally, Market Regulation's methodology served to overestimate the profits per share that were enjoyed by Knight from Joseph Leighton's execution of the institutional orders that were examined. Although Market Regulation attempted to segregate and exclude intervening trades that were believed to be unrelated to each institutional order being examined, Market Regulation nevertheless failed to segregate and account for the impact that these intervening trades had upon the weighted average cost basis that it used to calculate the institutional order's profit per share.[51] The practical effect of this inconsistency in Market Regulation's methodology

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so. Instead, Joseph Leighton provided relatively small, partial fills to the institution, and continued this pattern of buying and selling stock until the order was completed.

50 Staff's summary spreadsheets also show that the market for the securities traded for each of the orders examined generally moved several dollars, and often tens of dollars, both up and down during the trading day. The majority of the 56 transactions examined in detail by staff were executed in March and April 2000, at the height of a period of historical volatility for Nasdaq securities. Indeed, seven of the 56 trades examined occurred on April 4, 2000, the single most volatile day on record for Nasdaq securities.

51 Putting aside the question of whether it was appropriate for staff to calculate profits by comparing an average cost (sales) price to the actual prices at which trades were executed, we note that, because Market Regulation did not provide a reasonable approximation of Knight's

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was to apply certain profits that would have been sustained on trading unrelated to the institutional order to the institutional order itself.[52] We therefore do not rely upon these exhibits.

G. Knight's Supervisory and Compliance Systems

At all relevant times, Knight maintained comprehensive, detailed written supervisory and compliance procedures. Under these procedures, Pasternak was responsible for the overall supervision of the firm. Until August of 2000, Pasternak was also the firm's trading room manager and was thus directly responsible for Knight's proprietary trading and market making. Pasternak thus oversaw and reviewed the firm's trading and market making to ensure compliance with the federal securities laws and FINRA rules. In this role, Pasternak testified, he received and reviewed daily reports indicating trading conducted in each market maker's account and daily profit and loss figures.

As Knight's institutional sales department manager, John Leighton was responsible for supervising the firm's institutional sales activities and all of the firm's institutional sales department representatives. He reported directly to Pasternak. Under the firm's written supervisory procedures, John Leighton was, among other things, required to review each day's institutional trading activity and trade allocation reports. In this respect, John Leighton testified that he reviewed and initialed a report detailing the institutional sales department's trading activity.[53] This report showed all trades executed by Knight's sales traders each day and included information concerning the institution with which Knight traded, the security being traded, the volume of stock bought (sold) by the institution, the execution price, and whether the execution was within the inside market. In addition to the trade reports that John Leighton reviewed, he was also required to examine all customer correspondence, maintain a customer complaint file, and to meet regularly with institutional customers to ensure that their accounts were being properly handled by Knight's institutional sales traders and to resolve any complaints they may have concerning the trades executed by Knight.

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cost basis, it cannot be said to have reasonably calculated "excessive" profits greater than a chance figure of three to 12 cents.

52 The respondents proffered the testimony of their expert, Wolk, who presented certain counter analyses that correct for this error in Market Regulation's approach. Wolk's analyses illustrate that Market Regulation generally overestimated the profits and profit per share associated with the reviewed trades, in many cases grossly overestimated those figures, and in other cases assigned profitability to an institutional order that could in fact have resulted in a loss to Knight.

53 The institutional sales activity report that John Leighton reviewed nonetheless did not identify the profits (losses) earned on any particular institutional order.

Besides the written supervisory procedures applicable to Pasternak and John Leighton, the firm's procedures generally contained detailed prescriptions concerning compliance with FINRA's "fair pricing" rule, Rule 2440, the requirement that the firm buy (sell) securities to customers at "the prevailing market price," the calculation of mark-ups, and the reporting of "riskless" principal transactions, which the firm's policies stated did not apply where Knight was acting as a market maker. The procedures established by the firm in addition provided direction concerning the "best execution" obligations of all registered representatives under the federal securities laws and FINRA rules. In this respect, the firm's procedures incorporated NASD Notice to Members 97-57, which addressed the execution of not-held orders by market makers.

Knight employed compliance and legal personnel to review the firm's written supervisory procedures and to ensure that the firm was complying with the federal securities laws and FINRA rules. The principal function of Knight's compliance department was to supervise the firm's books and records and all proprietary, market making, and institutional sales trading undertaken by the firm. The compliance department thus sought to employ personnel who had an understanding of Knight's business operations and the applicable laws and regulations that applied to these operations. Knight's compliance and legal departments also employed numerous people who had been formerly employed by both the Commission and FINRA. This included Amoruso, the firm's chief compliance officer, who served previously as a deputy director of FINRA's New York district office, and Dorsey, the firm's general counsel and a former Commission attorney.

To assist the firm's personnel with compliance issues and to ensure that the compliance department stayed familiar with the firm's operations, Amoruso testified that compliance department personnel sat amongst institutional sales traders and market makers during the day. Knight, however, also utilized comprehensive automated compliance and order management systems. These systems automated the firm's protocols for compliance with order handling, short sales, and trade reporting requirements, and generated numerous exception reports. All of the compliance protocols implemented by Knight's systems were designed around the market-making accounts through which the entirety of the firm's trading passed. Knight's systems were therefore designed to allow supervisory and compliance personnel to review all trades effected by Knight's market makers, including trades executed for institutional customers. Although the compliance department did not supervise the institutional sales department, it did conduct regular surveillance of the institutional sales department's trading, albeit indirectly. As an adjunct to this surveillance, the compliance department was required to periodically review a sampling of institutional trades, the size and frequency of that trading, and to meet with Knight's institutional sales traders and customers to discuss their business. Amoruso testified that these reviews did not reveal any concerns over the way in which Joseph Leighton or any other Knight sales trader executed institutional, not-held orders.

The unrebutted testimony presented at the hearing below established that Pasternak was fully supportive of Knight's compliance efforts. Pasternak testified that he relied upon Knight's compliance and legal departments to ensure that the firm's compliance procedures and systems were up to date. Pasternak thus encouraged Knight's compliance department to continually review the firm's systems and supported the implementation of new procedures even if they were not dictated by current regulatory concerns. Continuous reviews conducted by both the compliance and legal departments evidenced to them that Knight's systems were consistent with industry standards and were reasonably designed to ensure compliance with the federal securities laws and FINRA rules. No one ever advised Pasternak that the firm's written supervisory procedures or compliance protocols suffered from any notable deficiencies.

The preponderance of the evidence makes clear that Pasternak was viewed within Knight as an active supervisor who, despite being responsible for a large organization and multiple companies, could often be found interacting with Knight's market makers and institutional sales traders. Pasternak was also notably supportive of the firm's compliance efforts. Pasternak thus met every week with Knight's senior managers and compliance and legal department personnel. At these meetings, which included the firm's chief compliance officer and general counsel, supervision and compliance issues were frequently discussed concerning Knight's market making and institutional sales trading. Because of Knight's size and the other organizations for which he was responsible, Pasternak testified that he nevertheless relied upon multiple personnel below him to handle much of the day-to-day supervisory issues that arose within the various departments at Knight. For example, in his role as the trading room manager, Pasternak relied upon two directors of trading, beneath whom were multiple deputy trading room managers and team captains, all of whom were registered general securities principals of the firm. Pasternak testified that he met regularly with his subordinates, including John Leighton, to discuss the manner in which they were discharging their supervisory responsibilities. Pasternak also observed the performance of these individuals while sitting on the firm's market-making and institutional trading desks.

In addition to his supervisory duties, Pasternak maintained an active market-making account for which he was responsible. Pasternak testified that he was thus able to observe all of the trades executed in this account, including trades executed on behalf of the firm's institutional sales traders. As noted above, Knight's trading activities were in this way unique in that all institutional trading conducted by the firm was subject to review both through the supervisory systems designed and enforced for the institutional sales department and those for the market-making department as well.

The preponderance of the evidence also showed that John Leighton too was an active participant in the enforcement of the firm's supervisory procedures. He was both visible to and interacted frequently with all of his subordinates on the institutional sales desk. In this respect, John Leighton testified that he followed the execution of institutional orders by the firm's various sales traders and assistant traders and reviewed the order tickets for those trades.[54] He also randomly monitored telephone conversations between sales representatives and institutional customers. Like Pasternak did with the firm's market-making department, John Leighton

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[54] To facilitate his supervision of Knight's institutional sales department, John Leighton appointed one of the institutional sales department's team captains to serve as his liaison between the institutional sales department and Knight's compliance and legal departments. This individual was charged with reviewing any exception reports related to institutional trading that were generated by Knight's compliance department.

testified that he also relied upon the institutional sales department's team captains, each a registered general securities principal, to assume certain supervisory responsibilities over the sales traders and assistant sales traders assigned to each team captain.[55]

John Leighton held frequent meetings with institutional sales department personnel to review the department's trading and to discuss any issues concerning the firm's institutional sales activity.[56] Personnel from Knight's compliance department attended these meetings. Despite Market Regulation's assertion that John Leighton turned a blind eye to Joseph Leighton's trading, unrebutted evidence shows that Joseph Leighton received no special treatment from his brother and was required to comply with all supervisory procedures and compliance demands that were in effect for all other institutional sales traders. Knight's compliance and legal personnel testified that they never detected any failure on the part of John Leighton to implement the supervisory procedures for which he was responsible while he was the head of the institutional sales department.

Despite the comprehensive nature of Knight's automated compliance functions, it is not disputed that Knight's systems did not monitor, or produce any exception reports concerning, the amount of profits or losses per share generated by the execution of any particular institutional, not-held order.[57] Nor did the firm's written supervisory procedures impose upon any Knight personnel the duty to monitor such information. From a practical standpoint, the firm believed such reporting was not possible given the large volume of institutional trading that the firm conducted through its market-making accounts, the fact that the firm's systems were not designed to segregate any trading conducted in those accounts, and given the extent to which the quality of any order executions were dependent upon the institutional customer's expectations and instructions.

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55 Throughout these proceedings, the parties have disputed the extent to which John Leighton effectively delegated certain supervisory responsibilities to institutional sales department team captains that reported to him. We have determined that we need not resolve this dispute. Although the firm's written supervisory procedures state that each of the registered principals in Knight's institutional sales department was required to review on an ongoing basis all institutional trading activity, John Leighton remained at all times responsible for reviewing the trading conducted by the institutional sales department team captains, sales traders, and assistant traders. We are thus not concerned with the extent to which John Leighton delegated to team captains certain recordkeeping functions concerning new account forms and order tickets that are not at issue in this case.

56 When John Leighton was absent, institutional sales department team captains ran these meetings.

57 Market Regulation presented as evidence certain "trade blotters" generated by Knight's systems that showed the total sales credit earned by Joseph Leighton on particular institutional trades and from which one could calculate the sales credit per share earned on any trading. Market Regulation concedes that these trade blotters were readily available to Knight's senior managers, including John Leighton and Pasternak.

There is no dispute, however, that senior managers of the firm did receive periodic reports that detailed information concerning the sales credits generated by Knight's institutional sales trading. Sales credits were the sole estimation of profits (losses) generated by Knight's institutional sales department. Thus, Pasternak and John Leighton testified that they each received and reviewed detailed information concerning the sales credits and other compensation garnered by Knight's institutional sales traders each month.[58] Both Pasternak and John Leighton therefore had a general awareness of the "profits" that Joseph Leighton garnered for Knight from his institutional trading, the amount of such figures on a per share basis, and the extent to which these sums contributed to the overall performance of both the institutional sales department and Knight.

Pasternak and John Leighton both testified that they did not find Joseph Leighton's contributions, both in terms of gross sales credits and sales credits per share, in any way alarming or indicative of potential wrongdoing. This was because Joseph Leighton was Knight's most senior and talented sales trader and serviced Knight's largest institutional customers, who in turn were executing large-volume trades in high-dollar Nasdaq securities during a period of unprecedented volatility. Indeed, the testimony of Pasternak, John Leighton, and the buy-side traders with which Joseph Leighton traded makes clear that they all recognized that the appropriateness of any compensation that was earned by Knight on any particular institutional trade depended upon factors that, for the most part, could not be monitored by automated compliance systems. These factors included instructions given by institutional buy-side traders, the extent to which liquidity for a particular security presented itself while an order was active, decisions by institutions to alter the pace of their trading while orders were active, the market conditions under which each order was executed, and negotiations over execution prices. From the perspective of Knight's legal and compliance personnel, the profit (loss) earned on any particular trade was viewed as an empty data point.

The preponderance of the evidence presented at the hearing makes clear that whether Joseph Leighton met his best execution obligations when executing an institutional, not-held order depended to a large degree upon the institution's assessment of his ability to follow its instructions and to meet its trading objectives within the confines of the market. Both Pasternak and John Leighton testified that they therefore met regularly with Knight's institutional customers to ensure their satisfaction with the trading that they were conducting with Knight and to determine if they wished to express any complaints or concerns concerning Joseph Leighton's trading. The evidence is clear that these institutional customers were satisfied with the executions that Joseph Leighton provided them and that none of them ever voiced any concern or complaint concerning the prices at which Joseph Leighton executed their orders.

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58 Pasternak also received from Knight's finance department monthly performance reports that reflected the basis for all compensation that he was required to authorize for each of Knight's institutional sales traders and market makers, including the basis for any compensation that was shared by John Leighton and Joseph Leighton.

H. Events Preceding Joseph Leighton and John Leighton Leaving Knight

1. Hewitt Approaches Pasternak About the Leightons

In June 1999, Hewitt was hired to replace Pasternak as president of Knight. Hewitt was hired to focus upon Knight's development of new products, its international business, and trading technology.

Although Pasternak contemplated giving Hewitt a future role in building Knight's institutional sales trading business at the time he was hired, Hewitt did not during his tenure at Knight have any operational or supervisory responsibilities for Knight's institutional sales department, which were retained by Pasternak. Hewitt testified that he nevertheless met with both John Leighton and Joseph Leighton in a series of meetings during August and September 1999 to get to know them and to familiarize himself with the operations of Knight's institutional sales department.

As a result of these meetings, Hewitt developed the opinion that John Leighton had neither the background nor the qualifications to run Knight's institutional sales department. Hewitt also testified that he was "astonished" to learn from John Leighton that Joseph Leighton's institutional trading was generating an average "profit" per share in excess of 25 cents and that John Leighton and Joseph Leighton shared approximately $20 million in compensation the year prior to Hewitt's arrival.[59]

Hewitt testified that he could not comprehend and did not understand how Joseph Leighton's institutional sales trading could produce the returns and or justify the levels of compensation that he says were conveyed to him by John Leighton. Although he possessed no experience with institutional sales trading or market making, reviewed no records related to Joseph Leighton's trading, looked at no data concerning the sales credits being generated by other institutional sales traders, and never discussed the nature of Knight's institutional trading with any of the firm's other sales traders or Joseph Leighton's customers, Hewitt "surmised" that the "net economics" did not support the results and that Joseph Leighton, with his brother's consent, must have been engaged in "front running."[60]

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59 Hewitt never examined Knight's records to confirm these figures or to compare them to the results enjoyed by other institutional sales traders at Knight. Indeed, the figures that Hewitt claims were relayed to him by John Leighton are inconsistent with the record evidence. Knight's institutional group performance data shows that Joseph Leighton enjoyed average monthly sales credits per share of approximately 16 cents during the first six months of 1999 and that John Leighton and Joseph Leighton earned a combined $4.3 million the year prior to Hewitt's arrival at Knight.

60 Hewitt, who erroneously viewed Knight's institutional sales trading as akin to agency or "riskless" principal trading, used the term "front running" during direct examination to mean that Knight was taking advantage of institutional orders to generate certain gains that were not shared

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Hewitt testified that, in or about October 1999, he raised his concerns about Joseph Leighton's trading profits with Pasternak and expressed to Pasternak a conviction that he could no longer work with John Leighton because he wasn't "my kind of guy." Pasternak recalled meeting with Hewitt at this time, but only to discuss John Leighton's leadership of the institutional sales department. The record is clear, however, that the only action that Hewitt requested of Pasternak at this time was to begin a search to replace John Leighton as the head of Knight's institutional sales efforts. Pasternak acceded to Hewitt's request.

The search for John Leighton's replacement to lead Knight's institutional sales department focused upon Stellato, Hewitt's former colleague at another firm. With Pasternak's blessing, Hewitt offered Stellato the position as head of institutional sales in January 2000, which Stellato accepted. Stellato, however, did not begin employment with Knight until August 2000, due to problems arising with his separation from his previous firm.

2. Stellato's Review of Joseph Leighton's Trading

After Stellato's arrival at Knight, Hewitt testified, he informed Stellato that he thought that Joseph Leighton was engaged in "potentially" illegal or inappropriate activity and requested that Stellato "sort [it] out."[61] A few weeks later, he claims that Stellato called him and stated that he had reviewed certain evidence that indicated that Joseph Leighton was "front running" institutional orders.[62] Stellato later provided Hewitt with documentation that Stellato asserted

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with its institutional customers. Hewitt tempered his views upon cross-examination. He clarified that his view of "front running" in this case meant that Joseph Leighton and Knight, which executed orders as a principal, did not disclose to institutions the manner in which Knight accumulated stock to fulfill an institution's order or Knight's cost basis for such stock. In this respect, Hewitt said he saw no problem with the compensation that Joseph Leighton's trades were generating for Knight, only that he believed Knight had an obligation to disclose its cost basis and profits to institutional customers. Hewitt conceded, however, that he was unaware of any rule that required the disclosures that his view of "front running" required. He further admitted that he was not aware of any market maker that made such disclosures for institutional not-held orders executed on a net basis.

61 Despite the fact that Hewitt says he believed that Joseph Leighton could be involved in illegal activity, he admits that he never raised the issue with either Knight's compliance department or legal personnel.

62 In its decision, the Extended Hearing Panel majority relied heavily upon previously recorded testimony given by Stellato to support its findings that John Leighton and Pasternak failed to reasonably supervise Joseph Leighton and respond to "red flags." After careful consideration, we find that Stellato's recorded testimony lacks reliability; fairness warrants against affording it more than minimal weight in reaching our decision. *See Tom,* 50 S.E.C. at 1145. We do so for the following reasons. First, we have concluded that Stellato's testimony, provided over many days before FINRA staff, Commission staff, and a FINRA arbitration panel,

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was support for his claims with respect to Joseph Leighton's execution of three specific institutional orders and informed Hewitt that he found the levels of return on these trades "inconceivable."[63]

3. Pasternak's Subsequent Actions

Upon receiving this information, Hewitt informed Pasternak of Stellato's complaints. Pasternak asked Stellato to prepare a report outlining his allegations. After receiving the report, Pasternak met with Stellato to discuss his findings. Pasternak testified that Stellato was unable to describe to him the trade reporting data upon which the report was supposedly based.[64] Nevertheless, Pasternak understood from this meeting that Stellato believed that Joseph Leighton was engaging in improper trading practices and making too much money on institutional trades.[65]

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is inconsistent, prone to embellishment, and itself dependent upon hearsay for effect. Second, Stellato's testimony was contradicted by several witnesses that both appeared at the hearing and provided recorded testimony to FINRA staff and his testimony lacks corroboration. Third, the testimony that Stellato gave in this case and others was given subsequent to his filing of an arbitration claim against Knight and Pasternak after his dismissal from Knight. The existence of Stellato's arbitration claim, a history of litigation against his former firm, and other substantial evidence prevent us from ignoring in this case the potential for Stellato's bias. Finally, although available and having been requested by Market Regulation to appear and testify at the hearing under NASD Rule 8210, Stellato declined to testify in person before the Extended Hearing Panel.

63 Hewitt testified that it was "not my job to understand" and that he never reviewed the documentation to independently verify Stellato's conclusions.

64 Indeed, Stellato's report consisted of several spreadsheets that had been prepared by another individual at Knight who had no background in institutional sales trading. Stellato's testimony makes clear that he did not know how these spreadsheets were prepared or the data upon which they were based and did nothing to verify the calculations set forth therein. Stellato relied solely upon these spreadsheets for his accusations that Joseph Leighton's trading was improper and marked by "excessive" profits.

65 The record is unclear as to what Stellato specifically found troubling about Joseph Leighton's trading other than what he claimed to be indicia of improperly derived levels of profit. We nevertheless can discern from the record a perspective that Stellato viewed Joseph Leighton's institutional trading as being consistent with the fulfillment of "riskless" principal orders that should have been immediately executed, at least partially, whenever Knight accumulated stock at prices that represented Knight's cost plus a mark-up (or mark-down) or equivalent fee. Stellato admitted, however, that any conclusions concerning the appropriateness of Joseph Leighton's trading depended upon, among other things, the instructions he received

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Pasternak testified that he therefore personally went into Knight's systems and records and retrieved order tickets and trade and market information for each of the three trades covered by Stellato's report. Pasternak also testified that he discussed the trades with Joseph Leighton. Pasternak testified that he determined that Stellato's recount of each of the trades was incorrect and that Joseph Leighton had not made as much money as Stellato had alleged. Pasternak further concluded that Stellato did not understand how retail orders that Knight executed for other broker-dealers interacted with Knight's institutional trading and could affect the volume and cost of an inventory of stock held by a particular market maker, particularly given Knight's guaranteed "automatic execution" of a large volume of pre-opening retail orders.

Based upon the foregoing, Pasternak testified that he concluded that Stellato's allegations were unfounded. Pasternak nevertheless met with Amoruso, the firm's chief compliance officer, and Dorsey, the firm's general counsel, and requested that Knight's compliance and legal departments conduct an independent review of Joseph Leighton's trading practices to determine whether anything about them was illegal or improper.

4. Knight's Compliance and Legal Departments Agree with Pasternak

Amoruso testified that he reviewed the reports that Stellato provided to Pasternak and conducted an in-depth review of the three trades that Stellato highlighted. Like Pasternak, Amoruso concluded that there were errors in the spreadsheets that Stellato provided that overstated the amount of profit that he claims was earned on any particular trade. Amoruso also concluded that there was no evidence that Joseph Leighton had engaged in front running, as that term is defined from a regulatory perspective. From Amoruso's view, Stellato had not provided any evidence that Joseph Leighton's trading violated any rule or regulation or was in any respect improper.

Dorsey testified that he agreed with Amoruso's assessment. He testified that he viewed Knight's institutional trading as a negotiated business that was highly dependent on executing trades in conformance with the instructions given by institutions. Dorsey testified that he did not believe that the manner in which Joseph Leighton and Knight's market makers accumulated stock to fulfill an institution's order was in any way improper and did not constitute front running (or for that matter trading ahead). Dorsey also believed that any profits that Knight earned from Joseph Leighton's trading were justified as compensation for the risks that Knight undertook to make markets and execute institutional orders. Dorsey knew of no requirement that Knight disclose its cost basis in any stock sold to (bought from) an institution or that explicitly limited the amount of profit made on not-held orders executed for them on a net basis, as long as the prices provided to institutions were fair and reasonably related to the market.[66] Dorsey

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[cont'd]

from an institution and the risks he undertook on Knight's behalf to execute an order. These are factors for which Stellato readily confessed he had no personal knowledge or understanding.

66 Both Amoruso and Dorsey testified that they were unaware of any regulatory requirement that required the disclosure of such information to customers or that equated the fulfillment of

[Footnote continued on next page]

testified that he concluded that Stellato had provided no evidence of wrongdoing and that Joseph Leighton and Knight had fulfilled any obligations that they possessed to provide institutions with best execution and fair pricing.

5. The Leightons Leave Knight

Pasternak testified that he ultimately concluded that neither Joseph Leighton nor John Leighton had engaged in any wrongdoing. Pasternak testified that he decided, however, that Joseph Leighton's trading presented a "marketing problem" such that Joseph Leighton's trading profits, taken out of context and without knowledge of the terms and market conditions under which they were earned, could be perceived by Knight's customers as being the result of improper practices. Pasternak also testified that he concluded that the atmosphere within the firm was such that Hewitt and Stellato could not coexist with John Leighton and Joseph Leighton. Therefore, in a sign of support of the management changes that he had approved, Pasternak agreed with Hewitt that John Leighton and Joseph Leighton should separate from Knight.[67]

John Leighton and Joseph Leighton left Knight on September 7, 2000. Thereafter, the firm negotiated severance payments to both Joseph Leighton and John Leighton, and they were permitted to resign from Knight effective in December 2000.[68]

[cont'd]

the firm's best execution obligations to those customers with some arbitrary figure added to Knight's cost basis. They further testified that Knight's legal and compliance departments also could discern no legal requirements or standards that would compel or sanction the monitoring of such information on individual institutional trades. In this respect, Amoruso testified that he regularly met with a group of compliance directors from other large wholesale market-making firms. This "working" group discussed industry trends, compliance issues special to their firms, and possible best practices to resolve the issues with which they were confronted. No wholesale market maker, like Knight, employed exception reports concerning profits or losses per share on institutional, not-held orders at the time of the trading with which we are concerned here.

67 Ultimately, Pasternak decided to change Knight's direction and management, and Hewitt and Stellato were asked to leave Knight as well.

68 The Uniform Termination Notices for Securities Industry Registration (Forms "U5") that were filed signifying the disassociation of Joseph Leighton and John Leighton from Knight stated that their separations from the firm were "voluntary" and did not indicate that either was terminated from the firm for any improper or suspected improper conduct. The evidence does not support any suggestion that the U5 filings did not accurately reflect the reasons for the departure of Joseph Leighton and John Leighton from Knight.

IV. Discussion

A. Fraud

In its complaint, Market Regulation alleged that Joseph Leighton deceptively garnered high profits for Knight that represented economic gains to which institutional customers were otherwise entitled, in violation of the antifraud provisions of the Exchange Act, as well as those of Exchange Act and FINRA rules. Exchange Act Section 10(b), Exchange Act Rule 10b-5, and NASD Rule 2120, each proscribe fraudulent and deceptive acts and practices in connection with the purchase and sale of securities.[69] A violation of each of these provisions requires proof that a person, acting with scienter, misrepresented or omitted material facts or employed a deceitful device in connection with securities transactions.[70] *SEC v. First Jersey Secs., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996); *Alvin W. Gebhart*, Exchange Act Rel. No. 58951, 2008 SEC LEXIS 3142, at *22-23 (Nov. 14, 2008).

Market Regulation's core allegations concern Joseph Leighton's execution and pricing of institutional, not-held orders to buy (sell) Nasdaq securities during 1999 and 2000. From the complaint, the arguments and evidence Market Regulation presented during the proceedings below, and the tenor of the briefs filed before the NAC, we have perceived three main bases upon which Market Regulation's assertion that Joseph Leighton defrauded Knight's institutional customers is founded: a breach of a fiduciary duty to disclose Knight's cost basis in securities sold to (bought from) institutions; a deceptive "trading ahead" scheme that was furthered by

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69 Section 10(b) of the Exchange Act makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of SEC rules. 15 U.S.C. § 78j(b). Exchange Act Rule 10b-5 prohibits, in addition to nondisclosure and misrepresentation, "any device, scheme, or artifice to defraud" or any practice "which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. § 240.10b-5. NASD Rule 2120 states that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

70 Both knowing and reckless conduct suffice to establish scienter. *See Tellabs, Inc. v. Makor Issues & Rights., Ltd.*, 127 S. Ct. 2499, 2507 n.3 (2007) (reserving the issue but stating: "Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required."); *see also Dep't of Enforcement v. Meyers*, Complaint No. C3A040023, 2007 NASD Discip. LEXIS 4, at *28 (NASD NAC Jan. 23, 2007) ("The courts have defined recklessness as 'an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'"). The test for materiality is whether a reasonable investor would consider the information significant with respect to an investment decision, such that the information would alter the "total mix of information" available. *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

material omissions of fact; and a failure to provide best execution, as evidenced by what Market Regulation asserts are "excessive" profits.

The Extended Hearing Panel majority's decision did not address Market Regulation's claim that Joseph Leighton committed fraud, finding instead that he violated his obligation to observe the high standards of commercial honor required under NASD Rule 2110.[71] Market Regulation nevertheless bases its cross-appeal, in part, upon a request that we further examine Joseph Leighton's trading practices and find that they exhibit fraud, including all of its elements. Market Regulation avers that this is necessary to establish the "true nature and extent of the misconduct and customer harm that occurred on the [r]espondents' watch" for purposes of assessing an appropriate level of sanctions.

Although we ultimately reverse the panel's majority decision, and vacate the sanctions imposed, we nevertheless find, based upon the nature of the allegations distinctive to this case, that we must address the claim that Joseph Leighton engaged in deceptive practices because it informs and colors Market Regulation's claims that John Leighton and Pasternak failed to supervise reasonably his conduct. After careful consideration of the entire record, we reject each of Market Regulation's fraud theories and find that staff failed to prove by a preponderance of the evidence that Joseph Leighton's trading practices amounted to a fraudulent device in violation of the federal securities laws or FINRA rules. Furthermore, for the reasons discussed below, we reverse and dismiss the majority's finding that Joseph Leighton violated NASD Rule 2110.

1. Breach of Fiduciary Duty

Market Regulation's fraud claim is first and foremost premised upon a pervasive undercurrent that Joseph Leighton possessed a fiduciary's duty to disclose to Knight's institutional customers the manner in which he accumulated stock and priced transactions, including the prices at which Knight bought (sold) stock to fulfill institutional orders and thus any profits that Knight enjoyed from his institutional trading. By failing to disclose Knight's cost basis, Market Regulation avers, Joseph Leighton "knowingly exploited" what it claims was an inability of Knight's institutional customers to obtain information concerning the securities he traded and deceived them about the true cost of their transactions.

Silence may constitute a violation of the antifraud provisions of the federal securities laws, and thus of FINRA rules, when a duty to speak arises from a relationship of trust and confidence between the parties to a securities transaction. *Chiarella v. United States*, 445 U.S.

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[71] NASD Rule 2110 provides that FINRA members shall, in conducting their business, "observe high standards of commercial honor and just and equitable principles of trade." A violation of another Commission or FINRA rule is also a violation of NASD Rule 2110. *See Dist. Bus. Conduct Comm. v. Euripides*, Complaint No. C9B950014, 1997 NASD Discip. LEXIS 45, at *18-19 (NASD NBCC July 28, 1997). By operation of NASD Rule 0115, NASD Rule 2110 is applicable to FINRA members and all persons associated with FINRA members.

222, 230 (1980); *see also SEC v. Zandford*, 535 U.S. 813, 823 (2002) (finding that "any distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients"). "Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts.'" *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Dealers that execute trades for a customer with whom a fiduciary relationship exists must therefore make a full disclosure of all information bearing upon the desirability of a transaction.[72] *Geman v. SEC*, 334 F.3d 1183, 1189 (10th Cir. 2003). This includes the disclosure of any adverse profit motives that the dealer, although buying and selling securities as a principal for its own account, may have with respect to the customer with whom it shares a fiduciary relationship.[73] *Id.* at 1189-90; *accord Arleen W. Hughes*, 27 S.E.C. 629, 635-36 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949). A dealer that is reposed with fiduciary obligations must therefore disclose the price at which it bought (sold) securities that it then sells to (buys from) its customer, so that the customer will understand what profits the broker-dealer realized by executing the transaction. *Id.* at 635-37.

Market Regulation's arguments generally presuppose the existence of a fiduciary relationship between Joseph Leighton and Knight's institutional customers. Market Regulation, however, has presented no compelling precedent to support the proposition that a broker-dealer that executes institutional not-held orders, as a principal, on a net basis, is reposed with general fiduciary obligations to the institutions with which it trades.

Indeed, fiduciary relationships generally do not arise from the ordinary interaction of broker-dealers and their customers and therefore are not to be presumed or implied without careful consideration.[74] *United States v. Skelly*, 442 F.3d 94, 98 (2d Cir. 2006); *see also Moss v.*

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[72] Exchange Act Section 3(a)(5)(A) defines the term "dealer" to mean "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise." 15 U.S.C. § 78c(a)(5)(A).

[73] Such disclosure requires more than the fact that the broker-dealer will act or has acted as principal in the transaction. *Norris & Hirshberg, Inc. v. SEC*, 177 F.2d 228, 233 (D.C. Cir. 1949).

[74] As the plethora of cases that Market Regulation cites in support of its arguments highlight, fiduciary relationships have been found to exist in limited areas, including cases in which a broker renders investment advice to his customer, manages his customer's discretionary account, or solicits or recommends a type of investment that the customer is not likely to understand given the comparative sophistication of the parties. *See, e.g.*, *United States v. Dial*, 757 F.2d 163 (7th Cir. 1985) (finding that a commodities broker, who conceded he was acting as a fiduciary when he solicited customer orders, committed fraud by trading ahead of his customers without telling them what he was doing), *cert. denied*, 474 U.S. 838 (1985); *Geman*, 334 F.3d 1183 (finding that a broker-dealer and investment adviser that specifically represented that it was undertaking fiduciary responsibilities to its customers fraudulently engaged in riskless principal transactions that rested upon misrepresentations and omissions concerning the manner of the broker-dealer's trading); *Press v. Inv. Servs. Corp.*, 988 F. Supp. 375, 386 (S.D.N.Y.

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Morgan Stanley, Inc., 719 F.2d 5, 15 (2d Cir. 1983) ("We find nothing in the language or legislative history of section 10(b) or rule 10b-5 to suggest that Congress intended to impose a special duty of disclosure on broker-dealers simply by virtue of their status as market professionals."). Dealers, like Knight, ordinarily do not undertake duties as fiduciaries when they act as principals opposite institutional counterparties in arm's-length transactions. *See Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 150 (S.D.N.Y. 2000); *Banca Cremi, S.A. v. Alex. Brown & Sons*, 132 F.3d 1017, 1038 (4th Cir. 1997); *West Virginia v. Morgan Stanley & Co.*, 459 S.E.2d 906, 910 (W. Va. 1995).

The question of whether a fiduciary relationship exists between parties to a securities transaction is a factual issue that courts have ordinarily framed with a view to state law.[75] *See Pasternak*, 561 F. Supp. 2d at 499; *see also McAdams v. Mass. Mutual Life Ins. Co.*, 391 F.3d at 303; *McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 736 F.2d 1254, 1258 (8th Cir. 1984); *Spicer v. Chicago Bd. Options Exch., Inc.*, No. 88 C 2139, 1990 U.S. Dist. LEXIS 14469,

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1997) ("'[I]n the absence of discretionary trading authority delegated by the customer to the broker . . . a broker does not owe a general fiduciary duty to his client." (*quoting Bissell v. Merrill Lynch & Co.*, 937 F. Supp. 237, 246 (S.D.N.Y. 1996)), *aff'd*, 166 F.3d 529 (2d Cir. 1999); *Hughes*, 27 S.E.C. at 629 (finding that a broker-dealer that also served as an investment advisor to customers that were largely unfamiliar with the practices of the securities industry had a fiduciary obligation to disclose that she was acting as a principal and the cost of the securities she sold to customers); *Dist. Bus. Conduct Comm. v. Goodman*, Complaint No. C9B960013, 1999 NASD Discip. LEXIS 34 (NASD NAC Nov. 9, 1999) (finding that a registered representative violated the antifraud provisions of the federal securities laws and FINRA rules by committing sales practice abuses with respect to retail customers that he had solicited and to whom he made unsuitable recommendations), *aff'd*, 54 S.E.C. 1203 (2001). These cases, however, rest upon essential facts or conditions that are inapposite to those presented here.

[75] No one fact is necessarily dispositive in determining whether a fiduciary relationship exists between the parties to a transaction. *See McAdams v. Mass. Mutual Life Ins. Co.*, 391 F.3d 287, 303 (1st Cir. 2004); *Arst v. Stifel, Nicolaus & Co.*, 86 F.3d 973, 978 n.4 (10th Cir. 1996). Our responsibility is instead to give effect to the reasonable expectations of those involved by looking to all of the circumstances surrounding their relationship. *E.F. Hutton & Co., Inc.*, 49 S.E.C. 829, 832 (1988); *Hughes*, 27 S.E.C. at 639 ("We emphasize that it is not intended that the disclosure requirements, which we have found applicable to registrant, be imposed upon broker-dealers who render investment advice merely as an incident to their broker-dealer activities unless they have by a course of conduct placed themselves in a position of trust and confidence as to their customers."); *see also Pine Belt Enters., Inc. v. SC&E Admin. Servs., Inc.*, Civ. No. 04-105, 2005 U.S. Dist. Lexis 23567, at *9-10 (D.N.J. Oct. 6, 2005) ("To succeed on a claim for breach of fiduciary duty a plaintiff must demonstrate that the relationship between the parties presumes a fiduciary duty, or because of the circumstances of the parties' specific relationship, a fiduciary relationship has arisen or can be implied.").

at *26 n.8 (N.D. Ill. Oct. 24, 1990), *aff'd*, 977 F.2d 255 (1992). Under New Jersey law, "[t]he essence of a fiduciary relationship is that one party places trust and confidence in another who is in a dominant or superior position."[76] *F.G. v. MacDonell*, 696 A.2d 697, 703-04 (N.J. 1997). This standard, which imposes a fiduciary duty where one party relinquishes control to another dominant or superior party upon whom the first party relies, is consistent with those applied by other courts in similar contexts. *See, e.g., United States v. Szur*, 289 F.3d 200, 210 (2d Cir. 2002) ("At the heart of the fiduciary relationship lies reliance and de facto control and dominance."); *Arst*, 86 F.3d at 979 ("'A fiduciary relationship implies a condition of superiority of one of the parties over the other.'" (*quoting Rajala v. Allied Corp.*, 919 F.2d 610 (10th Cir. 1990)); *CFTC v. Heritage Capital Advisory Servs., Ltd.*, 823 F.2d 171, 173 (7th Cir. 1987) ("A confidential or fiduciary relationship arises where one party possesses superior knowledge and influence over the other party . . . ."); *Leboce v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 709 F.2d 605, 607 (9th Cir. 1983) ("It is where the agent 'for all practical purposes' controls the account that California law imposes fiduciary obligations."); *Osan Ltd. v. Accenture LLP*, 454 F. Supp. 2d 46, 56 (E.D.N.Y. 2006) ("'[The] law [of fiduciary duty] recognizes that there is an imbalance inherent in certain relationships which places one party at a disadvantage in its dealings with the other party.'" (*quoting Langford v. Roman Catholic Diocese of Brooklyn*, 677 N.Y.S. 2d 436, 438 (N.Y. Sup. Ct. 1998)); *Lehman Bros. v. Minmetals*, 179 F. Supp. 2d at 151 (stating that a fiduciary relationship depends upon whether one person has been reposed with such trust and confidence as to gain "superiority or influence" over the other).

We find that Market Regulation failed to prove by a preponderance of the evidence that Joseph Leighton assumed the role of a fiduciary to the institutions with which he traded. Knight, as a wholesale market maker, did not maintain customer accounts for the institutions with which it dealt. Knight therefore did not act as a broker or agent for institutional customers.[77] *Compare G. Alex Hope*, 7 S.E.C. 1082, 1083 (1940) (holding that "[a] broker is an agent"), *with Congregation of the Passion v. Kidder Peabody & Co., Inc.*, 800 F.2d 177, 183 (7th Cir. 1986) ("[T]he dealers acted merely as the instrument for executing the transactions . . . ."). Institutional buy-side traders rather placed orders that they understood would be executed by Knight, as a dealer, on a principal-to-principal basis. In this respect, the elements of control, reliance, and dominance ordinarily associated with a fiduciary relationship are lacking. The institutions with which Joseph Leighton traded determined the securities and quantities thereof to trade, they provided specific instructions on how their orders should be worked and interact with the market, and their orders were closely monitored and guided by the institutions' buy-side traders from beginning until end. Knight's institutional customers were themselves fiduciaries and viewed it

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76 In its decision dismissing the Commission's civil complaint against the respondents, the district court applied New Jersey law, the location of Knight's operations, and concluded that the elements of a fiduciary relationship did not exist between Joseph Leighton and the institutions he served. *Pasternak*, 561 F. Supp. 2d at 499.

77 Exchange Act Section 3(a)(4)(A) defines the term "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A).

as their sole responsibility to remain the ultimate arbiters of whether the trading being conducted by Joseph Leighton met their instructions and trading objectives. *See Market 2000 Report*, 1994 SEC LEXIS 143, at *26 (Jan. 1994) ("As fiduciaries, institutional money managers are obligated to obtain best execution on their transactions."). Knight's institutional customers did not relinquish control of their orders nor abdicate to Joseph Leighton a position of dominance and superiority. *See Pasternak*, 561 F. Supp. 2d at 506.

The fact that Joseph Leighton was imparted an element of discretion as to the times and prices at which not-held orders would be executed does not alter our conclusion. Joseph Leighton did not undertake obligations to act as a fiduciary to Knight's institutional counterparts. *See Pasternak*, 561 F. Supp. 2d at 506. We emphasize that a grant of time and price discretion for purposes of executing a not-held order is not the same as a grant of trading discretion over investment decisions to be made for a discretionary account. *See Pearce v. Duchesneau Group, Inc.*, 392 F. Supp. 2d 63, 70 (D. Mass. 2005) ("'Where the account is non-discretionary, meaning that the customer makes the investment decisions, and the stockbroker merely receives and executes a customer's order, the relationship generally does not give rise to general fiduciary duties.'" (*quoting Patsos v. First Albany Corp.*, 741 N.E. 2d 841, 849-50 (Mass. 2001)); *see also* NASD Rule 2510(d)(1) (excepting from the provisions of NASD Rule 2510 discretion exercised pursuant to a not-held order as to the price at which or the time when a customer's order is to be executed). Thus, we must look to the degree and extent of discretion that a customer has assigned to those with whom he trades to determine the existence of a fiduciary relationship. *Pearce*, 392 F. Supp. 2d at 70; *see also McAdams v. Mass. Mutual Life Ins. Co.,* 391 F.3d at 303 ("Key factors in this fact-specific inquiry include . . . whether one party has granted another party a great deal of discretion."); *cf. McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750, 766 (3d Cir. 1990) ("[W]e believe our focus must be on the relationship between McAdam and Murray vis-à-vis the 'special' investment opportunity."); *Lehman Bros. v. Minmetals*, 179 F. Supp. 2d. at 151 ("Courts in this District have found that a fiduciary relationship could potentially arise in a 'principal-to-principal' arm's length relationship based upon the degree of trust that exists in that relationship."). "[T]rading without the customer's prior approval suggests an account is discretionary while frequent communications between the customer and the stockbroker . . . suggests that the customer has retained control." *Pearce*, 392 F. Supp. 2d at 70; *accord McAdam v. Dean*, 896 F.2d at 766-67 ("There is no evidence that McAdam ever suggested to Murray what investment moves he should make, nor is there any suggestion that Murray purported to consult with McAdam about the transactions supposedly performed in the account.")

The discretion that institutions granted Joseph Leighton to execute their not-held orders in this case operated as a mechanism by which they extended, rather than relinquished, their control and dominance. By utilizing not-held orders for their trading purposes, institutions relieved Joseph Leighton of his ordinary duty to execute their orders with immediacy or at a particular price and permitted him instead to trade at prices and in volumes that better suited their objectives, expressed desires, instructions, and market conditions. Retaining anonymity for purposes of avoiding adverse price movements in the difficult-to-trade environment for Nasdaq securities during the relevant time period was important to the institutions. Not-held orders provided this anonymity and allowed institutions to retain control over the course of their trading, avoiding the pressing forces of the market to which their orders could have been subjected absent the use of a not-held order. The constant communications between buy-side traders and Joseph Leighton, the point and frequency of the instructions given to him by the institutions, and the nature of their trading relationship are facts that support the conclusion that institutions retained such control and dominance over their affairs as to outweigh the discretion granted to Joseph Leighton and undermine the Extended Hearing Panel majority's finding that the parties were in "unequal positions."

In reaching this conclusion, we cannot ignore the sophistication and acumen of the institutions with which Joseph Leighton traded. *See McAdams v. Mass. Mutual Life Ins. Co.*, 391 F.3d at 303 (noting that the question of whether an insurer owed a fiduciary duty to others rested upon "key factors," including "one party's lack of sophistication relative to another on the relevant issues"); *Walter v. Holiday Inns, Inc.*, 985 F.2d 1232, 1239 (3d Cir. 1993) ("As a general proposition courts and commentators have recognized that in determining whether a fiduciary duty has been breached by a material misstatement or by a failure to disclose a material fact, the sophistication of the complaining partner . . . [is a] key factor[] to be considered."); *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049 (11th Cir. 1987) ("The experience and sophistication of the investor are also relevant to determine the extent of the fiduciary duty of care in explaining contemplated securities transactions."); *Leboce*, 709 F.2d at 607 ("We have not found nor has Leboce cited to us any California cases imposing fiduciary duties on a broker in favor of an investor of Leboce's sophistication and independence."). Beyond the question of discretion or control, a customer's investment intelligence is a factor to consider when determining whether a fiduciary relationship exists between parties. *Pearce*, 392 F. Supp. 2d at 70.

The institutions with which Joseph Leighton traded were highly sophisticated financial organizations. They had at their disposal complex market surveillance tools and consultants that closely scrutinized the market for the securities in which they were trading and the executions that Joseph Leighton provided.[78] Institutional buy-side traders also were in frequent contact with other market makers in an effort to continually monitor and gauge the color of the markets in which they were trading. Knight's institutional customers hence simply did not suffer from the types of informational disadvantages about prevailing market prices or conflicts ordinarily associated with fiduciary or other relationships of trust and confidence.

Knight's institutional customers also possessed notable bargaining power.[79] Buy-side trader testimony established that institutions possessed the power to reject any execution price

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[78] As the Commission has commented, institutions use their own proprietary systems or third party services to gather a substantial amount of data about transaction costs and execution quality in order to monitor the performance of broker-dealers and to comply with their own best execution responsibilities. *Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, Exchange Act Rel. No. 48952, 2003 SEC LEXIS 3013, at *25 & n.32 (Dec. 18, 2003).

[79] Institutions and sophisticated individual customers often negotiate prices that are better than the prices received by those with less market power. *See Report Pursuant to Section 21(a)*

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that they thought was not satisfactory.[80] The evidence further confirms that, if an institution determined that its orders were not executed in conformity with its instructions or its observations of the market, it could, among other things, renegotiate the price for a particular trade, demand a commensurate discount on a future trade, or cease doing business with the broker-dealer either on a temporary or continuing basis. Thus, to assuage institutional customers, Joseph Leighton and others testified, Knight often "printed to the volume" regardless of whether the market for a security traded up (or down) relative to Knight's proprietary position and executed trades at prices that caused Knight to suffer losses when necessary to meet customer expectations.

We recognize that buy-side traders testified that they placed their "trust" and "confidence" in Joseph Leighton and expected him to use his brokerage judgment to help them get the best possible executions for their orders. These facts alone, however, do not compel a finding that Joseph Leighton assumed the role of a fiduciary. That one party to a security transaction trusts another and relies upon him to perform does not give rise to a confidential, fiduciary relationship. *Banca Cremi*, 132 F.3d at 1038; *accord Geman*, 334 F.3d at 1189 (stating that a fiduciary relationship results when one person manifests his consent to be controlled by a second and the second person agrees to so act on the first person's behalf (*citing* Restatement (Second) of Agency, § 1(1) (1958)); *Arst*, 86 F.3d at 980 ("We have held that 'conscious assumption of the alleged fiduciary duty is a mandatory element . . . .'" (*quoting Rajala*, 919 F.2d at 615)); *Barnes v. First Franklin Fin. Corp.*, 313 F. Supp. 2d 634, 639 (S.D. Miss. 2004) ("[U]nilateral trust alone will not support a finding of a fiduciary relationship."); *Spicer*, 1990 U.S. Dist. LEXIS 14469, at *47 ("'Normal trust . . . plus [even] a slightly dominant business position, [does] not operate to turn a . . . contractual relationship into a confidential or fiduciary relationship.'" (*quoting Carey Elec. Contracting, Inc. v. First Nat'l Bank of Elgin*, 74 Ill. App. 3d 233, 238 (2d Dist. 1979)). There is no evidence to suggest that Knight's institutional customers ever asked Joseph Leighton to act as their fiduciary, that he understood they were making such a request, or that he in any manner assented to act as such. Consequently, we reject

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of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, 52 S.E.C. 882, 895 n.33 (Aug. 8, 1996); *cf. Order Approving Proposed Rule Change by National Assoc. of Secs. Dealers, Inc. Relating to Limit Order Protection on Nasdaq*, Exchange Act Rel. No. 35751, 1995 SEC LEXIS 1269, at *22-23 (May 22, 1995) ("Unlike institutional customers who are in a better position to negotiate their own protection with market makers, public customers have less viable alternatives in determining where their orders are ultimately sent for execution.").

[80] As FINRA has recognized, the prospect that institutional customers would accept execution prices that are not reflective of the markets in which they are trading is highly unlikely. *See Order Approving Proposed Rule Change*, Exchange Act Rel. No. 16960, 1980 SEC LEXIS 1134, at *9 n.26 (July 7, 1980).

Market Regulation's claim that Joseph Leighton committed fraud by his silence concerning Knight's costs and profits.[81]

2. Trading Ahead

Market Regulation's second theory that Joseph Leighton committed fraud rests upon allegations that Joseph Leighton's practices, as they related to the execution of institutional, not-held orders, constituted a deceptive trading scheme. The scheme, Market Regulation contends, consisted of having Knight, upon the receipt of an order, establishing a proprietary position in its market making account for the ordered security. Then, the premise goes, Joseph Leighton secretly delayed executing the order to take advantage of improving market conditions rather than executing an offsetting, contemporary transaction with the institution. Equating Joseph Leighton's execution of the orders at issue in this case with the fraudulent practices that encompassed the transactions that we examined in *Department of Enforcement v. Nicolas*, Complaint No. CAF040052, 2008 FINRA Discip. LEXIS 9 (FINRA NAC Mar. 12, 2008), Market Regulation contends that Joseph Leighton engaged in deceptive misconduct by "trading ahead" of institutions and misleading them for profit.

We disagree with Market Regulation's assessment of Joseph Leighton's trading practices. First, the theory that Joseph Leighton manipulated not-held orders to advantage Knight and himself ignores the fundamental nature of a not-held order. Unlike a market order, which requires immediate execution, a not-held order allows a market maker to trade the ordered security for its proprietary account without the requirement that it contemporaneously execute its institutional customer's order. *See NASD Notice to Members 97-57*. The market maker is thus free to trade the ordered security for its proprietary account at any price, including the same price

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81 The application of general agency principles that have been applied in certain relationships between broker-dealers and their customers would not in this case alter our views of Joseph Leighton's obligation to disclose Knight's costs and profits to institutional customers. *See, e.g., Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990) ("A broker is an agent who owes his principal a duty to act only as authorized."); *E.F. Hutton*, 49 S.E.C. at 832 n.9 ("By agreeing to obtain execution on Manning's behalf, Hutton became Manning's agent for that purpose."). An agent who deals with his principal in his own account may be excused from a duty to disclose information that could reasonably affect the principal's judgment when the principal manifests that he knows all material facts in connection with the transaction or does not care to know them. *See* Louis Loss & Joel Seligman, *Securities Regulation* 3870 n.116 (3d ed. 2004) (citing Restatement (Second) of Agency § 390 & cmt. b; *id.* § 389 cmts. b, d); *see also* Restatement (Third) of Agency § 8.06 ("Conduct by an agent that would otherwise constitute a breach of duty . . . does not constitute a breach of duty if the principal consents to the conduct . . . .") & cmt. c ("A principal may consent to an agent's receipt of a material benefit in connection with a transaction . . . ."). Indeed, the parties to a securities transaction may alter the duties presumptively applied by the law governing fiduciaries. *See E.F. Hutton*, 49 S.E.C. at 832; *see also Hughes*, 27 S.E.C. at 635 ("An exception is made, however, where the principal gives his informed consent to such dealings.").

or even a better price than that ultimately received by the institutional customer when its not-held order is executed. *Id.* To fill a not-held order at an acceptable price, a market maker is also permitted to trade ahead of the institutional customer's order.[82] *NASD Notice to Members 97-57.* Not-held orders placed by institutional customers thus permit a sales trader to accumulate a security for the firm's market-making account at one price and to execute or fill an institutional customer's order at a subsequent time at another price. *Id.*; *see also NASD Notice to Members 99-65.*

The unique characteristics and virtues of a not-held order are thus that they permit an institutional sales trader, like Joseph Leighton, to quietly, in a principal capacity, acquire securities over time, monitor market conditions, and exercise limited discretion as to when to execute an offsetting transaction with the institutional customer. This required, with the trades at issue in this case, that Joseph Leighton and Knight's market maker in the subject security obtain a substantial volume of stock necessary to fulfill the institutional customer's order through many smaller transactions and to do so without adversely affecting the price of the stock or betraying the institutional customer's market anonymity. Joseph Leighton also needed to ensure that he provided to the institutional customer an execution that was consistent with its volume requests and provided a price or prices that were reflective of where the market, as a whole, had traded throughout the day. Joseph Leighton's executions thus needed to be in smaller increments and not contemporaneous with Knight's market-making activity on the other side of the market to avoid precipitating detrimental trading activity by other market participants. Not-held orders thus "necessarily require[d]" that Joseph Leighton accumulate securities ahead of executing Knight's institutional customers' orders and "manipulate the execution of the trades to arrive at best execution for the customer."[83] *Pasternak*, 561 F. Supp. 2d at 507.

Second, the assertion that Joseph Leighton engaged in deceptive misconduct was not borne out by the evidence presented at the hearing. As Market Regulation conceded at closing arguments before the Extended Hearing Panel, it can point to no testimony or contemporaneous evidence to support the contention that Joseph Leighton deceptively delayed order executions to disadvantage Knight's institutional customers. Rather, the evidence establishes that the institutions with which Joseph Leighton traded were aware of and had a voice in controlling the timing of Knight's execution of their orders. They controlled the pace of their executions and

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82 FINRA has recognized, however, that a broker-dealer that receives a large, potentially market moving, institutional order could violate its duty of best execution, discussed *infra* Part IV.A.3, by engaging in hedging or other prepositioning activity that could affect the market for a security that is involved in a transaction. *See NASD Notice to Members 05-51* (Aug. 2005). A broker-dealer in such cases must "refrain from any conduct that could disadvantage or harm the execution of the customer's order or place the member's financial interests ahead of those of its customer's." *Id.*

83 For large institutional orders, price impact costs are a more significant component of execution quality than spread costs. *See Regulation NMS*, Exchange Act Rel. No. 49325, 2004 SEC LEXIS 479, at *18 (Feb. 26, 2004).

determined the life of each order. Buy-side traders testified that they expected Knight to accumulate a position for the securities they were trading without Joseph Leighton immediately reporting to them each buy (sell) transaction. They thus anticipated and desired smaller prints, over time. Market Regulation's claim that Joseph Leighton was in some manner able to deceptively withhold the execution of the institutions' orders without their knowledge is therefore contrary to the record evidence.

Third, we find Market Regulation's comparison of Joseph Leighton's trading practices to those we condemned in *Nicolas* to be without merit. In *Nicolas*, we held that the respondents, among other things, participated in a fraudulent scheme and omitted material facts. 2008 FINRA Discip. LEXIS 9, at *1. At the heart of the respondents' misconduct in *Nicolas* were actions taken to "trade ahead" of a customer's market orders. *Id.* at *32. Instead of providing full and prompt execution of the customer's orders, the respondents instead intentionally delayed time-stamping and executing the orders until their firm had established a proprietary position in the ordered securities that matched exactly the size of the customer's orders. *Id.* The respondent's firm then executed all orders with the customer on a principal basis. *Id.* We concluded that the respondents were thus able to gain risk-free profits from transactions that were effectively designed and executed as "riskless" principal transactions. *Id.* at *34-36. We further found that the respondents' failure to disclose these profits, which dwarfed the mark-ups or commissions that were falsely confirmed as being the only costs borne by the customer, constituted material omissions that denied the customer an awareness of the availability of superior prices. *Id.* at *36-37.

Nicolas can be distinguished from the present case on several levels. Foremost, whereas *Nicolas* was concerned with the gaming of a customer's market orders, the transactions with which we are concerned in this case involved the execution of not-held orders. Additionally, the not-held orders that Joseph Leighton executed for institutional customers were not, as Market Regulation advocates, "riskless" principal transactions.[84] The Commission has in the past recognized the difficulty that a dealer has identifying when a riskless principal transaction has been effected where that dealer also regularly engages in market making activities for the particular security being traded by its customer.[85] *See Order Approving Proposed Rule Change*

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[84] "[A] riskless principal [transaction] occurs where a dealer, after receiving a customer order for a security, purchases [or sells] the security from [or to] another firm for its own account, and then contemporaneously sells [or buys] that security to the customer." *Kevin B. Waide*, 50 S.E.C. 932, 933 n.2 (1992). As the Commission has concluded, "a riskless principal transaction is the economic equivalent of an agency trade." *Id.* at 935-36. In such instances, "a firm is adequately compensated by a mark-up [mark-down] over its cost." *Id.* at 936.

[85] FINRA too has noted that a riskless principal transaction generally involves two orders, the execution of one being contingent or dependent upon the receipt of another. *NASD Notice to Members 99-65*. FINRA has thus concluded that if a market maker cannot identify which trade or series of trades were undertaken in its proprietary account to fulfill a customer's order, the market maker is at risk and the execution of the customer's order is not a riskless principal transaction. *NASD Notice to Members 99-65*; *see also NASD Notice to Members 99-66* (Aug.

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by NASD Relating to Trade Reporting, Exchange Act Rel. No. 41208, 1999 SEC LEXIS 593, at *11 (Mar. 24, 1999). "In making a two-sided market, involving price quotations for both the bid and the offer, a market maker may often engage in transactions that effectively offset one another, giving the appearance of being 'riskless' principal transactions, even though the market maker did not structure any particular pair of transactions as offsetting, 'riskless' principal transactions." *Secs. Confirmations*, Exchange Act Rel. No. 15219, 1978 SEC LEXIS 566, at *28 (Oct. 6, 1978). Under such circumstances, the Commission has stated that a dealer cannot "be considered a market maker for some trades but not for others." *Strategic Res. Mgmt., Inc.*, 52 S.E.C. 542, 545 (1995). Consequently, a dealer that engages in a transaction that could otherwise be characterized as "riskless" in fact undertakes the transaction at risk when it is also engaging in normal market-making functions in the security being traded by its customer. *Id.* In such a case, the dealer does not enter into riskless principal transactions even in those instances where the dealer buys or sells a security on the inter-dealer market at a time when it can offset a customer's order on the opposite side of the market. *Id.* There is no dispute that Knight held itself out and acted as a market maker, regularly conducting inter-dealer trades on both sides of the market, for each of the securities that Knight's institutional customers bought (sold) through the execution of their not-held orders.

Moreover, in a net trading environment, a market maker is at risk and is entitled to the difference between its cost and the price of the offsetting transactions with its customers as compensation for the risks it undertakes in performing its dealer functions. *See NASD Notice to Members 99-65*; *NASD Notice to Members 01-85*. When a market maker employs net pricing, the execution of an order that would otherwise appear to be a riskless principal transaction is a transaction involving risk because the market maker acquires or sells securities at one price for its proprietary account and effects the offsetting execution with its institutional customer at a different price. *Id.* Here, the record is clear that institutions requested and agreed to net executions from Knight.

Finally, Joseph Leighton's and Knight's execution of institutional not-held orders in this case undeniably was accompanied by the commitment of Knight's capital. The exhibits summarizing Joseph Leighton's handling of certain trades show that Knight accommodated institutional customers by selling stock from its inventory to start an order or by selling securities short to the institution at various points while the order was active. Customers also acknowledged that, although they could not recall any specific instances, they frequently "backed away" or "walked away" from the unfilled portions of their orders or canceled orders outright, in which case Knight remained at risk for any securities that it had accumulated in anticipation of fulfilling a customer's order but had not yet printed. *See NASD Notice to Members 99-65*.

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1999). The evidence is clear that Knight's systems did not segregate or separately account for securities purchased (or sold) in anticipation of fulfilling a particular institutional order from its other trading.

We thus find that *Nicolas* provides us with few fruitful bearings concerning the issues we are asked in this case to reflect upon. Market Regulation's implicit assertion that Joseph Leighton, by failing to execute institutional not-held orders using "cost-plus" pricing, garnered secret, risk-free profits analogous to those at issue in *Nicolas* is without merit. *Cf. Strategic Res. Mgmt.*, 52 S.E.C. at 545 (setting aside FINRA findings that a market maker charged excessive mark-ups when FINRA erred by using the market maker's cost of the securities to calculate mark- ups). Nor do we find, as we did in *Nicolas*, that Joseph Leighton omitted material facts by failing to disclose the profits Knight earned from the execution of institutional not-held orders. As a market maker and because it executed institutional orders on a net basis, Knight plainly did not have the same obligations to disclose its compensation under Exchange Act Rule 10b-10's confirmation provisions that we found that the respondents violated in *Nicolas*.[86] More importantly, our finding that the respondents deceptively failed in *Nicolas* to disclose profits earned from the execution of riskless principal trades was premised upon their false representations that agreed-upon transaction costs were the only costs incurred by the customer. We can discern in this case no similar statements that would otherwise have required Joseph Leighton to disclose to Knight's institutional customers Knight's costs or profits resulting from the execution of their orders.[87] *See Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105,

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86 Exchange Rule 10b-10(a)(2)(ii)(A) requires a dealer to disclose, when it executes a riskless principal transaction for a customer, "the difference between the price to the customer and the dealer's contemporaneous purchase . . . or sales price . . . ." 17 C.F.R. § 240.10b-10(a)(2)(ii)(A). Market makers, however, are exempt from the confirmation requirements of this provision. *Secs. Confirmations*, 1978 SEC LEXIS 566, at *27-28. For all other trading conducted by a dealer on a principal basis, Exchange Act Rule 10b-10(a)(2)(ii)(B) requires the dealer to disclose "the reported trade price, the price to the customer in the transaction, and the difference, if any, between the reported trade price and the price to the customer." 17 C.F.R. § 240.10b-10(a)(2)(ii)(B). Nevertheless, where net trading is concerned, the reported price and the price to the customer are the same, and a dealer is not required to confirm to its customer the profit it has earned when executing the customer's transaction. *See Notice of Filing of Proposed Rule Change by NASD Relating to Disclosure and Consent Requirements when Trading on a Net Basis with Customers*, 2005 SEC LEXIS 750, at *6 n.9; *see also Confirmation Disclosure for Reported Securities*, 1985 SEC LEXIS 712, at *22 (Sept. 11, 1985).

87 In its decision, the Extended Hearing Panel's majority found that Joseph Leighton "led [institutions] 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" and further that he "misled [them] into believing that they received best execution services at least as good as, if not superior to, the generally prevailing industry practice." These findings find no support in the record. The evidence instead establishes, abundantly and without uncertainty, that Joseph Leighton and the institutional customers with whom he traded never discussed the manner in which Joseph Leighton would price their executions, other than providing net pricing, and that Joseph Leighton never agreed or represented that he would limit in any approach the amount of compensation that Knight earned from the execution of institutional, not-held orders to an arbitrary sum greater than Knight's costs.

1119 (D.R.I. 1990) ("While the line between half truths and untruths is sometimes difficult to draw, both trigger a duty to disclose any additional or contradictory facts that may be necessary to present . . . a complete picture . . . ."); *see also* 17 C.F.R. § 240.10b-5(b) (making it unlawful for any person "to omit to state a material fact necessary in order to make the statements made . . . not misleading . . . ."). We thus reject Market Regulation's assertion that Joseph Leighton engaged in a deceptive scheme that caused him to "trade ahead" of institutional customer orders.

3. Best Execution and "Excessive" Profits

The third, and final, feature of Market Regulation's claim that Joseph Leighton engaged in fraud rests upon assertions that his execution of institutional, not-held orders denied institutions "best execution" and resulted in Knight deceptively earning outsized trading profits. We conclude that Market Regulation's theories and the evidence it presented in support of its claims do not support the conclusion that Joseph Leighton failed to provide best execution to Knight's institutional customers or that the profits he garnered for Knight were in any manner the proceeds of fraud.

a. Best Execution

As to best execution, a broker-dealer is required to seek for its customer's order the most favorable terms reasonably available under the circumstances.[88] *Newton*, 135 F.3d at 270. This duty hence requires a broker-dealer to execute a customer's transaction at the best, reasonably available price.[89] *Id.* at 270. A broker-dealer that accepts an order from a customer makes a material misrepresentation concerning the transaction if the order is not executed in accordance with the broker-dealer's implied representation that it will provide best execution.[90] *Newton*, 135 F.3d at 269-70. Joseph Leighton is not liable for any such misrepresentations.

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88 Predating the federal securities laws, the duty of best execution has its roots in the common law agency obligations of undivided loyalty and reasonable care. *See Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998). Although we conclude in this case that there existed no general fiduciary relationship between Joseph Leighton and Knight's institutional customers, FINRA has recognized that a broker-dealer may, when executing not-held orders, violate certain obligations that are derived from the law of agents and fiduciaries, including the duty of best execution. *See NASD Notice to Members 97-57* ("MMA could potentially violate its fiduciary duties to its customer in the way it 'works' the order.").

89 Other terms, in addition to price, are relevant to best execution, including the size of the customer's order, the security being traded, speed of execution, and the cost and difficulty of executing an order in a particular market. *Id.* at 270 n.2.

90 In addition to the recognized duty of best execution that has been incorporated into the federal securities laws through case law and Commission decisions, NASD Rule 2320 requires, among other things, that a broker-dealer provide its customers with "best execution" by using "reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing

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First, a broker-dealer's best execution duty is subject to limitation and alteration by any instructions given by its customer. *See Newton*, 135 F.3d at 269. Indeed, moderation of the best execution duty is acknowledged in the guidance that FINRA has provided with respect to a market maker's obligations concerning not-held orders. For these orders, because the market maker has been given discretion to "work" the order, the market maker "does not owe the same best execution obligations" to the customer as if the order were a market or limit order.[91] *Id.* The market maker instead possesses the "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."[92] *Id.*

Here, the evidence established that whether Knight and Joseph Leighton met their best execution obligations when executing an institutional, not-held order depended in large part upon the institution's assessment of the ability of Joseph Leighton to follow its instructions and to meet its trading objectives, within the confines of the market. In this respect, institutions recognized that the quality of the executions that Joseph Leighton provided to them was not governed by price alone and certainly not by the price at which Knight acquired (or sold) securities to fulfill their orders.[93] Institutions were largely indifferent to Knight's cost basis and were not overtly concerned with how much money Knight made (lost) executing their trades. It was instead important to them that Knight provide sufficient market liquidity to allow them to buy or sell large volumes of stock and to do so at prices that were reflective of the market as a whole.

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market conditions." NASD Rule 2320. Market Regulation did not in this case allege that Joseph Leighton violated NASD Rule 2320.

91 When handling a not-held order, a market maker "must use its brokerage judgment in the execution of the order, and if such judgment is properly exercised, the broker is relieved of its normal responsibilities with respect to the time of execution and the price or prices of execution of such an order." *See NASD Notice to Members 97-57.*

92 Neither Joseph Leighton nor Knight's institutional customers had any recollection of the specific trades reviewed in this case and thus also did not have any memory of any instructions or terms that may have accompanied the execution of those trades. As even buy-side traders called in support of Market Regulation's case acknowledged, any examination of the quality of the executions that Joseph Leighton provided them is thus based largely upon hindsight and ignores any analysis of the difficult market conditions that existed for the Nasdaq securities that institutions were trading with Knight in 1999 and 2000.

93 As institutions have recognized in filings with the Commission, price is just one element in overall execution quality. *Regulation NMS*, Exchange Act Rel No. 51808, 2005 SEC LEXIS 1349, at *906 (June 9, 2005). Institutional traders thus often trade off price for liquidity, speed of execution, likelihood of completion, and other attributes. *Id.*

Using real time market data and automated surveillance tools, and even after imputing an assumed mark-up (mark-down) or commission equivalent, Knight's institutional customers determined that Joseph Leighton provided them with executions of good quality that were consistent with their trading instructions and market conditions. These institutions, which given their knowledge of numerous subjective factors were well placed at the time to determine whether the executions Joseph Leighton provided to them were agreeable, never found any fault with the net prices at which Knight executed their not-held orders.[94] These institutions also often penalized broker-dealers for unacceptable fills by taking their business elsewhere. Indeed, Market Regulation's assertion that Joseph Leighton failed to provide best execution to Knight's institutional customers cannot be squared with the little evidence that was presented on the issue at the hearing below. This uncontested evidence established that Joseph Leighton generally provided greater liquidity at superior prices for the volatile Nasdaq securities traded by institutions in 1999 and 2000 than sales-traders at other broker-dealers.

Second, the application of best execution concepts inevitably involves a "facts and circumstances" analysis. *See NASD Notice to Members 97-57* ("Depending upon the particular set of facts surrounding an execution, actions that in one set of circumstances may meet a firm's best execution obligation, may not meet that standard in another set of circumstances."). Market Regulation in this case nevertheless abandoned any specific analysis of the trade executions that we are called upon to revisit. Market Regulation instead argues for a "one-size-fits-all" best execution standard for the not-held orders that Joseph Leighton filled for institutions on a net basis. In this respect, Market Regulation equates Joseph Leighton's obligation to provide best execution with what it claims was the "custom and expectation of the industry" that he would price institutional orders based upon Knight's proprietary cost (sales price), plus some "reasonable" amount of compensation in the form of a mark-up (mark-down) or other fee of not greater than 12 cents.

The evidence, however, does not support Market Regulation's assertion that an "industry standard" existed by which Knight was required to price not-held orders based upon its cost, plus an arbitrary figure of nominal compensation. Joseph Leighton and the institutions with which he traded never discussed this pricing convention, and there is no evidence that this was the manner in which other wholesale market makers executed and priced transactions undertaken with institutions on a net basis at the time. Rather, by agreeing to the use of net pricing, Knight's institutional customers understood that Knight would purchase from (sell to) the institutions securities that had been acquired (sold) for Knight's proprietary accounts.[95] The record further

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[94] Knight's institutional customers were in many aspects in the best position to ascertain whether best execution had been met because they knew best and understood their instructions and specific trading objectives. *See Order Approving Proposed Rule Change*, 1980 SEC LEXIS 1134, at *9 n.26 (July 7, 1980) (noting that the prospect that institutional customers would accept execution prices that are not reflective of the markets in which they are trading is highly unlikely).

[95] FINRA has recognized that decisions about methods of pricing and compensation are generally made in arm's length negotiations between broker-dealers and their customers based

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indicates that, for undertaking the service of executing their not-held orders, Knight would be compensated by the difference between the prices at which it acquired (disposed) securities as principal and the prices at which the offsetting transactions to the institutions were executed. Given the volatile market for Nasdaq securities in 1999 and 2000, this "spread" could be sizeable and was reflective of the market risk to which Knight was subjected by trading with institutions into and out of its principal accounts. Thus, despite whatever unilateral expectations, beliefs, or assumptions institutions may have convinced themselves of otherwise, we conclude that the preponderance of the evidence shows that the institutions with which Joseph Leighton traded expected Knight to attempt to profit from their trading, regardless of the mark-up (mark-down) or commission equivalent that the institutions themselves imputed to their orders.

b. "Excessive" Profits

Turning next to Market Regulation's claims concerning Knight's "excessive" trading profits, Market Regulation takes issue with the prices at which Joseph Leighton executed institutional, not-held orders and, in essence, alleges that Joseph Leighton overcharged customers in order to garner greater compensation for Knight and himself. We find that these assertions have no support in the law or in the record evidence.

First, Market Regulation's depictions of Knight's profits are premised upon what we have concluded above is a faulty assumption that Joseph Leighton was obligated, given a tenuous "industry standard," to use "cost-plus" pricing whereby the prices at which Joseph Leighton executed institutional orders on a net basis were reflective of Knight's cost (sales price) and some amount of "reasonable" compensation in the form of a mark-up (mark-down) or other similar fee. No provision of the federal securities laws, no FINRA rule, and no industry standard establishes or advocates for the pricing and compensation standards that Market Regulation implicitly seeks to impose in this case upon market makers. Indeed, FINRA has made clear that market makers are not obligated to impose or accept any particular compensation model, nor does it suggest the appropriate level of compensation that market makers must accept for executing orders. *See NASD Notice to Members 01-85.* FINRA rules and guidelines thus state that a market maker is entitled to profit from its trading with customers and that Knight's cost basis was not in this case an arbitrary limiter of the prices that it could charge for securities that it sold to (and bought from) institutions.[96] *See* NASD Rule 2440; *see also* NASD IM -2440-1(c)(2)

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upon structures that they independently determine to be appropriate for their business relationships. *See NASD Notice to Members 01-85*. The method of compensation used in this case for the execution of institutional orders - net pricing - was clearly understood by the parties. We therefore reject Market Regulation's assertion that Joseph Leighton had any misunderstanding of his customers' instructions and expectations concerning the pricing conventions to be used for executing their orders.

96 We thus do not accept Market Regulation's claim, which is based in part upon fiduciary principles that were not proven to be applicable here, that Joseph Leighton was required to subjugate Knight's interests entirely to those of the institutional customers for which he executed

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("The amount of profit or loss to the member from market appreciation or depreciation . . . would not ordinarily enter into the determination of the amount or fairness of the mark-up."); *cf. NASD Notice to Members 01-85* ("The difference between the price of the market maker's transaction and the price of the offsetting transaction to the customer is the market maker's compensation."); *NASD Notice to Members 99-65* ("[A] Market Maker is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price (with no markup, markdown, commission equivalent, or other fee).").

Second, we reject Market Regulation's assertion that a failure to impose cost-plus pricing suggests that Knight and Joseph Leighton were free to charge any sums they wished for the institutional orders they executed. A broker-dealer makes an implied representation that the prices charged in transactions with customers are reasonably related to "the prices charged in an open and competitive market." *First Jersey Secs.*, 101 F.3d at 1469; *accord Duker & Duker*, 6 S.E.C. 386, 389 (1939) ("This fraud is avoided only by charging a price which bears a reasonable relation to the prevailing price . . . ."); *see also* IM-2440-1 ("It shall be deemed a violation of Rule 2110 and Rule 2440 for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security or to charge a commission which is not reasonable."). NASD Rule 2440 thus requires that where a market maker sells (buys) for its own account to (from) its customer it shall do so "at a price which is fair, taking into account 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." A broker-dealer who charges a customer a price that includes an undisclosed, excessive mark-up (or mark-down) violates the antifraud provisions of the federal securities laws. *See SEC v. First Jersey Secs.*, 101 F.3d at 1469; *see also Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031, 1033 (3d Cir. 1987) ("The SEC has established through its enforcement actions the principle that charging undisclosed excessive commissions constitutes fraud.").

We cannot, however, on the basis of this record, conclude that Joseph Leighton violated any duty of fair dealing in the manner in which he priced the execution of institutional, not-held orders. Foremost among the details upon which we base this decision is the fact that Market Regulation clearly disclaimed any suggestion that it was alleging or attempting to prove in this case that Joseph Leighton violated NASD Rule 2440 or included excessive mark-ups for his order executions.[97]

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not-held orders by refraining from any manner of profit beyond some nominal sum not to exceed 12 cents above Knight's cost basis. *Cf. E.F. Hutton*, 49 S.E.C. at 832 ("[A]bsent disclosure and a contrary agreement, a fiduciary cannot compete with his beneficiary . . . .").

97 NASD Rule IM-2440-1 describes a number of factors to be considered in determining the fairness of a mark-up (mark-down), and generally limits permissible mark-ups (mark-downs) to no more than five percent of a transaction's value. A mark-up (mark-down) is generally not calculated with reference to the market maker's cost, but instead is calculated by the difference between the price charged to the customer and the prevailing market price. *See First Jersey*

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What is more, Market Regulation eschewed any consideration or analysis in presenting its evidence of the fact-sensitive inquiry that would be necessary to determine whether Knight and Joseph Leighton in this case garnered unfair prices and compensation from their order executions. In this respect, Market Regulation urges us to ignore the numerous factors that must be considered in support of any assertion of fraud based upon a claim of unfair pricing; these factors include: the cost of the transaction, the expertise of the broker-dealer, the type and availability of the security, market conditions, and the overall risk undertaken by the broker-dealer. *See Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 535 (2d Cir. 1999); *see also* NASD Rule IM-2440-1.

Finally, as a factual matter, we cannot find that the profits that Joseph Leighton and Knight earned from the execution of institutional, not-held orders were in any approach quantitatively offensive. As we conclude above, we do not find that Market Regulation's "profit" summaries, either based upon Knight's sales credit data or upon staff's attempt to reverse manufacture Joseph Leighton's executions, are reliable. At best, this evidence is indicative of a general impression of profitability. Profits earned by a securities dealer, however, are not to be condemned outright. *See Duker & Duker*, 6 S.E.C. at 389; *see also G. Alex Hope*, 7 S.E.C. 1082, 1084 (1940) ("It is not, of course, the amount of the profit *per se* which we condemn."). Instead, "[t]he reasonableness of the profit can be determined only on the basis of the individual facts of each case." *Duker & Duker*, 6 S.E.C. at 389.

Based upon the record before us, the prices at which Joseph Leighton executed any particular institutional order cannot be condemned as fraudulent. Nor can we conclude that Joseph Leighton committed fraud in garnering any sum in profits. The evidence provided at the hearing on balance showed that the prices at which Joseph Leighton filled orders bore a reasonable relation to the prevailing market prices and that his profits were not unreasonable given existing market conditions. Indeed, the uncontested evidence presented by the respondents established that Joseph Leighton provided execution prices significantly better than the volume-weighted average price for the securities being traded by institutions and that his "profits," even using Knight's inflated sales credit figures, reflected a benign percentage of total transaction values and was often less than the spread at which market makers sold the same stock in small retail transactions.

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To summarize, we decline Market Regulation's request that we find that the record in this case supports the claim that Joseph Leighton engaged in fraud. While we recognize that Section 10(b) of the Exchange Act, as implemented through Exchange Act Rule 10b-5, has aptly been

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[cont'd]

Secs., 101 F.3d at 1469. A mark-up (mark-down) and a market maker's profit on a trade executed on a net basis therefore are not coextensive. A profit earned by a market maker on a trade could include a mark-up (mark-down), but it could also include sums that the market maker properly earned by committing the firm's capital or accumulating a position in a security on behalf of a customer. *Pasternak*, 561 F. Supp. 2d at 504.

described as a "catchall provision," what it catches must be fraud. *Chiarella*, 445 U.S. at 234-35. Thus, conduct without a particular affirmative statement can be "deceptive" and therefore a violation of the antifraud provisions of the federal securities laws. *United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008). But "the concept of 'deception' . . . irreducibly entails some act that gives the victim a false impression." *Id.* Considering the evidence in the record, as well as the lack of evidence, we conclude that Market Regulation failed to prove by a preponderance of the evidence that Joseph Leighton's trading practices amounted to a fraudulent device in violation of the federal securities laws and FINRA rules. Nor has Market Regulation proven that Joseph Leighton lied to Knight's institutional customers or in any manner sought to deceive customers by failing to disclose information for which a duty to reveal existed. We find that Knight was entitled to earn profits, especially when it placed itself at risk for the sake of its customers. Market Regulation failed to establish that any level of profits enjoyed by Knight and Joseph Leighton in this case contravened any notions of best execution or fair dealing that arise when a broker-dealer is handling institutional, not-held orders.

No rule or regulation, promulgated by the Commission or FINRA, limits the profit earned on a trade executed for a not-held order or prohibits the trading practices that Market Regulation contends were fraudulent in this case. Indeed, we conclude that the only governor of the pricing that Joseph Leighton provided to institutional customers in this case is NASD Rule 2440 and the interpretative guidance that FINRA has adopted concerning "excessive" mark-ups – violations of which Market Regulation specifically disclaimed and evidence of which it made no effort to prove. No matter how self-evidently "deceptive" Market Regulation steadfastly asserts Joseph Leighton's practices were, absent some evidence of "manipulation or a false statement, breach of a duty to disclose, or deceptive communicative [mis]conduct," we conclude that Market Regulation's allegation that Joseph Leighton committed fraud must be dismissed. *Finnerty*, 533 F.3d at 150.

4. NASD Rule 2110

The Commission has construed NASD Rule 2110 to prohibit practices that violate "pre-existing standards with respect to a broker-dealer's obligations to its customers." *E.F. Hutton & Co.*, 49 S.E.C. at 835. These standards "go beyond legal requirements and depend on general rules of fair dealing, the reasonable expectations of the parties, marketplace practices, and the relationship between the firm and the customer." *Dep't of Enforcement v. Shvarts*, Complaint No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12 (NASD NAC June 2, 2000). As the Commission has stated, "[i]f no other rule has been violated, a violation of Rule 2110 requires evidence that the respondent acted in bad faith or unethically." *Chris Dinh Hartley*, Exchange Act Rel. No. 50031, 2004 SEC LEXIS 1507, at *10 n.13 (July 16, 2004).

Given our view of Joseph Leighton's obligations and duties to his institutional customers, our scrutiny of the evidence concerning the reasonable expectations of Knight's institutional customers, and the reality that Joseph Leighton's practices do not appear to have contravened any market or regulatory standards, we cannot find that Joseph Leighton's trading practices were in any manner undertaken in bad faith or exhibited unethical conduct. We therefore reverse and dismiss the Extended Hearing Panel majority's finding that Joseph Leighton violated NASD Rule 2110.

B. Supervision

In its complaint, Market Regulation alleged that John Leighton and Pasternak failed to establish, implement, and maintain a supervisory system reasonably designed to ensure that Joseph Leighton's trading practices conformed to the federal securities laws and FINRA rules. Market Regulation's complaint is supported by a thematic undergirding that John Leighton and Pasternak, aware of what it has with single-minded doggedness characterized as Joseph Leighton's "excessive" profits, failed to take steps to supervise reasonably Joseph Leighton's execution of institutional, not-held orders and prevent his alleged fraud. Market Regulation further claims that, despite the existence of numerous "red flags," Pasternak failed to take steps to address evidence of irregularities presented to him concerning Joseph Leighton's trading. The Extended Hearing Panel majority agreed with Market Regulation's assessment of the respondents' alleged misconduct and found that John Leighton and Pasternak each violated NASD Rules 3010 and 2110.

Given the record we find before us, and our view of the theories that Market Regulation has put forth in support of its claims, we reverse the majority's decision. The burden of proof in this case rested with Market Regulation, which was required to show that the respondents' supervisory conduct was not reasonable. *See Dist. Bus. Conduct Comm. v. Lobb*, Complaint No. C07960105, 2000 NASD Discip. LEXIS 11, at *16 (NASD NAC Apr. 6, 2000). Market Regulation has not sustained its burden of showing that, under all the circumstances present here, John Leighton and Pasternak failed to exercise reasonable supervision over Joseph Leighton.

1. Oversight and Control

NASD Rule 3010(a) provides that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." NASD Rule 3010(a) thus requires, among other things, the designation of appropriately registered principals to carry out the supervision of each of the member's lines of business, the assignment of each registered person to an appropriately registered supervisor, and reasonable efforts to determine that all supervisory personnel are qualified to carry out their assigned duties. NASD Rule 3010(b) further requires that each member "establish, maintain, and enforce written supervisory procedures to supervise the types of business in which it engages and to supervise the activities" of those who are associated with the firm. "Whether a particular supervisory system or set of written procedures is in fact 'reasonably designed to achieve compliance' depends on the facts and circumstances of each case." *Richard F. Kresge*, Exchange Act Rel No. 55988, 2007 SEC LEXIS 1407, at *27 (June 29, 2007) (*quoting La Jolla Capital Corp.*, 54 S.E.C. 275, 281 & n.15 (1999)).

As the Commission has long recognized, a "determination that a respondent has violated NASD's supervisory rule is not dependent on a finding of a violation by those subject to the respondent's supervision." *Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *47 (July 6, 2005). We cannot ignore, however, the fact that Market Regulation's claims and the Extended Hearing Panel majority's findings that John Leighton and Pasternak failed as supervisors are informed in this case by injudicious views of Joseph Leighton's conduct. In this respect, both Market Regulation and the panel's majority enjoy a vision of the charges surrounding the issue of the respondents' supervision that is undeniably colored by the prism through which they view Joseph Leighton's profits as unlawfully "excessive" or "extraordinary." For instance, Market Regulation asserts that "[t]he extraordinary profits earned by Joseph Leighton's trading cried out for supervisory attention." The Extended Hearing Panel's majority too concluded that the respondents' "supervisory void" "allowed Joseph Leighton to take advantage of his customers . . . by filling orders at prices that netted Knight unreasonably high profits."

Their views of the reasonableness of John Leighton's and Pasternak's supervisory diligence are also well-versed in the erroneous conclusion that Joseph Leighton's execution of institutional orders did not conform to what we have concluded is an unsubstantiated "industry practice." Thus, both Market Regulation and the majority avow that, because John Leighton and Pasternak were not at once outraged and did not take action to limit the amount of compensation that Knight earned from the execution of not-held, net-priced orders to some "reasonable" figure of not more than 12 cents per share above Knight's cost, the respondents fundamentally failed to supervise Joseph Leighton's trading practices. As Market Regulation puts it, "these huge profits certainly were well known to Pasternak and John Leighton – they received monthly reports showing each sales trader's total profits and average profits per share – but they never inquired as to how Joseph Leighton made so much money on his trades." The majority takes issue with the respondents' conduct in a similar tack by equating its findings of supervisory failures with the conclusion that "Joseph Leighton made no effort to conform to industry practice."

We thus agree with the dissent that Market Regulation's claims that John Leighton and Pasternak failed to discharge reasonably their supervisory duties are perched largely upon the bald assertion that "high profit[s] are an indicium of wrongdoing." By failing to limit Joseph Leighton's profits, both Market Regulation and the panel's majority plainly imply, John Leighton and Pasternak failed to discharge reasonably their duties as supervisors. Without more, however, Joseph Leighton's profits, and thus the respondents' supervision of him, cannot be condemned outright. *See Duker & Duker*, 6 S.E.C. at 389; *G. Alex Hope*, 7 S.E.C. at 1084. While institutions may now think, with the benefit of a distanced vantage, that they could have received better prices for the securities they bought from or sold to Knight, we do not find this to be a suitable basis upon which to find that Pasternak and Leighton did not discharge reasonably their supervisory duties. *Cf. Lobb*, 2000 NASD Discip. LEXIS 11, at *22 n.19 (*citing Quest Capital Strategies, Inc.*, Admin. Proc. File No 3-8966, 1999 SEC LEXIS 727, at *55-56 (Apr. 12, 1999) for the proposition that we must be careful not to substitute knowledge gleaned with hindsight for an assessment of whether a supervisor's conduct was proper under the circumstances).

More importantly, we conclude that the preponderance of the evidence does not support Market Regulation's complaint or the majority's conclusion that John Leighton and Pasternak failed to supervise reasonably Joseph Leighton's trading practices. At the outset, we note that Market Regulation provided scant evidence during its case-in-chief concerning the alleged supervisory failures of John Leighton and Pasternak and instead focused its evidence primarily upon Joseph Leighton's alleged fraud. Market Regulation explained that "to a large degree" "a lot" of the evidence that it intended to marshal in support of its claims concerning John Leighton and Pasternak was in the recorded testimony that had been admitted into evidence.

The slenderness of Market Regulation's evidence concerning the respondents' alleged supervisory failures was not augmented in any substantive manner by the remaining record evidence upon which both Market Regulation and the Extended Hearing Panel's majority draw in support of their respective allegations and findings. Indeed, we find that key aspects of the majority's decision, and to a lesser extent Market Regulation's arguments, lack annotative transparency. To the extent that their suggested conclusions draw upon the evidence, they rely to an unsatisfactory degree upon unreliable, recorded testimony, taken years after the fact, and seek to substitute unremarkable lapses in recollections and anecdotes for probative evidence of wrongdoing.

As Knight's chief executive officer, Pasternak did not and could not have reasonably supervised personally the conduct of each of the firm's many traders, assistant traders, and other personnel. Instead, Pasternak relied justifiably upon a comprehensive supervisory infrastructure that was designed and regularly overseen by Knight's compliance and legal departments.[98] The firm, with the support of Pasternak, maintained compliance protocols and written supervisory procedures reasonably designed to monitor and detect wrongdoing by the firm's market makers and institutional sales traders. The unrebutted evidence makes clear that Knight's compliance and legal departments, which were charged with reviewing Knight's supervisory and compliance systems, assured Pasternak that Knight's systems were designed to detect and prevent violations of the federal securities laws and FINRA rules.

Pasternak at all times also sought to require Joseph Leighton and all other institutional sales traders to act in compliance with the federal securities laws and FINRA rules. Knight's extensive system of supervisors and compliance protocols was further enhanced by a comprehensive system of automated monitoring and controls. The trading conducted by Joseph Leighton and all other institutional sales traders was subject to surveillance by Knight's compliance department, which reviewed all trading that occurred through Knight's market-making accounts and maintained an active, physical presence on the trading floor of Knight's institutional sales and market-making departments. Each of the trades executed by Joseph Leighton was routed through Knight's market makers, and was thus executed and subjected to all of the oversight to which Knight's market making activities were subjected, both by automated and human assets.

This is not to suggest that Pasternak was a distant figure. Pasternak reviewed daily all of the trading activity conducted by Knight's market makers and the profits (losses) associated with each market-making account. Pasternak also maintained a regular presence among Knight's

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98 The Commission has long maintained that a president of a FINRA member firm is responsible for supervision of the firm's trading, unless, as we find is the case here, the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties. *See Prager*, 2005 SEC LEXIS 1558, at *43 n.45.

market makers and institutional sales traders. Pasternak further met every week with Knight's senior managers, including John Leighton, and compliance and legal department personnel. At these meetings, which included the firm's chief compliance officer and general counsel, supervision and compliance issues were frequently discussed concerning Knight's market making and institutional sales trading.

Pasternak delegated convincingly the day-to-day supervision of Knight's institutional sales department to John Leighton, an experienced sales trader and supervisor. Although Market Regulation's complaint alleged that Pasternak was responsible for creating an "inherently defective" supervisory system due to the fact that John Leighton shared in the trading profits of his brother, the Extended Hearing Panel rejected this argument. The Extended Hearing Panel concluded that while John and Joseph Leighton were brothers and shared compensation, these facts did not prevent John Leighton from acting as Joseph Leighton's designated supervisor. We agree with the majority's conclusion.[99] There is no evidence that the Leightons' income-sharing agreement was in any manner improper. Indeed, the evidence showed that such agreements, and the broader proposition of supervisors sharing in the performance of their subordinates, were not uncommon at the time.[100] More importantly, the evidence is undeniable that Joseph Leighton received no special treatment and was not exempted from any existing supervisory or compliance protocols. There is nothing in the evidence to suggest that Pasternak did not at all times require all market makers and sales traders, including Joseph Leighton, to comply with the federal securities laws and FINRA rules, as well as with Knight's procedures and policies.

John Leighton too, in accordance with Knight's supervisory procedures, regularly reviewed the activities of Knight's institutional sales traders. As head of Knight's institutional sales department, John Leighton's supervisory responsibilities were defined by Knight's written supervisory procedures. The preponderance of the evidence makes clear that he performed all of

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99 Before the NAC, Market Regulation has, by all impressions, abandoned its assertion that Pasternak was responsible for a conflict of interest that existed between John and Joseph Leighton and failed to address this conflict from a supervisory perspective. Indeed, although we recognize that the combination of a familial relationship and income sharing could, in certain cases, create supervisory weaknesses, we conclude that the record in this case does not support the contention that Pasternak sanctioned an inherently defective supervisory system. The testimony of witnesses for both the complainant and the respondents undermined the proposition that John and Joseph Leighton could evade or bypass existing protocols in a combined effort to engage in wrongdoing. To the extent that any argument raised by Market Regulation during these appellate proceedings was meant to suggest that the relationship of John and Joseph Leighton called for an element of heightened supervision, we find that the systems and procedures in place at the time, which called for Pasternak to review all compensation shared by the Leightons, and the sources thereof, were reasonably designed.

100 The events at issue in this case predate *NASD Notice to Members 04-71*, which served to amend NASD Rule 3012 and established requirements concerning the supervision of certain "producing managers." *NASD Notice to Members 04-71* (Oct. 2004).

the supervisory duties he was designated concerning the monitoring of the trading activities of Joseph Leighton and all other institutional sales trading personnel. *See Lobb*, 2000 NASD Discip. LEXIS 11, at *23 n.20 ("A supervisor's adherence to his or her firm's supervisory procedures will not necessarily shield the supervisor from liability, but it is a factor to be considered in determining whether the supervision was reasonable."). We find that John Leighton's supervision was reasonably designed and asserted to prevent the alleged violations at issue. *See Albert Vincent O'Neal*, 51 S.E.C. 1128, 1135 (May 26, 1994) ("[T]he test is whether O'Neal's supervision was reasonably designed to prevent the violations at issue, not . . . whether, if all the many other supervisory functions he performed were taken into account, his overall supervisory performance somehow earned him a hypothetical passing grade."). John Leighton was actively involved and queried institutional sales department traders and assistant traders about the orders they were handling and observed the manner in which they worked orders on behalf of institutional customers. John Leighton ensured that the personnel in his department were adequately trained in their functions and that meetings were regularly held to discuss compliance issues.

Undeniably, it appears the crux of both Market Regulation's arguments and the majority's findings that John Leighton and Pasternak did not endorse and employ an adequate supervisory system is that Knight did not have automated reports to monitor the "execution quality" of institutional, not-held trades filled by the firm's institutional sales department. Without reports that tracked the profits per share earned by Knight from the execution of an institutional order, the thought goes, neither John Leighton nor Pasternak could have monitored or investigated whether Joseph Leighton provided Knight's institutional customers with "best execution" and the respondents thus allowed Joseph Leighton to "supervise himself."

Market Regulation did not establish, however, that an automated system that tracked the profits (losses) earned on individual institutional trades was the only course that could provide a suitable mien of execution quality. As the uncontested evidence shows, wholesale market makers, like Knight, did not employ exception reports concerning profits (losses) per share earned on institutional, not-held orders at the time of the trading with which we are concerned here. This fact, although not dispositive, weighs in favor of John Leighton and Pasternak. *See SEC v. Geon Indus., Inc.*, 531 F.2d 39, 52 (2d Cir. 1976) ("[T]he lack of proof of any specific industry practice that E&H should have followed in order to make Rauch's contacts with Neuwirth less likely argues in [E&H's] favor . . . .").

Moreover, the evidence makes clear that various subjective factors worked together to determine whether a market maker provided best execution and fair pricing when executing an institutional, not-held order, and those factors did not fit neatly into a specific formula. Thus, as an institution would know its instructions and particular trading strategy, Knight's customers were in many respects best positioned to ascertain whether best execution was being met. Unless the customer raised a concern about the executions that Joseph Leighton provided them, it would be difficult for his supervisors to determine whether the customer was not satisfied.

With this perspective, the evidence established that John Leighton and Pasternak were well-acquainted with Joseph Leighton's trading. They each understood the manner in which he worked and executed orders, possessed a familiarity with his pricing practices, recognized the qualities of the difficult-to-trade Nasdaq securities for which institutions had a fondness during the relevant period of time, and had a general appreciation of the manner in which institutions traded. With this knowledge, both John Leighton and Pasternak maintained regular contact with Knight's institutional customers to ensure their satisfaction with the trading that they were conducting with Knight and to determine if they wished to express any complaints or concerns about Joseph Leighton's trading. The solicitation of feedback from Knight's institutional customers, when coupled with the lack of any apparent complaints, holds much meaning in the context of the issues we address here. *Cf. Lobb*, 2000 NASD Discip. LEXIS 11, at *17 ("A supervisor's failure to contact a customer can constitute a violation of the supervision rules under certain circumstances."). Knight's customers were by all accounts satisfied with Knight and Joseph Leighton.

Finally, John Leighton and Pasternak regularly reviewed Joseph Leighton's sales credit figures. The fact that Joseph Leighton garnered high sales credit sums, either on a gross per share basis, did not put John Leighton and Pasternak on notice that Joseph Leighton was violating any provision of the federal securities laws or FINRA rules.[101] They were certainly not aware of any unilateral expectation of institutional customers or of any regulatory requirement that called for cost-plus pricing and, therefore, had no reason to know that the compensation that Joseph Leighton earned for Knight could be deemed, per se, "excessive." John Leighton and Pasternak fairly attributed Joseph Leighton's performance to the prominence of his trading, the size and stature of his institutional clients, and the prices, volume, and volatility of the securities that he traded with customers.

2. Red Flags

The final element of Market Regulation's contentions regarding deficient supervision at Knight is that Pasternak failed to respond to indications of irregularities or "red flags" concerning Joseph Leighton's trading and John Leighton's management of the institutional sales department that were brought to Pasternak by Hewitt and Stellato. The Commission has held that "[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review." *Christopher J. Benz*, 52 S.E.C. 1280, 1283 n.13 (1997), *aff'd*, 168 F.3d 478 (3d Cir. 1998). Once indications of irregularity arise, a supervisor must respond accordingly. *La Jolla Corp.*, 54 S.E.C. at 285.

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[101] Market Regulation claims that Joseph Leighton's sales credit figures constituted a "red flag." This assertion, however, introduces an element of inconsistency and circumlocution to Market Regulation's arguments. On the one hand, Market Regulation contends that Knight's systems provided evidence of Joseph Leighton's alleged wrongdoing by virtue of the sales credit figures that John Leighton and Pasternak regularly reviewed. On the other hand, Market Regulation refuses to acknowledge the tracking of these sales credit figures when it contends that John Leighton and Pasternak did not foster and employ adequate supervisory systems for Joseph Leighton's trading, which Market Regulation challenges was marked by "excessive" profits as evidenced by Joseph Leighton's sales credits.

The Extended Hearing Panel's majority found that Hewitt expressed concerns to Pasternak regarding Joseph Leighton and John Leighton to which Pasternak failed to respond reasonably in violation of his supervisory responsibilities under FINRA rules. We conclude that the record does not support this finding.

Hewitt and Pasternak recalled differently their initial conversation about Joseph Leighton and John Leighton that occurred shortly after Hewitt joined Knight in the latter part of 1999. Hewitt states that he informed Pasternak that he believed Joseph Leighton was engaged in "front running" and that he was unbelieving of the profits that Joseph Leighton garnered from his execution of institutional orders. Pasternak recalls meeting with Hewitt, but only to discuss Hewitt's desire to change the management of the institutional sales department, specifically to replace John Leighton as its head. The Extended Hearing Panel's majority made no clear or affirmative credibility determinations that would resolve this conflict based upon the evidence.

We find that the preponderance of the evidence leads us to conclude that Hewitt did not advise Pasternak that he believed Joseph Leighton was engaged in wrongdoing, and thus that there were no "red flags" for Pasternak to address. First, there is no evidence that Hewitt sought or requested that anyone take action to discipline or dismiss Joseph Leighton from Knight for any improper trading. Hewitt also himself never took any action while acting as Knight's president to address any of the improprieties in which he claims Joseph Leighton was engaged.[102] Hewitt accordingly continued to benefit, until Joseph Leighton and John Leighton left Knight a year later, from Joseph Leighton's profitable trading by collecting from Knight's management bonus pool. Market Regulation essentially asks us to take action against Pasternak for failing to take steps that Hewitt himself never suggested or chose to take.

Second, we cannot ignore the fact that Hewitt's comments were influenced by what bordered on personal animosity for John Leighton.[103] He clearly had a desire that someone other

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102 Hewitt's testimony evidenced a novice's understanding of Knight's business and Joseph Leighton's trading. By his own admission, Hewitt had no experience with or real comprehension of institutional sales trading and reviewed no records concerning Joseph Leighton's trading. He never personally observed Joseph Leighton's trading or spoke with Knight's institutional customers. He instead projected onto Knight and Joseph Leighton expectations associated with the agency and riskless principal trading with which he was familiar from his previous professional experiences. Indeed, Hewitt's allegations of wrongdoing are based upon the same faulty assumptions that would require disclosure of Knight's cost and the submission of Knight's interests to institutional customers upon which Market Regulation's fraud claims are in this case based.

103 Inserting an element of bias into Hewitt's testimony, Market Regulation staff showed Hewitt, while preparing him to testify at the hearing, an anonymous letter that was deeply critical of Hewitt's tenure at Knight and was sent to Pasternak shortly before Hewitt's departure from Knight. Market Regulation staff, without any apparent justifiable authentication, attributed the letter's authorship to John Leighton.

than John Leighton, whom Hewitt deemed not to have the proper "credentials," run the institutional sales department. Hewitt, therefore, far from endorsing the removal of anyone for wrongdoing, instead only envisioned a demotion of some manner that would result in John Leighton reporting to a new head of institutional sales and, presumably, Joseph Leighton being subjected to an additional layer of control. Hewitt's testimony therefore can be reconciled with Pasternak's that Hewitt questioned only John Leighton's management qualifications at the time, not Joseph Leighton's trading practices.[104]

We nevertheless conclude that although Pasternak clearly disagreed with Hewitt's assessment of John Leighton, he immediately acceded to the only request that Hewitt made of him. That was to begin a search to replace John Leighton as the head of Knight's institutional sales department. The majority's suggestion that Pasternak ignored Hewitt, whatever the nature of his concerns, therefore is not true.

We also find that the evidence does not support the Extended Hearing Panel majority's conclusion that Pasternak failed to respond appropriately to "red flags" raised by Stellato concerning specific examples of alleged questionable trading by Joseph Leighton. When Stellato presented Pasternak with issues regarding Joseph Leighton's trading shortly after Stellato joined the firm in 2000, Pasternak personally undertook an examination of the three trades that Stellato flagged for him. In the course of his review, Pasternak also spoke to Joseph Leighton. Moreover, Pasternak immediately called upon Knight's legal and compliance departments to conduct an independent review of the trades, which they did. Pasternak concluded that Stellato's conclusions were off-base. Both Amoruso, Knight's chief compliance officer, and Dorsey, the firm's general counsel, reported back to Pasternak that their departments did not discern any impropriety in the not-held, net trading being conducted by Joseph Leighton with institutions. Pasternak fittingly relied upon the conclusions of Amoruso and Dorsey, and he was reasonable in believing that Knight's compliance and legal departments would be able to ascertain if Joseph Leighton's trading was in any respect improper.

Pasternak, Amoruso, and Dorsey all informed Stellato that they did not believe that his concerns were well-founded. Indeed, the evidence shows that Stellato's analysis was ill-informed and simply incorrect. Nevertheless, Pasternak concluded that the Leightons could not any longer work effectively with Hewitt and Stellato, and within weeks arranged for the Leightons to leave Knight. Pasternak, Amoruso, and Dorsey told Stellato that, if he was concerned over the profits or trading practices of Knight's institutional sales traders, he could, as head of institutional sales, implement whatever controls or limits he believed were necessary to

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104 Our conclusion that Hewitt did not in late 1999 raise concerns about Joseph Leighton's trading with Pasternak is supported by additional evidence. First and foremost, Hewitt claimed that he raised these concerns with, among others, Dorsey at the same time. There is no corroboration in the record for this assertion and his testimony was in fact directly contradicted by Dorsey. Indeed, Hewitt readily admitted upon cross-examination that although he believed that Joseph Leighton was engaged in "illegal" conduct, he never addressed these concerns with Knight's legal and compliance personnel.

address his concerns going forward. Stellato subsequently never sought to add any supplemental trading controls or to limit sales traders' profits. Stellato did not request or make any changes to Knight's supervisory and compliance policies. The institutional sales department continued to operate without change while under Stellato's control, which confirmed suspicions held by Pasternak and Dorsey that Stellato's real agenda was to secure control of Knight's institutional sales department.[105]

Though the majority found that Pasternak "gave no indication that he would follow up on Stellato's allegations" and "disregarded [his] concerns," the record does not support these conclusions. Instead, under the facts of this case, we find that Pasternak responded promptly and appropriately to the concerns raised by Stellato.

* * *

As a result of their supervisory and monitoring efforts, there is no reasonable basis from which to conclude that John Leighton and Pasternak should have concluded that Knight's institutional customers were being defrauded by Joseph Leighton. After reviewing the entire record and considering the arguments raised by the parties, we find that the conduct of John Leighton and Pasternak, under the particular facts of this case, was reasonable and did not constitute a violation of NASD Rules 3010 and 2110. We therefore reverse the Extended Hearing Panel majority's findings.

V. Conclusion

We reverse the Extended Hearing Panel's findings that Joseph Leighton committed a violation of NASD Rule 2110 in the manner in which he executed institutional, not-held orders during the period of 1999 to 2000. We further reverse the majority's findings that John Leighton and Pasternak failed to supervise reasonably Joseph Leighton's trading practices. We therefore dismiss in their entirety the claims set forth in Market Regulation's complaint. Consequently, the sanctions imposed upon the respondents by the Extended Hearing Panel majority are hereby vacated.[106]

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105 Indeed, the branch manager of Knight's Boston office informed Pasternak in July 2000, prior to Stellato formally joining Knight and before Stellato ever spoke to Pasternak about Joseph Leighton's trading, that Hewitt and Stellato told him that they contemplated the imminent departure of the Leightons from Knight.

106 We also have considered and reject without discussion all other arguments advanced by the parties.

On Behalf of the National Adjudicatory Council,

Marcia E. Asquith

Marcia E. Asquith, Senior Vice President and
Corporate Secretary