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August 31, 2009

**Via U.S. Mail and email (rule-comments@sec.gov)**

Office of the Secretary
United States Securities and Exchange Commission
100 F Street
Washington, D.C. 20549-9303

Re: **Release No. 34-60403 dated July 30, 2009**

Dear Securities and Exchange Commission:

This letter is submitted in response to the Commission's invitation for comments in response to Release No. 34-60403 on the use of the remaining funds in the seven Fair Funds established pursuant to the Commission's settlement with seven New York Stock Exchange ("NYSE") specialist firms (the "Specialist Firms") on March 30, 2004 and July 26, 2004 (the "Settlement Orders"). The Commission has stated that the remaining funds amount to approximately $135 million (the "Remaining Funds"), and proposes to accept, in the absence of public comments, the determination of the Administrator of the Fair Funds, Heffler, Radetich & Saitta, L.L.P. (the "Administrator" or "Heffler"), to distribute the Remaining Funds to the United States Treasury. For the reason discussed below, we adamantly oppose this proposed distribution of the Remaining Funds.

**Background Facts**

As stated in the Release, the Settlement Orders directed that the Specialist Firms pay disgorgement and civil penalties totaling $247,028,778, and that these funds were to be used to:

(a) reimburse injured customers for their loss; (b) pay pre-judgment and post-judgment interest to the injured customers; and (c) pay the costs for administering the Distribution Plan. According to the Release, the Administrator has paid injured customers an aggregate of more than $123 million in five (5) distributions to date, "comprised of over $96 million in disgorgement and over $26 million in pre- and post-judgment interest."

Although the Release does not provide a breakdown of the amounts paid by the Specialist Firms for disgorgement as opposed to penalties, the Settlement Orders reflect that over $157 million was paid for disgorgement and approximately $89 million was paid for civil penalties. As stated in the Distribution Plan, the unlawful conduct of the Specialist Firms "caused over $157 million in customer harm." Thus, after nearly five (5) years of administering the Plan, the Administrator has been successful in reimbursing injured customers for approximately $96 million of more than $157 million of losses, or only approximately 61% of the minimum amount of their losses.

In order to determine if the Administrator's proposed distribution of the Remaining Funds to the U.S. Treasury is fair and reasonable, it is necessary to examine the nature and extent of the proceedings which culminated in the Settlement Orders and the approval of the Fund Administrator's Modified Fair Fund Distribution Plan (the "Distribution Plan"). The Administrator summarized the Commission's enforcement action against the Specialist Firms as follows in the Distribution Plan:

> This distribution plan ("Plan") concerns the seven Fair Funds established pursuant to the U.S. Securities and Exchange Commission's (Commission") orders to house the disgorgement and civil penalties obtained as part of the Commission's settlements with the seven New York Stock Exchange ("NYSE") specialist firms * * * (the "Specialist Firms"). In its orders, the Commission

> found that from at least 1999 to 2003, the Specialist Firms violated their basic obligation to serve public customer orders over their own proprietary interests.
>
> The Specialist Firms had a general duty to match executable public customer or "agency" buy and sell orders and not to fill customer orders through trades from the firms' own account when those customer orders could be matched with other customer orders. Through various forms of improper conduct, the Specialist Firms violated this obligation by filling orders through proprietary trades rather than through other customer orders. The unlawful conduct took two basic forms: Specialist Firms would "interposition" by buying stock for the firm dealer's account from the customer sell order, and then filling the customer buy order by selling from the dealer account at a higher price – thus realizing a profit for the firm account. Alternatively, Specialist Firms would fill agency orders through a proprietary trade for the firm's account – and thereby improperly "trade ahead" of the other agency order. As a consequence, the customer order that was traded ahead of was disadvantaged by being executed at a price that was inferior to the price received by the dealer account. By engaging in these forms of unlawful conduct the Specialist Firms caused over $157 million in customer harm.

Significantly, as set forth in the Distribution Plan, the Administrator utilized information furnished by the Commission and the New York Stock Exchange ("NYSE") in identifying the injured customers who were entitled to reimbursement for their losses (the "Injured Customers"), and then utilized the calculations made by the Commission and the NYSE in determining the amount to be distributed to each Injured Customer:

> Based on the transaction data supplied to Heffler by the staff of the NYSE and the requirements outlined in the October 13 Orders, the Distribution Plan is divided into three separate phases. The initial phase of the Plan is to identify the customers who were injured as a result of the Specialist Firms' trading violations, as previously determined by the Commission staff and the NYSE using specific criteria in connection with the Specialist Firm Orders (the "Injured Customers"). The amount of disgorgement and the specific violative trades that will be eligible for proceeds from the Distribution Funds were determined through the use of a retroactive surveillance conducted by the NYSE at the request of the Commission's Office of Compliance, Inspections and Examinations. The surveillance was designed to identify specific transactions where specialists had unlawfully traded ahead of executable customer orders, and transactions where specialists had unlawfully interpositioned themselves between two customer

> orders that should have been matched against one another. The surveillance looked at various types of electronic trading data, including the time an order is entered, the time it is executed or canceled, the execution price, and whether there were any intervening trades for the specialist's proprietary account. In determining which trades to include, the surveillance used certain time parameters depending on the type of trading violation and the time frame in which the trading occurred. In accordance with the terms of the Specialist Firm Orders, Heffler must look at the violative trades that have already been identified by the Commission staff and the NYSE (the "Violative Transactions") in order to identify the customers who were injured as a result of such violative trades, and the class of claimants is limited to those injured customers. The second phase is to calculate each Injured Customer's Distribution Amount (defined below), which consists of the Disgorgement Amount (defined below), the prejudgment interest, and post-judgment interest calculated through the date of distribution. The final phase is to distribute the Distribution Funds to the Injured Customers. * * *

Because the Commission and the NYSE provided the data for identification of the Injured Customers and calculated the Injured Customers' losses, it was unnecessary for any Injured Customer to file a notice of claim or supporting documentation in order to be entitled to a distribution from the Fair Funds. Instead, the Administrator sent clearing firms and their nominees (collectively, the "Clearing Firms") data with regard to each of the Violative Transactions and requested that the Clearing Firms submit the names and addresses of the Injured Customers to the Administrator based upon this data. Whether because of institutional indifference or incompetence (or some other unknown reason), this mechanical procedure followed by the Administrator has resulted in the failure, to date, to identify the Injured Customers who suffered more than $60 million of the losses from the Violative Transactions (the "Unassigned Losses"). Because the Administrator has been unable to connect any customers to the Unassigned Losses, it is unknown what percentage of these Unassigned Losses derive from Violative Transactions for the account of Empire Programs, or for the account of any other

Injured Customer who has been identified and has received reimbursement for some of the Violative Transactions.

Moreover, apart from this serious issue of the extent to which Injured Customers, as identified by the Administrator, were also Injured Customers with respect to a portion of the Unassigned Losses, we believe it is important to recognize that the Violative Transactions were a fraction of the unlawful proprietary trades executed by the Specialist Firms from 1999 to 2003. To the best of our knowledge, the Commission has not publicly disclosed the metrics utilized in identifying the Violative Trades. The Distribution Plan sheds the most light on this issue, albeit without providing any specificity and stating only that the Commission used "certain time parameters depending on the type of trading violation and the time frame in which the trading occurred" in determining the Violative Transactions.

The specific parameters utilized by the Commission were, however, disclosed, in the recent opinion issued by Judge Sweet in *In re NYSE Specialists Secs. Litig*., Case No. 03 Civ. 9264 (RWS) (S.D.N.Y. March 14, 2009). Most importantly, as Judge Sweet stated in this Opinion, the lead plaintiff's expert in that action asserted that the Commission's parameters for identifying the Violative Trades resulted in a failure to capture many cases of unlawful interpositioning and trading ahead, resulting in a significant understatement of customer injuries:

> In connection with the SEC's investigations of the Specialist Firms, the NYSE designed and created a computer algorithm to identify specific stock transactions where specialists had traded ahead of public orders, interpositioned themselves between public orders, and failed to execute public limit orders by trading for their own personal accounts. [Commission's Office of Compliance, Inspections and Examinations ("OCIE")] Rep. at 21. In addition to identifying individual violations, often referred to as "exceptions," the algorithm also identified the number of disadvantaged shares and disadvantaged dollar amounts. <u>See</u> Fund Administrator's Modified Fund Distribution Plan ("Distribution Plan")

at 5, Pl. Ex. 20. The same algorithm was used, with minor modification, in the DOJ's criminal investigations of the individual specialists (the "DOJ Algorithm").

The DOJ Algorithm utilizes two parameters designed to ensure accurate reporting of priority rule violations. First, it includes what OCIE refers to as a "freeze parameter." This parameter limits exceptions to trades that occurred between orders having identical Display Book times. Because of the way the Display Book operates, the only time that a given order would appear simultaneously on the Display Book is when the Display Book is frozen by the specialist, often while a clerk is reporting a trade, and orders queued off-screen. OCIE Rep. at 22. According to OCIE, the original purpose of this particular parameter was "to prevent the specialist from being able to argue that he had verbally given the clerk instructions to execute the first order prior to the second contra-side order arriving to the Display Book." Id. at 21.

The second parameter in the DOJ Algorithm limits trading ahead exceptions to those proprietary trades that occur more than ten seconds after the public order first appears on the Display Book. This ten-second lag provides for the situation where a specialist "verbally trades with the crowd, and it takes the clerk some amount of time before entering into report mode and freezing the Display Book." Id. at 16. The ten-second lag marks a departure from the NYSE's previous surveillance programs which allowed for a more generous 60-second lag. Id. at 15.

**The Expert Reports**

In support of its motion for class certification, CalPERS submitted the Corwin Report, the Rebuttal Report of Corwin ("Corwin Rebuttal"), the Curtin Report, and the Rebutttal Report of Curtin ("Curtin Rebuttal"). The Corwin Report reviews and assesses the results produced by the DOJ Algorithm and analyzes whether implementing alterations to the DOJ Algorithm could "more accurately identify violative conduct." Corwin Rep. at 1. The Curtin Report then uses the NYSE data for 55 representative stocks during the Class Period to implement Corwin's recommended modifications. Curtin Rep. at 3. The Corwin and Curtin Rebuttals were submitted in response to the Specialist Firms' opposition to class certification, and specifically address critiques submitted to the Court by the Specialist Firms' expert, Dr. Mukesh Bajaj. See Baja Decl.

The Corwin Report concludes that:

> the general methodology used [in the DOJ Algorithm] to identify trading violations is appropriate and that the algorithm identifies

> significant numbers of disadvantaged orders during the period from 1999 through 2003. However… several of the parameters used in the DOJ Algorithm resulted in a failure to identify the many cases of interpositioning and trading ahead by NYSE specialists. As a result, the disadvantaged dollar amounts based on the application of the DOJ's algorithm were significantly understated.

Corwin Rep. at 2. Corwin describes two changes which, when applied to the DOJ Algorithm, he asserts more accurately capture and identify interpositioning and trading ahead violations.

First, Corwin eliminates the requirement in the DOJ Algorithm that only orders that arrive on the Display Book during a "freeze" are marked as interpositioning exceptions. Id. at 10. According to Corwin, "[i]f both orders are visible on the Display Book prior to the first specialist trade, interpositioning would result regardless of whether or not the orders arrived during a freeze." Id. Based on this logic, Corwin eliminates the "freeze" restriction from the DOJ Algorithm.

Second, Corwin reduces the lag-time parameter in the DOJ Algorithm from ten seconds to one second. Corwin cites OCIE's determination, based on the interviews with specialists and specialist clerks from each of the seven firms, that "it is extremely rare for the clerk to enter into report mode [at which time the Display Book is frozen and a customer order cannot arrive at the Specialist's post] more than two to three seconds after the specialist instructs the clerk to do so." OCIE Rep. at 16. Accordingly, Corwin concludes that "[t]he 10-second lag applied in the identification of trading ahead violations appears to be a remnant of surveillance parameters in use at the NYSE for many years." Corwin Rep. at 14. Based on his belief that the specialist "should be aware of executable orders on the Display Book almost immediately after their arrival," Corwin's algorithm reduces lag-time to at least one second. Id. at 15.

In addition, Corwin makes two minor adjustments to the DOJ Algorithm in order to correct what he calls "bugs" in that code. These modifications results in a 0.5% decrease in identified interpositioning and trading ahead exceptions and a 0.5% decrease in the total disadvantaged dollar amount relative to the DOJ Code. Id. at 6n.6.

According to Corwin, the adjusted algorithm can be applied to any NYSE stock for any date, including the full set of NYSE stocks traded between 1999 and 2003. Id. at 2. (emphasis supplied)

Based upon the contentions of the Department of Justice in criminal trials of individual traders for the Specialist Firms, there is no dispute that the premises of the Corwin Report are accurate. The record of those criminal trials is replete with numerous arguments made by the DOJ, and testimony adduced by the DOJ – with staff of the Commission literally, or at least cognitively, at its side – which demonstrate that significant trading ahead violations occurred in much less than 10 seconds, and in as little as a "split second," and that interpositioning violations often occurred when the Display Book was not in the "freeze" mode. For the sake of brevity, pertinent excerpts from the proceedings in the criminal actions are attached as Appendix A to this letter (and are incorporated into this letter by reference).

We are not privy to the amount of customer injuries suffered as a result of these unlawful proprietary trades which were not included in the universe of Violative Trades. However, we are informed and believe that these additional customer injuries amount to several hundreds of millions of dollars. Presumably, the Commission can verify the amount of these additional damages by re-running its algorithm with the substitution of the parameters utilized by Corwin for *In re NYSE Specialists Secs. Litig*.

**The Administrator's Determination That the Remaining Funds Should Be Distributed to the Unites States Treasury Should Be Rejected**

With the foregoing facts in mind, we believe it is neither fair nor reasonable to remit the Remaining Funds to the U.S. Treasury. As a threshold matter, the Administrator's proposed payment of the Remaining Funds to the U.S. Treasury should be rejected as contrary to the Commission's Rules. As aptly stated in the comment letter dated January 26, 2006 submitted by the Washington Legal Foundation in response to the Release No. 53025 (Dec. 27, 2005), "[s]o long as there remain any plausible injury claims that have no been fully satisfied, the Remaining Funds should not be distributed to *anyone* other than injured investors – and certainly not to the U.S. Treasury. *See* 17 C.F.R § 201.1102(b) (a distribution plan may not provide for payment to the U.S. Treasury unless the cost of administering a plan of disgorgement relative to the value of the available disgorgement funds and the number of potential claimants would not justify distribution of the disgorgement funds to injured investors).” (emphasis in original)

Here, it is conceded that more than $60 million of injuries suffered by investors, plus pre- and post-interest on such losses, have not been paid under the Plan. There is no question that the costs of administering a plan of disgorgement with regard to these funds justify the distribution to injured investors. Accordingly, pursuant to the Commission’s Rules, the Remaining Funds must not be delivered to the U.S. Treasury.

In making a determination of a fair and reasonable disposition of the Remaining Funds, it is respectfully submitted that the Commission should follow the standards set forth in the American Law Institute’s Final Draft Principles of the Law of Aggregate Litigation (the “ALI Draft”), which the Second Circuit has determined is “an appropriate standard for courts to consider in distributing class action settlements.” *SEC v. Bear, Sterns & Co., Inc.*, 03 Civ. 2937 (WHP), 2009 U.S. Dist. LEXIS 57822 (June 10 2009), citing *Masters v. Wilhelmina Model Agency, Inc.*, 473 F.3d 423, 436 (2nd Cir. 2007).[1] The ALI Draft states:

[1] The American Law Institute is generally recognized as the leading independent organization for producing scholarly work concerning principles of law, and as reflected by the Second Circuit’s respect for the standards of the ALI Draft, is heavy relied upon by federal and state courts in interpreting and applying laws. *See* ALI’s web site (www.ali.org) for a further description of its organization and work.

> If the settlement involves individual distributions to class members and funds remain after distributions (because some class members could not be identified or chose not to participate), the settlement should presumptively provide for further distributions to participating class members unless the amounts involved are too small to make individual distributions economically viable or other specific reasons exist that would make such further distributions impossible or unfair. (ALI Draft, § 3.07 at 220.[2]

This proposed rule is premised on the proposition that "funds generated through the aggregate prosecution of divisible claims are presumptively the property of the class members. * * *." *Id.* at § 3.07 at 220. In the Comment to this proposed Rule, the ALI Council explained:

> Assuming that class members can be reasonably identified and that direct distributions make economic sense, funds may remain because some class members could not be identified or chose not to file claims. Under this Section, assuming that further distributions to the previously identified class members would be economically viable, that approach is preferable to cy pres distributions. This Section rejects the position urged by a few commentators that a cy pres remedy is preferable to further distributions to class members. Those commentators reason that further direct distributions would constitute a "windfall" to those class members. However, few settlements award 100 percent of a class member's losses, and thus it is unlikely that in most cases that further distributions to class members would result in more than 100 percent recovery for those class members. In any event, this Section takes the view that in most circumstances distributions to class members better approximate the goals of the substantive laws than distributions to third parties that were not directly injured by the defendant's conduct.

The application of these principles to distributions of Fair Funds is no less fair and reasonable, and no less appropriate, than their application to private class actions. Notably, in our January 24, 2006 comment letter to Release No. 34-53-25, we suggested that the Remaining Funds should be distributed pro-rata to the identified injured customers. This suggestion was then rejected by the Commission in the May 2006 Order (Release No. 53823) on the grounds

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[2] *Masters v. Wilhelmina* addressed the propriety of applying the standards of the Draft No. 2 of the ALI's proposed rules. There is no difference between the content of the Final Draft and Draft No. 2 with regard to the distribution of remaining funds to previously identified members of the class.

that "such payments would result in the injured customers obtaining an undeserved windfall." In light of the rejection of this "windfall" reasoning in the ALI Draft, the Second Circuit's approval of the ALI Draft's standards in *Masters v. Wilhelmina*, and all of the facts and circumstances here, it is respectfully submitted that the Commission should reconsider its position and should, consistent with the ALI Draft, make a pro-rata distribution of the Remaining Funds to the identified Injured Customers.[3]

In this regard, two points are particularly important. First, in view of the immense disparity between the amount of minimum damages caused by the violative trading here (at least $157 million) and the amount actually distributed to identified customers (only $93 million), the assertion that Empire, or any identified customer, received reimbursement of anywhere near 100% of its actual losses is nothing more than a speculative conclusion lacking any factual basis – according to the Commission's own computations, there are approximately $60 million of customer losses which have not been distributed to any customers. An unknown percentage of these losses might well relate to Empire's trades which were hijacked by the Specialist Firm's for their unlawful proprietary trading practices.

Secondly, and at least as importantly, the Commission did not attempt to, or purport to, reimburse customers for 100% of the losses caused by the Specialist Firm's illegal proprietary trading. As discussed above, it is apparent that the injuries suffered by customers as a result of the illegal trading practices of the Specialist Firms far exceed the Remaining Funds. The Settlement Orders were just that – a settlement of the Commission's claims against the

[3] Significantly, in numerous other instances the Commission has directed the distribution of remaining funds to the injured investors on a pro-rata basis without limitation to the actual injury suffered by individual customers. Examples of these pro-rata distributions are cited in Appendix B annexed hereto and incorporated into this letter.

Specialists. Given the magnitude of these additional customer losses which were not covered by the Settlement Orders, coupled with the reality that a portion of the Unassigned Losses might relate to trades by customers who have already been identified, a pro-rata distribution of the Remaining Funds to the Injured Customers who have been identified by the Administrator is fair and reasonable in these facts and circumstances.

Such a pro-rata distribution is mandated by application of the standards of the ALI Draft, and no reason exists here to depart from these standards. Indeed, all of the criteria under the ALI Draft for a pro-rata distribution of remaining funds to previously identified investors are present here. Moreover, such a pro-rata distribution would not only satisfy, and be consistent with, the requirements of Section 1102(b) of the Commission's Rules, but would fulfill the Commission's stated goals of reimbursing customers for their losses, protecting the interests of investors, and utilizing any Remaining Funds for the benefit of investors.[4]

**Conclusion**

In light of all of the facts and circumstances here, it is respectfully submitted that the Administrator's determination that the Remaining Funds should be distributed to the U.S Treasury is not fair or reasonable, is contrary to law, and contrary to appropriate standards embodied in the ALI Draft. Based upon fair and reasonable standards, as embodied in the ALI

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[4] Pursuant to the Settlement Orders, the Commission exercised its discretion under Section 308(a) of the Sarbanes-Oxley Act to add the civil penalties to the Distribution Fund and directed that any Remaining Funds are to be utilized for the benefit of investors. In commenting on the adoption of this provision of the Sarbanes-Oxley Act, the Commission issued a report in early 2003 stating, among other things, that "[t]he Fair Fund provision is an innovative legislative response to some of the financial obstacles that prevent the Commission from providing funds to injured investors. Making appropriate distributions to investors, by applying the Fair Fund provision, is a desirable and important objective. The Commission intends to use the provision whenever reasonably possible, consistent with its mission to protect investors."

Draft, it is further respectfully submitted that the Remaining Funds should be distributed on a pro-rata basis to previously identified Injured Customers.[5]

Thank you very much for your consideration of this letter.

Very truly yours,

Robert A. Martin

cc: Allan H. Carlin, Esq.
Alan H. Martin

5 Alternatively, it is respectfully submitted that the Commission should expand the Violative Transactions so as to include unlawful proprietary trades which were executed in less than ten seconds or when the Display Book was not in the freeze mode, and the Distribution Plan should be further modified for the distribution of the Remaining Funds by the Administrator following the procedures set forth in Section III of the Distribution Plan for identifying the injured customers for these additional Violative Transactions. While implementation of this alternative is contrary to the desired goal of obtaining finality with respect to this matter, such a continuation of the administration of the Fair Funds for purposes of providing restitution to the injured customer would be preferable to remitting their losses to the U.S. Treasury, and would prevent an unfair, unreasonable, arbitrary and capricious conclusion to this matter.

## APPENDIX A

**Trading Ahead Violations**

Clerks testified under oath in the criminal trials of individual traders for Specialist Firms that specialists knowingly traded ahead of public orders in as little as 1 second. Theodore Christopher Gastonis, a clerk for Robert Scavone, testified at trial that trading ahead of public orders was done in as little as a "split second":

Q. Were there times that you would do this where the trades would be on the book for less than ten seconds?
A. Yes.
Q. Can you describe how low that range would be of an order appearing in the book and then the specialist trading. You said sometimes it would be less than ten seconds?
A. It could be a split second. It could be ten seconds.
Q. I'm sorry?
A. It could be a split second. It could be ten seconds.

*United States of America v. Robert Scavone (05 CR 390), Page 383:8-16 (July 26th 2006)*

Counsel for the US Attorney represented to Judge Chin in Federal Court that trading ahead was illegal regardless of the amount of time it takes for the Specialist to execute the order:

*"Mr. Barkow [US Attorney]: Your Honor, the rule is that it is against the rules, it is improper, it is illegal to trade ahead, regardless of the amount of time. That's what the rule is. And so the monitoring policy doesn't change that. * * *"*

*United States of America v. Thomas Murphy and David Finnerty, Pre-Trial Oral Argument July 12, 2006*

Similarly, the US Attorney asserted in the *Government's Memorandum of Law in Opposition to Defendant's Discovery Motions in United States of America v. Thomas Murphy* that:

*"Contrary to defendants' assertion, there is not '10 second standard.' (Def. Mem. At 33). The relevant rules provide that a specialist may not trade ahead of an executable public order he is aware of period – regardless of any time parameter. (See NYSE Rule 92(a); Ind. ¶ 17)."*

Likewise, the following testimony of Douglas Brendan Lange, a clerk for David Finnerty, describes how marketable public orders appear on the display book before the specialist is about to trade ahead of the public order, and how Mr. Finnerty directect him to "gray" out public orders:

Q. Now, when a specialist is about to execute a trade in front of a public order, does the Display Book screen do anything to notify the specialist that he's doing that?
A. There is a gray box that appears in the report window.

*United States of America v. David Finnerty (05 CR 393), Page 640:17-20 (October 18, 2006)*

Q. Now, the graying, does that indicate that a DOT order that could participate is not participating in the trade?
A. Yes.
Q. And is that the case where a floor broker is participating instead?
A. Yes.
Q. And is that the case where a cap order is participating instead?
A. Yes.
Q. And if in the report window --
MR. BANSAL: If we could have 113S at page, I believe it's 16. And we could blow up, thank you, the 8-price and the report window.
Q. Where 40 and prin is underneath the gray DOT order, what does that indicate?
A. That is indicating that the 4,000 shares for the principal account is trading where, an example where a marketable order or limit order could be executed against the sell side.
Q. And when you clerked for Mr. Finnerty and he directed you to input trades like you described, did the DOT orders gray?
A. Yes.
Q. And what did that indicate to you?
A. That an order that could participate was not participating.

*United States of America v. David Finnerty (05 CR 393), Page 712:12-713:9 (October 19, 2006)*

The fact that the specialists were "graying out" marketable public orders and trading instead for the principal account is a clear violation of Rule 92 regardless of how long the orders had been on the display book. In fact, in 2003, after the discovery of widespread wrongdoing, the NYSE added a "principal inhibitor" to the display book so that the specialist could not trade ahead of public orders regardless of time. This principal inhibitor did not use a 10 or 15 second timeframe:

> The NYSE undertakes to continue to identify and implement enhancements to its trading systems reasonably designed to prevent specialists from trading ahead and interpositioning. Prior to the date of this Order, the NYSE commenced implementation of this undertaking by modifying the Display Book to include the Principal Inhibitor function. The Principal Inhibitor function is an electronic default that blocks specialist dealer trades when the specialist is in the process of executing a proprietary trade while in possession of a customer order that could trade in place of some or all of the specialist's side of the trade. The specialist may override the electronic default by inputting information representing that the trade meets a specified exemption approved by the NYSE. With respect to this undertaking, the NYSE specifically undertakes to develop system enhancements to the extent practicable to limit those circumstances, not approved by the NYSE,

> in which the specialist may override the electronic default of the Principal Inhibitor function. The NYSE shall require that the system enhancements adopted in compliance with this undertaking may not be disabled by the specialists.

*SEC Administrative Proceeding Release No. 51524 dated April 12, 2005*

Additionally, counsel for the US Attorney's office in United States of America v. Michael Hayward and Michael Stern attempted to introduce a 3 second exception report during the criminal trial. The US Attorney's position was that 10 second time parameter was only used to clearly establish criminal wrongdoing, even though there were other examples of improper trades that were executed in less time. Keep in mind that the US Attorney utilized an SEC Staff Attorney throughout this trial who was present in the courtroom.

> MR. BARKOW: -- in any way they want.
> And finally, just to point one thing out, and I think the Court was aware that this would happen before the trial, but some of the clerks have testified that, in fact, they executed trading-ahead trades when the orders were on the book for less than ten seconds. I think Ms. Handelman said something like one to ten or five to ten seconds. Mr. Virga said three to ten and five to ten, I think. And so there is testimony and evidence in the record that says that there were instances where they were on the book for more than ten seconds and less than ten seconds.
> This three-second report, then, corroborates that testimony.

*United States of America v. Michael J. Hayward and Michael F. Stern (05 CR 390) Page 1554 7:19 June 27, 2006*

## Interpositioning Violations

Similar to Trading Ahead, Interpositioning violations subject to the Consent Orders were based on a criteria defined by either the NYSE or SEC. In order to qualify as an Interpositioning exception, orders had to appear on the display book either simultaneously or within 1 second of each other. Furthermore, the orders had to appear out a freeze of the display book (either an explicit or implicit freeze). The following is testimony of NYSE Managing Director Roken Ahmed pertaining to the Interpositioning criteria:

> Q. Could you tell us what is the definition of an interpositioning exception?
> A. If two orders, a buy order and a sell order are present at the same time, and the specialist instead of executing them against each other trades separately with each of them, that would be an interpositioning exception.
> Q. Now for your purposes in generating your reports, is a component of that definition you gave us linked to the concept

of a freeze?

A. Yes. In the exception reports, we included only those interpositioning examples, only those interpositioning instances that were, in which the orders came during freeze or within one second of the end of a freeze.

*United States of America v. David Finnerty (05 CR 390); Page 724:5-17 (October 20, 2006)*

Mr. Ahmed further clarified that orders that meet the definition of Interpositioning were excluded because they did not come out of a "freeze":

Q. Now, you mentioned that the parameters that you put together involved making sure that the orders came in either during a freeze or within one second after a freeze, correct?

A. Yes.

Q. Now, so if an instance, a trading instance met all of the criteria except -- all the criteria of interpositioning except that the orders didn't come in either during a freeze or within one second after a freeze, would they be anywhere in your exception reports?

A. They would not.

Q. Conceptually, would those trades nonetheless meet the definition of interpositioning?

A. Yes, they would.

*United States of America v. David Finnerty (05 CR 390) Transcript Page 766 3:15 (October 20, 2006)*

Another condition applied to certain Interpositioning transactions was that the orders were filled out of sequence. In other words, it was only a violation if the order that appeared second on the Display Book was executed first, and therefore the order that appeared first, was executed second. Similar to the freeze requirement, there is no reason why the specialists could not Interposition between public orders and still fill them in sequence. In fact, some specialists and their clerks who realized that out of sequence trades might draw the attention of market surveillance, deliberately used the "Fast Find" function of the display book to check the sequence of trades before executing their Interpositioning transactions. The following is trial testimony from Kathryn Handelman, who clerked for several specialists at Van Der Moolen including Richard Volpe and Michael Stern:

Q. Now there came a time when you were clerking for Mr. Stern in Lilly, am I correct?

A. Yes.

Q. And Mr. Stern, when orders used to come in one after another and there had been no oral consummation, he too used to interposition and trade ahead, correct?

A. Correct.

Q. And indeed, Mr. Stern is someone who ascended to the

management committee at VDM after the merger, am I correct?
A. Yes, that's correct.
Q. All right. And he certainly had another distinctive way of interpositioning and trading ahead; he used to use a fast find key, am I right?
A. Yes.
Q. And so that we all understand again -- the jury's probably got it from yesterday, but I'm the slow guy in the room -- by pushing the fast find key, you can see, or you could at that time see the sequence in which the orders came in, right?
A. Correct.
Q. And that permitted you to put in a trade with the earlier of the two orders, whether it was a buy or a sell, and pretend that you had orally consummated an order with that buy or sell, am I correct?
A. Yes.
Q. And that was a device to try and interposition without getting caught, am I right?
A. Yes.
Q. And you certainly knew that the use of the fast find key in that way was improper, am I right?
A. Yes.

*United States of America v. Richard Volpe (05 CR 390), Page 344:14-345:18 (September 7, 2006)*

Witness testimony confirms that the specialists frequently traded between two marketable public orders even when the orders were not associated with a freeze of the Display Book. Theodore Christopher Gastonis, a clerk for Robert Scavone, testified at trial that Robert Scavone would interposition between public orders that did not come out of a freeze:

Q. Were there times that Robert Scavone asked you to trade in the manner that you just described where the two trades didn't come in immediately after the book was unfrozen?
A. That they didn't come in?
Q. Yes, immediately after the book was unfrozen.
A. Yes.
Q. H'm?
A. Yes.
Q. Yes. Did Robert Scavone ever ask you to trade ahead of public orders in any other way?
A. Yes.
Q. Can you give an example.
A. On this?
Q. You can.
A. If the orders came in one before the other?
Q. Yes.

A. If 500 shares came in to buy and he said, right after 500
shares come in to sell, the 500 trade at 3 cents, I sold it,
meaning the specialist account. 500 trades at 3 cents. The
specialist sold it. And then the 500 trades again at $50. The
specialist bought it.
Q. With respect to that example, generally how long would the
public order have been on the book before the trade with the
specialist account?
A. Seconds.

*United States of America v. Robert Scavone (05 CR 390), Page 341:25-342:24 (July 26, 2006)*

In that same regard, Robert Corcoran, a clerk for Richard Volpe, testified as follows:

Q. Now, in this example that you've given, you said that the
orders, the 2,000 buy market order and the 2,000 sell market
order, they appeared at the same time out of the freeze, right?
A. Yes.
Q. When you executed trades in this example, in this pattern
in this example, was it always on the freeze or sometimes not
on the freeze?
A. Sometimes it wasn't on the freeze.

*United States of America v. Richard Volpe (05 CR 390) Page 449 23:25 Page 450 1:5 (September 7, 2006)*

Mr. Corcoran further confirmed that Interpositioning was improper, even when the orders did not appear at the exact same time:

Q. Now, the trades that you described were the same as in the
first example. So is the main difference that instead of the
orders coming in at the same time, they came one after the
next?
A. Yes.
Q. Now, Mr. Corcoran, when you executed a trade like this in
this pattern, what was your understanding of whether it was
proper or improper?
A. It was improper.
Q. Why?
A. Because it could have been paired off.

*United States of America v. Richard Volpe (05 CR 390), Page 451:11:- 452:-21 (September 7, 2006)*

The criteria used for Interpositioning was so limited that even orders that arrived within fractions of a second of one another were eliminated from the exception reports. Mr. Ahmed testified at trial regarding the exclusion of these exceptions:

> Q. In 2182, if we have a first trade where the specialist buys 1,000 shares at a low price from a 1,000 share market order to sell that appeared in the system at four seconds, and then in the second trade sells at a higher price to a 1,000 share market order to buy that appeared one second later, would these set of trades appear in the exception report?
>
> A. No. Because even though he had them both in his possession when he did the trade, when he did the first trade, even though it's possible he had both in his possession, we exclude this type of situation from the exception report.
>
> Q. Just to be clear, if this time here were 4.99999 and onward, and this were five seconds, so it was really, really close when these arrived, would it be in the exception report?
>
> A. No.

*United States of America v. Robert Scavone (05 CR 390) Page 632 9:22 (July 26, 2006)*

## APPENDIX B

The Commission has previously approved numerous Fair Fund distribution plans in which the distribution amount consisted of both disgorgement and civil penalties, and distribution payments were made on a pro-rata or other "group" basis, without limitation to the actual injury suffered by customers. Examples of such distribution plans, include, but are not limited to, the following: Janus Capital Management LLC (Release 34-57721) (where customer losses were determined to be less than $21 million, but the Fair Fund consisted of $100 million [a disgorgement payment of $50 million and civil penalties of $50 million. Therefore, payments to affected mutual funds of more than $79 million in excess of customer losses were approved as "fair and reasonable," as opposed to a windfall. This distribution plan provided in pertinent part as follows: "After distributing the funds according to the foregoing allocation of losses, funds will still remain in the Fair Fund. For example, amounts undistributed would include allocations to: accounts with distribution amounts below the *de minimis* amount, accountholders that cannot be located with commercially reasonable effort, accountholders that return or do not cash distribution checks, and accountholders that refuse distribution. One hundred and eighty days after the final distribution date any undistributed amounts will be placed into an account [the "Undistributed Funds" account]. Investors in the seven affected funds who did not receive a distribution under the Plan, or who dispute the amount of the distribution they did receive under the Plan, may file a dispute form with the IDC and request payment from the Undistributed Funds account [footnote omitted.] This account will close after all disputes are resolved, and in any event no later than nine months after the final distribution date, and any remaining undistributed funds will be allocated to the seven affected funds in proportion to the losses suffered by the shareholders in each fund."); AmSouth Bank, N.A. (now known as Regions Bank), and AmSouth Asset Management, Inc. (now known as Morgan Asset Management) (Release No. 34-56077) (providing that "[i]n situations in which distributions are unclaimed [checks not cashed], or persons to whom a distribution would otherwise be made cannot be identified or located, the distributable amounts will be paid to the fund to which the distribution relates," thereby, among other things, benefitting current owners of the fund who were not injured); Franklin Advisers, Inc. (Release 34-55868) ("For a number of reasons, the entire Fair Fund [consisting of disgorgement and civil penalties] may not be able to be distributed under the Distribution Plan described above. For example, BFDS may not be able to locate some Fair Fund Recipients, and others may not cash their Fair Fund distribution checks. Additionally, due to rounding all account allocations to the nearest cent, some residual amount may remain in the Fair Fund. Starting one hundred fifty (150) days after the initial distribution date, all undistributed assets remaining in the Fair Fund, minus any reserves for tax liability and tax compliance costs, will be paid to the Affected Funds in proportion to their Fund-Level Allocations of the Fair Fund discussed earlier, until the entire Fair Fund has been paid," thereby, among other things, benefitting current owners of the fund who were not injured); Franklin Advisers, Inc. and Franklin/Templeton Distributors, Inc. (Release 34-54342) (approving distribution to mutual funds rather than the shareholders of the mutual funds who were financially injured, thereby, among other things, benefitting current owners of the funds who were not injured); Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners, LLC, Kevin D. Larson, and James R. McBride (Release No. 55363**)** (providing that "[u]pon exhaustion of all procedures to identify and locate the Affected Mutual Funds and to reconcile all errors that result in non-delivery, if any portion of the Fair Fund remains undisbursed [whether because an Affected Mutual Fund has failed to supply identifying information to the Administrator, because the Administrator has been unable to locate an Affected Mutual Fund, because an Affected Mutual Fund or its successor no longer exists, because a check becomes stale, or for some other reason], the Administrator may make a secondary distribution of the remaining funds. Such a secondary distribution shall be on a pro rata basis to each Affected Mutual Fund that previously received a distribution"); and International Equity Advisors, LLC and Richard Roger Lund (Release 34-56220) (where the plan provided for distributions to eligible mutual funds based on a percentage of trading, rather than actual losses, and without distributions to the beneficial owners of the mutual funds. The plan provided in pertinent part as follows: "The Fund Administrator will determine the amount to be distributed to each Eligible Mutual Fund in the following manner. First, the Fund Administrator will determine, with reference to information collected by the staff of the Commission regarding trading in each Eligible Mutual Fund by the Respondents, what percentage of Respondents' cumulative trading [including all purchases and sales] in all Eligible Mutual Funds is represented by Respondents' trading in each Eligible Mutual Fund. Second, for each Eligible Mutual Fund, the Fund Administrator will multiply this percentage of total trading by the total amount of the disgorgement, prejudgment interest, and civil monetary penalty listed in paragraph 1, above, along with any interest accrued in the Deposit Account and less any taxes, fees or other expenses of administrating the plan [the "Distribution Fund"]. This amount represents each Eligible Mutual Fund's distribution amount.")