BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Jericho Nicolas San Francisco, CA, Angel Cruz San Francisco, CA, and Anthony Joseph Martinez Lake Grove, NY, Respondents.	DECISION Complaint No. CAF040052 Dated: March 12, 2008

Respondents participated in a fraudulent trading ahead scheme and made material omissions, which involved best execution violations and the issuance of false confirmations. Held, findings affirmed in part and reversed in part, and sanctions affirmed.

Appearances

For the Complainant: Leo F. Orenstein, Esq., Paul M. Schindler, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For Jericho Nicolas: Alvin L. Fishman, Esq., Tesler, Sandmann & Fishman

For Angel Cruz: Thomas M. Knepper, Esq., Jill J. Gladney, Esq., Knepper & Gladney

For Anthony Joseph Martinez: Pro se

Decision

Pursuant to NASD Rule 9311(a), Jericho Nicolas ("Nicolas"), Angel Cruz ("Cruz"), and Anthony Martinez ("Martinez") appeal from a June 5, 2006 Hearing Panel decision. The Hearing Panel found that respondents participated in a fraudulent scheme and made material omissions, and caused their firm, Kirlin Securities, Inc. ("Kirlin" or "the Firm"), to fail to provide accurate confirmations and to maintain inaccurate books and records. The Hearing Panel also found that Martinez failed to provide a customer with best execution and failed to submit accurate trade reports. For participating in a fraudulent scheme and making material omissions, the Hearing Panel barred all three respondents. In light of the bars, the Hearing Panel did not impose separate sanctions for the other violations.[1]

After a complete review of the record, we affirm in part and reverse in part the Hearing Panel's findings of violations, and we affirm the sanctions imposed. We find that respondents engaged in a months-long fraudulent scheme to trade ahead of a customer's orders and thereby reap risk-free trading profits. The first step of this scheme involved the respondents taking a large order from the customer and not seeking to fill that order on the best possible terms reasonably available.[2] Instead, the respondents took advantage of the information that the customer wanted to buy or sell and traded in the Firm's proprietary account to establish a position that, later the same day, the Firm would use to trade as a principal against the customer's order. The Firm's capital was never at risk because it knew that, within hours at the most, it would trade with the customer and finish the transaction with no position remaining. The Firm's price to the customer—excluding its commissions and markups—always favored the Firm. For example, if the Firm bought a stock for its proprietary account at $40 and the price rose to $42, the price to the customer was $42. However, the Firm did not tell the customer that it had reaped trading profits based on its knowledge of the customer's order. If the Firm bought a stock for $40 and the price dropped to $38, the price to the customer was $40. This was a true "heads I win, tails you lose" scheme. The Firm never lost any money when engaging in principal transactions with the customer.

In carrying out the fraudulent trading ahead scheme, respondents also committed other ancillary violations: Martinez failed to obtain best execution for EH, and respondents issued confirmations that failed to disclose Kirlin's trading profits as required. Based on these violations, we affirm the bars on respondents.

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[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA shall include, by reference and where appropriate, references to NASD.

[2] Based on the terms of the orders and then market prices, the customer was entitled to immediate execution. For example, none of the trades involved limit orders arriving at a point in time when the market price was outside the limit, thus not entitling the customer to immediate execution.

I. Background

A. Nicolas

Nicolas first became registered with a member firm in April 1990. From October 8, 1998, until August 25, 2004, Nicolas was registered with Kirlin as a general securities representative. Nicolas worked in Kirlin's branch office in San Francisco, California. Nicolas is currently registered with another member firm as a general securities representative.

B. Cruz

Cruz first became registered with a member firm in January 1990. From October 21, 1998, until September 3, 2004, Cruz was registered with Kirlin as a general securities representative and a general securities principal. Cruz worked in Kirlin's San Francisco, California office as the "managing director." Although Ailin Dorsey ("Dorsey") was the official branch manager of Kirlin's San Francisco office during the relevant period, the record demonstrates that Cruz was the de facto branch manager. Cruz is currently registered with another member firm as a general securities representative and a general securities principal.

C. Martinez

Martinez first became registered with a member firm in March 1992. Kirlin hired Martinez to be Kirlin's head equity trader. Martinez was registered with Kirlin as a general securities principal and a general securities representative from June 19, 1995, until April 23, 2001, and as an equity trader from November 22, 1999, until April 23, 2001. Martinez worked in Kirlin's main office in Syosset, New York. Martinez testified that, as the head equity trader, he supervised the other equity traders in the office. Martinez is not currently registered with any member firms.

II. Facts

With a view to explaining the details of the respondents' fraudulent scheme, we first address customer EH's relationship with Kirlin. We then describe the process by which EH's orders were placed, handled, executed, and confirmed, including the roles that each respondent played and how Kirlin profited from the scheme.

A. Nicolas Negotiates a Transaction Costs Agreement with EH

Nicolas was introduced to EH, who is based in Hong Kong, through KT, who was a mutual acquaintance as well as an associate of EH. Nicolas testified that EH was a sophisticated investor who had numerous accounts at various broker-dealers.

Nicolas's first meeting with EH was on a telephone call. In that initial call, EH indicated that he thought he was being overcharged by one of his other brokerage firms for his trading. Nicolas negotiated an agreement concerning transaction costs with EH, in which Kirlin would

charge EH $0.03 - $0.05 per share for trades of 10,000 shares or more, and $0.06 - $0.08 per share for trades of 9,999 shares or less, whether the transaction was done on an agency or principal basis. In June 1999, EH opened three accounts at Kirlin: one for himself, and two corporate accounts.[3] Nicolas was the registered representative for each of these accounts.

B. The Order Taking and Transmittal Process

Nicolas testified that either EH or his representative PW would place orders to buy or sell securities by calling Nicolas.[4] Nicolas testified that EH placed both market orders and limit orders. Nicolas also testified that he had no authority to place an order for EH without EH's approval. On some occasions when Nicolas was not accessible, other representatives, including Cruz, took orders from EH.[5]

Nicolas and Cruz testified that customer orders that exceeded a certain size had to be executed by Kirlin's trading desk in the Syosset office.[6] Whatever the exact contours of the policy, it is undisputed that all of EH's orders that Kirlin executed in a principal capacity were directed to Kirlin's trading desk for execution.

Nicolas testified that, on receipt of an EH order that the trading desk had to execute, he would fill out an order ticket and deliver it to Cruz or Dorsey, or just direct Cruz or Dorsey to fill out the order ticket. Whether Nicolas took the ticket to Cruz or Dorsey depended on who was available. Nicolas explained that he had no contact with Kirlin's trading desk, and that he had never spoken with Martinez, Kirlin's head equity trader.

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[3] The three EH accounts were delivery-versus-payment ("DVP") accounts. Nicolas testified that the payment for securities in a DVP account comes from a third party, unlike a cash account where cash or securities are held in the brokerage account. Nicolas testified that most of the payment for EH's transactions came from an account at the Bank of Austria.

[4] Nicolas would sometimes agree to watch the activity of certain stocks and, after doing so, call EH to discuss putting in an order to buy or sell.

[5] Nicolas testified that Cruz took orders from EH on approximately five or six occasions; Cruz testified that he took an order from EH at least once.

[6] Nicolas and Cruz offered slightly different explanations of which customer orders had to be directed to the trading desk. Nicolas testified that customer orders that exceeded 10,000 shares had to be executed by Kirlin's trading desk. Cruz testified that orders that exceeded $100,000 or that involved stocks in which Kirlin made a market would be executed by Kirlin's trading desk. Nicolas and Cruz agreed that Kirlin brokers were permitted to execute certain smaller orders through terminals connected to the Firm's direct order routing system.

Cruz and Dorsey each testified that, upon receipt of an EH order that had to be executed by the trading desk, he or she would call Kirlin's trading desk.[7] The Hearing Panel found, however, that Cruz's testimony that he immediately called in EH's orders upon receiving them was not credible.

Cruz and Dorsey both testified that they would time-stamp the customer order ticket once, approximately at the time they called that order into the trading desk.[8] Cruz further testified that, after he called in an order to the trading desk, he would put the order ticket to the side or hand the ticket to Dorsey.[9]

C. The Order Execution Process

Martinez worked on Kirlin's trading desk in the Syosset office. Martinez explained that when a trader received a customer order for execution, the trader would fill out a trade ticket and also write down the name of the broker or branch who called in the order. Martinez further explained that the trading desk time-stamped trade tickets twice: first upon receipt of an order from the broker or branch, and again upon execution.

The capacity in which Kirlin executed a customer order affected the nature of the Firm's compensation. If Kirlin acted in an agency capacity, the compensation earned was the commission charged.[10] If Kirlin acted as a principal,[11] Kirlin's trading generated "concessions," which, as Martinez explained, included two components: (1) the markup or markdown charged, typically between $0.03 and $0.08 cents per share on EH's orders; and (2) any trading profits earned by Kirlin, minus a $0.02 fee that went to the trading department. Portions of concessions were paid to Kirlin's brokers, but only the $0.02 fixed fee went to Kirlin's trading department. Finally, if Kirlin executed the order in a riskless principal capacity, the Firm was permitted to

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[7] Cruz testified that, when Nicolas brought an EH order ticket to him, Cruz would have been the person who called the order into the trading desk "99 percent of the time."

[8] Nicolas testified that there were two time stamp machines in the San Francisco office, one in Cruz's office and one in the "wire room" where Dorsey worked. Cruz testified that the wire operator in that office also had a third time stamp machine.

[9] Likewise, Dorsey testified that Cruz would sometimes deliver to her order tickets that he had already called into the trading desk, both executed and unexecuted orders.

[10] "An agency trade is a trade in which a broker/dealer, authorized to act as an intermediary for the account of its customer, buys (sells) a security from (to) a third party (e.g., another customer or broker/dealer). Such a trade is not executed in, or does not otherwise pass through, the broker/dealer's proprietary account." *NASD Notice to Members 01-85* (Dec. 2001).

[11] "A principal trade is a trade in which the broker/dealer buys or sells for an account in which the broker/dealer has a beneficial ownership interest (e.g., a proprietary account)." *Id.*

earn a markup or markdown but not trading profits.[12] Martinez explained that the Firm's compliance department and senior management informed him that the Firm could act in a principal capacity, as opposed to a riskless principal capacity, if the Firm could offset a customer order with proprietary positions that the Firm had taken on risk to establish.

Martinez testified that trading desk clerks would enter order information into the Brass Service Bureau and Order Management System ("BRASS").[13] For large principal trades or when the trading desk was busy, however, traders would hand off order information to Kirlin's operations department to enter such information directly into Kirlin's clearing firm's system. Martinez testified that the trader was responsible for the accuracy of this information.

D. In 151 Trades that Kirlin Confirmed as "Principal" Trades, Kirlin Earns Undisclosed Profits and Avoids Any Losses

From October to December 1999, Kirlin executed a total of 185 trades in EH's accounts. Nicolas, Cruz, and Martinez acknowledged that they participated in the order taking and execution process for many of these transactions, as reflected by the transaction information written in their handwriting on order and trade tickets.[14] EH's trades, which included buy and

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[12] "A riskless principal transaction occurs where a dealer, after receiving an order to buy or sell a security from a customer, purchases the security from another person to offset a contemporaneous sale to such customer or sells the security to another person to offset a contemporaneous purchase from such customer." *Strategic Res. Mgmt., Inc.*, 52 S.E.C. 542, 544 n.8 (1995). Whether an order is executed in a riskless principal capacity does not require that the offsetting transaction occur at the same time. Rather, transactions that are "designed to be offsetting" and that occur in "close time proximity" qualify as riskless trades. *Marc N. Geman*, 54 S.E.C. 1226, 1247 (2001), *aff'd*, 334 F.3d 1183 (10th Cir. 2003). In a riskless principal transaction, "[t]he broker/dealer generally charges its customer a markup, markdown, or commission equivalent for its services, which is disclosed on the confirmation required by Securities Exchange Act Rule 10b-10." *NASD Notice to Members 01-85*; *Kevin B. Waide*, 50 S.E.C. 932, 934 (1992) (holding that, in riskless principal transactions, "fairness ordinarily requires the firm to base its markup on a price that does not exceed its cost").

[13] As explained by the Commission in 1998, "BRASS is an order routing system operated by Automated Securities Clearance, Ltd." *Regulation of Exchanges and Alternative Trading Systems*, Exchange Act Rel. No. 40760, 1998 SEC LEXIS 2794, at *58 n.73 (Dec. 8, 1998).

[14] Nicolas identified his own handwriting on 128 of the 185 EH order tickets. Cruz identified price and concession information in his own handwriting on approximately 99 of EH's order tickets. Although Martinez—who appeared pro se—did not dispute the assertion of counsel for the Department of Enforcement ("Enforcement") that Martinez had "identified [his own] handwriting on all but approximately ten of the principal [trade tickets] for [EH] during the [relevant] period," we do not base our finding on this statement. The documentary evidence clearly demonstrates that Martinez identified his handwriting on the trade tickets for only 73 of the 151 principal trades. As to the other 78 principal trades, either Enforcement did not present

[Footnote continued on next page]

sell orders, were large, averaging more than 10,000 shares and more than $1 million per trade. EH's 185 transactions were in 49 different securities, and only seven transactions involved securities in which Kirlin made a market. The confirmations that Kirlin sent to EH confirmed that Kirlin executed 151 of these trades as principal trades ("the principal trades") and 34 as agency trades.

This proceeding primarily concerns the 151 principal trades. When executing those 151 principal trades, Kirlin generally filled EH's orders with securities that Kirlin had bought or sold for its proprietary account earlier in the day. In each such instance, Kirlin had in its inventory the *exact amount* of the securities needed to fill EH's orders, sometimes as the result of building this position through numerous trades. In its 151 principal trades with EH, Kirlin often made money and never lost money.

Specifically, in 100 of the 151 principal trades ("the profitable principal trades"), Kirlin nearly always began to establish its proprietary position before time-stamping EH's order ticket, and generally did not execute EH's order until it fully established an offsetting proprietary position. In these profitable principal trades, the price of the security moved in Kirlin's favor between the time it established its proprietary position and the time it executed EH's orders. In total, Kirlin earned trading profits of $694,000 in the 100 profitable principal trades. Kirlin did not disclose these trading profits to EH. For example:

- Transaction 17.[15] On October 8, 1999, between 12:48:44 p.m. and 12:57:15 p.m., Kirlin executed three transactions for its own account, buying an aggregate of 40,000 shares of Lucent Technologies Inc. for $2,546,875. At 1:27 p.m., Kirlin's San Francisco office time-stamped an order ticket for one of EH's accounts to buy 40,000 shares of Lucent Technologies Inc. At 1:28:43 p.m., Kirlin's trading desk time-stamped as executed the trade ticket for EH's order. To fill EH's order, Kirlin executed EH's order in a principal capacity and sold to EH the 40,000 shares in its inventory for $2,557,500. Kirlin charged a markup of $0.05/share ($2,000), which was disclosed on the confirmation. Kirlin earned trading profits of $9,900, which were not disclosed. Nicolas and Cruz identified their handwriting on the order tickets. Martinez identified his handwriting on the trade ticket.

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Martinez with a trade ticket to review or, where it did, Martinez did not identify the handwriting on the trade tickets as his own. Although Martinez testified that the fact that his handwriting was on a trade ticket did not necessarily mean that he had executed the order, it does show that he had knowledge of the particular transaction.

[15] Enforcement's exhibits numbered the various transactions at issue. Consistent with the Hearing Panel's decision, this decision will use Enforcement's numbering system to refer to specific transactions.

- Transaction 77. On November 15, 1999, between 2:42:10 p.m. and 2:44:40 p.m., Kirlin executed 14 transactions for its own account, selling short an aggregate of 12,000 shares of China.com stock for $1,375,643.75. At 2:45 p.m., Kirlin's San Francisco office time-stamped an order ticket for one of EH's accounts to sell 12,000 shares of China.com. At 2:45:54 p.m., Kirlin's trading desk time-stamped as executed the trade ticket for EH's order. To fill EH's order, Kirlin executed EH's order in a principal capacity and bought EH's 12,000 shares for $1,332,000, covering the Firm's short position. Kirlin charged a markdown of $0.05/share ($600), which was disclosed on the confirmation. Kirlin earned trading profits of $43,260, which were not disclosed. Nicolas and Cruz identified their handwriting on the order tickets. Martinez identified his handwriting on the trade ticket.

In addition to the 100 profitable principal transactions, there were 51 other principal trades ("the break even principal trades"), in which Kirlin executed EH's orders at a price that allowed Kirlin to avoid incurring any trading losses. Kirlin never disclosed to EH that it did not lose any money executing EH's orders. For example:

- Transaction 42. On November 4, 1999, between 9:31:52 a.m. and 10:17 a.m., Kirlin executed 15 transactions for its own account, buying an aggregate amount of 20,000 shares of BEA Systems, Inc. at an average price of $54.9703 per share. At 3:44 p.m., Kirlin's San Francisco office time-stamped an order ticket for EH's account to buy 20,000 shares of BEA Systems. The trade ticket was time-stamped as executed at 4:08 p.m. To fill EH's order, Kirlin executed EH's order in a principal capacity and sold EH 20,000 shares of BEA Systems. Instead of charging EH the prevailing market price, which had dropped to approximately $53 per share, Kirlin charged EH its average cost of $54.9703, plus a disclosed commission, allowing Kirlin to avoid approximately $40,000 in losses. Nicolas and Cruz identified their handwriting on the order ticket.[16]

The trading profits that Kirlin did not disclose to EH were sizeable and dramatically larger than the markups, markdowns, and commissions it did disclose. Specifically, in the 185 EH trades, Kirlin disclosed $95,172.80 in markups, markdowns, and commissions, averaging $514.45 per transaction ($0.04209/share). In contrast, Kirlin did not disclose $694,671 in trading profits, which over the 100 profitable principal trades averaged $6,946.72 per transaction ($0.8541/share).

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[16] The timing of Kirlin's establishing its proprietary positions and executing EH's orders in the break even principal trades did not reflect patterns that were as pronounced as the patterns in connection with the profitable principal trades. In approximately one-third of the break even principal trades, Kirlin began to build its offsetting proprietary position before it time-stamped EH's order ticket. In more than 60 percent of the break even principal trades, Kirlin fully established an offsetting proprietary position before executing EH's orders. In addition, whereas the record shows the amount of trading profits Kirlin earned in the 100 profitable principal trades, the record does not generally reflect the amount of trading losses that Kirlin may have avoided in the break even principal trades.

E. The Trades that Kirlin Confirmed as "Principal" Trades Were, in Fact, Riskless Principal Trades

Martinez offered an explanation for how the Firm consistently earned trading profits on EH's orders. Martinez testified that the trading profits resulted from a practice at Kirlin of allowing brokers or branches to establish proprietary positions—known at the Firm as placing "indications of interest" or "proprietary orders"—against which such brokers or branches would then solicit business. Specifically, Martinez testified that he would "regularly receive calls" from Cruz, among others, to establish such proprietary positions. Martinez testified that any of the traders on the trading desk had the authority to accept or reject proprietary orders. Martinez explained that he would fill such proprietary orders with "the street" or a hedge fund named PTJP. After filling the proprietary order, Martinez would inform whoever had placed that proprietary order (i.e., Cruz or Dorsey when such an order was placed by the San Francisco branch office) that the order had been executed and would provide the execution price. Martinez testified that all traders then knew to expect that the office that had placed the proprietary order would subsequently call in an offsetting, solicited customer order.[17] Martinez explained that this practice was used to "generate extra concessions" for the Firm's brokers.[18]

The Hearing Panel implicitly credited Martinez's testimony that Kirlin permitted brokers to establish proprietary positions. The Panel did not credit Martinez's claim, however, that, where such proprietary positions were ultimately used to offset EH's orders, brokers were using such proprietary positions to solicit *future* business. Indeed, the manner in which Kirlin's traders acted, and other circumstantial evidence, demonstrates that when Kirlin's traders established the proprietary positions that later offset EH's orders, they knew or must have known that Kirlin already had an EH order in hand and was not actually at risk:

- Kirlin would "never, ever lose any money" executing principal trades with EH.

- The proprietary positions that Kirlin used to offset EH's orders were often multi-million dollar positions, including 18 positions that exceeded its $2.1 million in excess net capital.

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[17] Martinez testified that he "probably told [the other traders] of the accepted practice" of "allow[ing] branches or brokers to give a proprietary order and then solicit orders." Martinez also explained that the brokers "generated their own ideas" of the proprietary positions to establish.

[18] Cruz denied that he ever communicated indications of interest to Martinez. Dorsey denied that she was aware of the practice of placing proprietary orders. The Hearing Panel did not credit their testimony.

- Despite the volatility of the market during the fourth quarter of 1999, Kirlin's trading desk never took any action to mitigate potential losses being incurred in the offsetting proprietary positions, even where those potential losses were large.

- Kirlin's trading desk would always offset its proprietary positions in a single transaction with EH, sometimes hours after establishing the proprietary position.

- Most of the offsetting proprietary trades involved stocks in which Kirlin did not make a market.

- Although the industry practice is for the trading department to earn a share of trading profits earned in proprietary trading, Kirlin's traders earned no portion of the trading profits earned on the profitable principal trades with EH.

In sum, the preponderance of the evidence demonstrates that the 151 principal trades involved transactions that were designed to be offsetting and riskless.

F. Post-Execution Process, Trade Confirmations, and Trade Reporting

When a trade was executed, the trader added the price and concession information to the trade ticket. Martinez testified that the trading department also would input fill information into BRASS and "report the customer price to the tape." Using order information that Kirlin entered into BRASS (or directly into the clearing firm's system), Kirlin's clearing firm generated and sent to EH a confirmation. The confirmations confirmed: (1) the quantity bought or sold; (2) the reported price; (3) the markup, markdown, or commission that was charged, which for EH's orders was always between $0.03 to $0.07 per share; (4) the price to the customer, which was the reported price net of any markup or markdown; (5) the capacity (principal or agent) in which Kirlin executed the trade; and (6) the gross amount of the transaction. The confirmations never disclosed the Firm's trading profits, or the differences between Kirlin's price and EH's price.

Cruz and Dorsey both testified that whoever on Kirlin's trading desk executed an order would contact them with fill information, including the price at which the trade was executed and, if the trade was a principal trade, the amount of the concession.[19] Cruz and Dorsey would write on the order tickets all fill information, including the concessions. Dorsey explained that she saved one copy of the order ticket as the "branch" copy and delivered a second copy to the broker's mailbox.[20] Dorsey testified that brokers would periodically pick up this information

[19] Cruz and Dorsey would inform the trading desk what the markup, markdown, or commission was.

[20] Dorsey compiled the branch copies of order tickets until the end of the day, when she would review them for completeness and to ensure that the commissions charged were within "the guidelines of the NASD." After reviewing the tickets, Dorsey initialed them and handed them to Cruz for his review.

from their mailboxes during the day. Nicolas testified that he would learn, generally at the end of the day, from the completed order tickets placed in his mailbox about fill information for EH's orders, including the price and any concessions.

Nicolas testified that, because EH's accounts were DVP accounts, EH requested that Nicolas send him a daily report of the activities in his three accounts, in advance of the official confirmations that Kirlin's clearing firm generated. Dorsey, at Nicolas' direction, prepared these daily reports using information from the completed order tickets. These daily reports consisted of a facsimile transmittal from Nicolas that was labeled "confirmation" and that attached additional pages setting forth information about EH's trades. Like the official confirmations, the daily reports disclosed the price charged net of the $.03-$.07 markup or markdown, but never disclosed any trading profits earned or price differences between Kirlin's price early in the day and EH's price later in the day.[21]

G. Respondents' Compensation from EH's Trades

Fifty percent of the concessions generated by EH's orders went to Nicolas. Nicolas' compensation skyrocketed when he began servicing EH's accounts.[22] For October to December 1999, Nicolas earned $379,593 from servicing EH's orders, $347,336 of which was undisclosed trading profits. As for Cruz's compensation, the remaining 50 percent of the concessions generated by EH's orders was credited towards the branch's annual net profits. Cruz earned 25 percent of these profits, among other compensation. None of the concessions went to Martinez. For 1999, Martinez earned a salary of $140,000 and a $60,000 bonus. Martinez testified that his bonus was based on his performance in his market-making account and that trading profits generated from non-market making trading "were in no way impacting" his compensation.

III. Procedural History

This proceeding grew out of a routine examination of Kirlin in which FINRA staff observed high markups, markdowns, commissions, and sales concessions.[23] On July 30, 2004,

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[21] Each daily report also stated, "[i]t is not the intent of this report to replace your confirmations, statements and/or 1099."

[22] During the first half of 1999—before EH opened an account at Kirlin—Nicolas' net monthly payout ranged from $3,503 to $6,746. In June and July 1999—the first two months in which Nicolas serviced EH's accounts—Nicolas's net monthly payout leapt to $51,059 and $148,986, respectively.

[23] This proceeding emanated from a larger investigation of the Firm. In related proceedings, Kirlin, Anthony Kirincic (Kirlin's president), and Dorsey submitted Letters of Acceptance, Waiver, and Consent, in which they consented, without admitting or denying the allegations, to violations that involved the conduct at issue here and other conduct. Kirlin consented to a censure, a $155,800 fine, and an order to pay $1,044,732 in restitution, among other sanctions. Kirincic consented to a $25,000 fine and a 30-day suspension in a principal or

[Footnote continued on next page]

Enforcement brought a five-cause complaint against Nicolas, Cruz, and Martinez concerning conduct that occurred between October 1 and December 31, 1999.

Cause one alleged that respondents violated an implied representation of fair dealing, effected trades for EH by means of a manipulative, deceptive, and fraudulent device, and materially misrepresented the terms of the brokerage services that Kirlin provided to EH, in violation of Sections 10(b) and 15(c) of the Securities Exchange Act of 1934 ("Exchange Act"), Section 17(a) of the Securities Act of 1933 ("Securities Act"), Exchange Act Rules 10b-5 and 15c1-2, and NASD Rules 2120 and 2110. Cause two alleged that respondents caused Kirlin to send to EH trade confirmations that were false, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-10(a)(2), and NASD Rules 2210, 2230, and 2110. Cause three alleged that Martinez failed to give customer EH best execution when executing principal trades, in violation of NASD Rules 2320 and 2110. Cause four alleged that respondents failed to make and keep, or caused Kirlin to fail to make and keep, accurate records of EH's orders, in violation of Sections 10(b) and 17(a)(1) of the Exchange Act, Exchange Act Rules 10b-10, 17a-3(a)(6), 17a-3(a)(7), 17a-4, and NASD Rules 2230, 3110, and 2110. Finally, cause five alleged that Martinez failed to make, or caused Kirlin to fail to make, accurate trade reports, in violation of NASD Rules 4632, 6130, 6420 and 2110.

Each respondent filed a separate answer denying the allegations and raising several affirmative defenses. An Extended Hearing Panel ("Hearing Panel") conducted a seven-day hearing. On June 5, 2006, the Hearing Panel issued a decision, which generally found that respondent had engaged in all alleged violations.[24] For respondents' participation in a fraudulent scheme, the Hearing Panel barred each respondent. In light of the bars, the Hearing Panel declined to impose additional sanctions for respondents' other violations. This appeal followed.

IV. Discussion

We begin our discussion with the most important question raised in this appeal: Did respondents participate in a fraudulent trading ahead scheme? Second, we consider whether Martinez failed to obtain best execution for EH. Third, we turn to whether respondents caused false confirmations to be issued by omitting price differences in riskless principal trades. Finally, we briefly examine the Hearing Panel's findings concerning additional false confirmation violations, books and record violations, and trade reporting violations.

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supervisory capacity. Dorsey consented to a $15,000 fine and a 20-business-day suspension in a principal or supervisory capacity.

[24] The Hearing Panel did not make any findings, however, concerning the allegations that respondents violated Section 15(c) of the Exchange Act and Exchange Act Rule 15c1-2, noting that such provisions applied only to broker-dealers.

A. Fraud

As explained below, the preponderance of the evidence, which is circumstantial, shows that respondents participated in a fraudulent trading ahead scheme and made material omissions with scienter.[25]

1. The Fraudulent Trading Ahead Scheme

Section 10(b) of the Exchange Act, Section 17(a) of the Securities Act, Exchange Act Rule 10b-5, and NASD Rule 2120 prohibit fraudulent and deceptive acts and practices in connection with the offer, purchase, or sale of a security.[26] Violations of these provisions may be established by a showing that persons acting with scienter misrepresented or omitted material facts in connection with securities transactions.[27] A fact is material "if there is a substantial likelihood that a reasonable investor would have considered the omitted or misstated fact important in making an investment decision, and disclosure of the omitted or misstated fact would have significantly altered the total mix of information available." *Robert G. Weeks*, Exchange Act Rel. 48684, at *27 n.17 (Oct. 23, 2003) (*citing Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), *and TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

In addition, the prohibition in Section 10(b) of the Exchange Act against employing "any manipulative or deceptive device or contrivance" includes any scheme to defraud, which includes "complex securities frauds" in which "there are likely to be multiple violators." *Arouh*, 2004 SEC LEXIS 3015, at *19. "A number of courts [have] concluded that a person's conduct as part of a scheme to defraud can constitute a primary violation as long as each defendant committed a manipulative or deceptive act in furtherance of the scheme." *Id*. at *19-20 (internal quotation marks omitted). "Accordingly, a person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a)." *Id*. at *20.

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[25] "[C]ircumstantial evidence can be more than sufficient to prove a violation of the securities laws." *Keith Springer*, 55 S.E.C. 632, 643 n.15 (2002); *see also Terrance Yoshikawa*, Exchange Act Rel. No. 53731, 2006 SEC LEXIS 948, at *17 (Apr. 26, 2006) (holding that proof of scienter "may be inferred from circumstantial evidence") (citing cases).

[26] *Leslie Arouh*, Exchange Act Rel. No. 50889, 2004 SEC LEXIS 3015, at *17 (Dec. 20, 2004); *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *2 & n.1 (Feb. 10, 2004).

[27] *Arouh*, 2004 SEC LEXIS 3015, at *17; Exchange Act Rule 10b-5(b); *Faber*, 2004 SEC LEXIS 277, at *13-14. Misrepresentations and omissions are also inconsistent with just and equitable principles of trade and violate NASD Conduct Rule 2110. *Faber*, 2004 SEC LEXIS 277, at *14.

The record demonstrates that respondents participated in a fraudulent scheme to trade ahead of, and earn risk-free trading profits from, EH's orders. The essence of the fraudulent scheme was Kirlin's actions to trade ahead of EH's orders. Based on our review of the order tickets, EH's orders constituted market orders, which Kirlin was required to execute "fully and promptly." *NASD Notice to Members 99-11* (Feb. 1999).[28] Instead of adhering to that responsibility, Kirlin generally delayed executing EH's market orders in the 151 principal trades until it traded ahead of EH's orders and established in its own proprietary account a position matching exactly the size of EH's orders. At some point after establishing that exact offsetting proprietary position—seconds, minutes, or hours later—Kirlin would execute EH's market orders in a principal capacity.[29]

Kirlin exploited its knowledge of EH's orders by executing EH's market orders at prices that did not give EH best execution and that ensured that Kirlin earned risk free profits on its principal trades. In 100 instances—the profitable principal transactions—the price of the underlying securities changed in a way that benefited the Firm, relative to its proprietary position. In those instances, Kirlin executed EH's market orders at the subsequent price, securing a trading profit for itself. By acting in this manner, Kirlin essentially stole EH's best

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[28] A firm's obligation to promptly execute market orders is based on "a member's basic fiduciary obligations and the requirement that it must, in the conduct of its business, 'observe high standards of commercial honor and just and equitable principles of trade.'" *See NASD Notice to Members 05-69* (Oct. 2005).

[29] Several witnesses, including Nicolas and Cruz, testified that EH placed both market orders and limit orders. The order and trade tickets contain no indication that any of the orders were limit orders. But even if any of EH's orders were limit orders, the record demonstrates that Kirlin impermissibly traded ahead of such limit orders. A limit order is an order to buy or sell a security at a specific price or better. *E.F. Hutton & Co.*, 49 S.E.C. 829, 830 n.2 (1988). Subject to exceptions that do not apply here, a broker-dealer is not permitted to accept and hold its customer's unexecuted limit order while trading the security for its own account at prices that would satisfy the customer's limit order. NASD IM-2110-2 ("the Manning Rule"); *NASD Notice to Members 95-43* (June 1995) (explaining that "it is inconsistent with a member's best-execution obligation . . . to trade ahead of a customer's limit order"); *see also* Exchange Act Rel. No. 53527, 2006 SEC LEXIS 688, at *13 (Mar. 21, 2006) ("NASD's longstanding position has been that the Manning Rule applies to all members . . . based on a member's best execution obligations."). If any of the 100 profitable principal trades involved limit orders, the fact that Kirlin gave EH a worse price than the price Kirlin paid or received to establish its proprietary position shows that Kirlin violated the Manning Rule in those instances, because it is highly unlikely that EH's limit price would have been inferior to the price that Kirlin obtained for itself earlier in the day. Likewise, to the extent that the 51 break even principal trades involved Kirlin initiating its proprietary position before executing EH's limit orders, the fact that Kirlin gave EH the price that Kirlin obtained earlier in the day demonstrates that Kirlin violated the Manning Rule by not immediately executing the limit order when the limit was reached.

execution price.[30] In 51 other instances—the break even principal trades—Kirlin just passed along its cost to EH, ensuring that it never lost money and was never at risk when executing EH's orders in a principal capacity.[31]

Throughout this scheme, Kirlin did not disclose that it was trading ahead of its customer's orders to create trading profits for itself. Nor did Kirlin disclose anything else that would have revealed the scheme to EH, including the facts that Kirlin was purposefully not obtaining best execution for EH and was making risk-free trading profits when executing EH's orders as a principal.

This trading ahead scheme was fraudulent. As the Commission held in *Jonathan Feins*, 54 S.E.C. 366 (1999), a respondent's failure to disclose that he was trading ahead of customer orders to generate trading profits for someone other than the customer amounts to fraudulent conduct. *Id*. at 372 (finding fraudulent conduct when a broker accepted customer's orders but failed to act for his customer's benefit and did not disclose his failure); *cf. Michael B. Jawitz*, 55 S.E.C. 188, 196-97 (2001) (holding that respondent acted fraudulently where he took actions that undercut an implied representation to customers that limit orders would receive the priority in execution mandated by the Manning Rule).

Moreover, a "[f]ailure to satisfy the duty of best execution can constitute fraud because a broker-dealer, in accepting an order from a customer, implicitly represents that it will execute it in a manner that maximizes the customer's economic benefit." *Geman*, 54 S.E.C. at 1250-51; *see also Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc*., 135 F.3d 266, 273 (3d Cir. 1998) (noting that a broker-dealer who accepts a customer order while intending to breach the duty to obtain best execution makes a material misrepresentation).

Furthermore, Kirlin's failure to disclose the fact that it was earning risk-free profits through executing EH's orders in a riskless principal capacity (and the amount of such profits), while at the same time representing that the agreed-upon transaction costs were the only costs that EH was incurring, was another material omission. Such omissions "misled [EH] about the terms of [Kirlin's] relationship with [him]" because EH otherwise "would have been aware of the possible availability of superior prices for [himself]." *Geman*, 54 S.E.C. at 1249. The SEC and the NAC have found similar conduct to be fraudulent. For example, in *Geman*, the Commission held that a broker-dealer's failure to disclose the profits it earned in riskless principal trades, coupled with its false suggestion that there was no difference between the customer's and broker-dealer's prices, was a violation of antifraud provisions. *Id*. at 1245-50.

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[30] Martinez's failure to obtain best execution for EH was a violation that was ancillary to the fraudulent scheme. We address that in Part IV.B below.

[31] The complaint contained no allegations that the Firm failed to obtain best execution for EH in the 51 break even trades, and we make no findings in that regard. With respect to those trades, the record does not contain a complete picture of what the market price was when Kirlin executed EH's orders or the amount of losses that the Firm may have avoided.

Likewise, in *Dep't of Enforcement v. U.S. Rica Financial, Inc*., Complaint No. C01000003, 2003 NASD Discip. LEXIS 24, at *11-26 (NASD NAC Sept. 9, 2003), the NAC found that a Firm violated antifraud provisions where it informed customers that they would be charged commissions in accordance with a published schedule, while omitting to disclose that it was earning undisclosed markups and markdowns in excess of such commissions through executing customers' orders on a riskless principal basis.[32]

2. Respondents' Arguments That There Was No Scheme or Material Omissions

Respondents raise numerous arguments challenging the finding that there was a fraudulent scheme and material omissions. First, Nicolas argues that his failure to disclose his own compensation was not a material omission, citing *United States v. Alvarado*, No. 01-Cr-156 (RPP), 2001 U.S. Dist. LEXIS 21100 (S.D.N.Y. Dec. 17, 2001), *aff'd*, 84 Fed Appx. 162 (2d Cir. 2003) (Table). In *Alvarado*, the court held that although a broker-dealer's commission is relevant to a customer, a registered representative's commission is paid by the brokerage house and not charged to the transaction and, therefore, is "not material . . . and it need not be disclosed." *Id*. at *27-28. Unlike *Alvarado*, however, the instant proceeding concerns respondents' failure to disclose a *broker-dealer's* compensation, not their own personal compensation.[33]

Second, Nicolas and Cruz argue that Kirlin made no material omissions because the back of the confirmations sent to EH contained the following language:

> For trades in which we acted as principal, the price shown may reflect revenue received by us in addition to any amount shown under "Commission/Mark***. Details will be furnished upon written request to the firm servicing your account.

We disagree that this provided adequate disclosure. "[A]dequate disclosure must provide a public customer with sufficient information to make an informed decision about whether to buy or sell securities at the dealer's price," and the whole of Kirlin's communications with EH failed to do that. *Meyer Blinder*, 50 S.E.C. 1215, 1229 (1992). Nicolas provided specific representations to EH of the transaction fees that EH would pay, and the boilerplate disclosed

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[32] Respondents make numerous arguments that they should not be held responsible for violating the antifraud provisions. We address respondents' arguments in the following three parts of this decision. In Part IV.A.2, we deal with respondents' arguments that there was no scheme and no material omissions. In Part IV.A.3, we address respondents' arguments that they lacked scienter. In Part IV.A.4, we address various other miscellaneous defenses that respondents advance.

[33] We do not address in this proceeding whether, or to what extent, the antifraud provisions required respondents to disclose their personal compensation.

only the unsurprising fact that Kirlin might earn trading profits in principal transactions. Such communications provided no hint that Kirlin might earn trading profits in riskless principal transactions, that such profits would exceed the agreed-upon transaction costs, or that Kirlin might not obtain best executions for EH.[34] Finally, even if there was some evidence that Kirlin would have furnished upon request material information about the Firm's compensation in riskless principal transactions, informing a customer that he can request such information is not equivalent to disclosure. *Cf. Associated Investors Sec., Inc*., 41 S.E.C. 160, 167 & n.16 (1962) (*citing Hughes v. SEC*, 174 F.2d 969, 976 (D.C. Cir. 1949)).

Third, Nicolas and Cruz argue that they were not required to disclose Kirlin's trading profits because respondents were not "fiduciaries," citing *Arleen W. Hughes*, 27 S.E.C. 629 (1948), *aff'd*, *Hughes v. SEC*, 174 F.2d 969, 976 (D.C. Cir. 1949), and *Geman*, 54 S.E.C. 1226. Respondents' reliance on these cases is misplaced. In *Hughes*, the Commission held that only broker-dealers who have "placed themselves in a position of trust and confidence as to their customers" are required to disclose their costs and trading profits in principal and riskless principal transactions. *Hughes*, 27 S.E.C. at 639. However, subsequent to the *Hughes* decision, the Commission adopted amendments to Exchange Act Rule 10b-10(a) requiring all broker-dealers—without regard to fiduciary status—to disclose their costs and trading profits in riskless principal transactions.[35] Likewise, in *Geman*, the Commission made no suggestion that its holding that a broker-dealer fraudulently failed to provide information about the profits it earned on riskless principal transactions was premised on that broker-dealer's status as a fiduciary. Rather, the Commission expressly noted that the broker-dealer's duty to disclose its markup or markdown in riskless principal transactions derived from Exchange Act Rule 10b-10 and applied to "a dealer that is not a market maker." 54 S.E.C. at 1245.

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[34] *Cf. Richmark Capital Corp*., Exchange Act Rel. No. 48758, 2003 SEC LEXIS 2680, at *9-11 & n.11 (Nov. 7, 2003) (holding that "generic" disclosure on back of confirmations that firm may buy or sell the relevant security did not disclose the firm's campaign to sell shares of that security), *aff'd*, 86 Fed. Appx. 744 (5th Cir. 2004) (Table); *Kenneth R. Ward*, Exchange Act Rel. No. 47535, 2003 SEC LEXIS 687, at *40 (Mar. 19, 2003) (holding that "boilerplate" disclosures in promotional materials disclaiming any accuracy of the information concerning securities "in no way overrode" a broker's unqualified recommendations about such securities), *aff'd*, 75 Fed. Appx. 320 (5th Cir. 2003) (Table); *Meyer Blinder*, 50 S.E.C. at 1229 (holding that a broker-dealer's generic disclosure on confirmations disclaiming that the confirmed price was market price was not adequate disclosure of anything, but was simply an unsuccessful attempt to limit its liability).

[35] *See Sec. Confirmations*, Exchange Act Rel. No. 15219, 1978 SEC LEXIS 566, at *51 (Oct. 6, 1978) (adopting amendments to Exchange Act Rule 10b-10 that required broker-dealers to disclose in riskless principal transactions the "mark-up, mark-down, or similar remuneration"); *Confirmation of Transactions*, 59 Fed. Reg. 59612, 59621 (Nov. 17, 1994) (adopting amendments to Exchange Act Rule 10b-10 that required broker-dealers to disclose in riskless principal transactions "the difference between the price to the customer and the dealer's contemporaneous purchase (for customer purchases) or sale price (for customer sales)").

Finally, Cruz argues that Kirlin's trading profits were not material information because it is unreasonable to presume that EH did not understand that Kirlin would earn trading profits when executing EH's orders in a principal capacity. No customer, however, would reasonably expect that his broker-dealer would earn substantial trading profits by delaying the execution of customer orders, trading ahead of such orders, and executing such orders in riskless principal transactions at prices that routinely failed to provide best execution.

Accordingly, we find that respondents participated in a fraudulent trading ahead scheme and omitted material information in their communications with EH. We now turn to whether respondents did so with scienter.

3. Scienter

Scienter "is the intent to deceive, manipulate, or defraud." *Ernst & Ernst*, 425 U.S. at 193. Scienter may be established by a showing of recklessness, "which involves an 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the [actor] or is so obvious that the actor must have been aware of it.'" *Donner Corp*., 2007 SEC LEXIS 334, at *40 (internal quotation marks omitted). As explained below, we affirm the Hearing Panel's findings that respondents participated in a fraudulent scheme and made material omissions with scienter.

a. Nicolas

Given the Firm's ability to consistently make profits and avoid losses when executing the 151 principal trades with EH, it is clear that *someone* with knowledge of EH's orders tipped Kirlin's trading department with information about those orders and that *someone* delayed time-stamping and sending EH's orders to Kirlin's trading department for execution, as even Cruz agrees. Nicolas denied that he shared the content of EH's orders with anyone at the Firm prior to delivering them to Cruz or Dorsey. The Hearing Panel did not clearly indicate whether it credited or discredited Nicolas' testimony, and the record does not otherwise demonstrate whether Nicolas delayed EH's orders or tipped anyone as to the content of those orders. It is not necessary, however, to resolve this credibility issue to find that Nicolas participated in the fraudulent scheme with scienter.

Assuming *arguendo* that Nicolas did not delay EH's orders or tip anyone as to the content of those orders prior to the execution of such orders, it is possible that Nicolas initially lacked an understanding of the fraudulent scheme when he began servicing EH's accounts. Nevertheless, Nicolas must have become aware that Kirlin was earning trading profits by delaying EH's orders, trading ahead of EH, and failing to give EH best execution.[36]

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[36] Nicolas also acknowledged that such conduct would be unethical.

Nicolas knew the time when he received orders from EH, knew the time when he carried such orders to Cruz or Dorsey, and received order tickets bearing time stamps of when orders were transmitted to the trading desk. Consequently, Nicolas knew or must have known that EH's orders were being held up. In fact, Nicolas admitted that, if someone was holding up EH's orders, he would have noticed that. As for the price that EH received, Nicolas testified that he had a quote system at his desk and would follow the price of the securities EH was trading, or was thinking of trading, during the day. Nicolas also admitted that he received completed order tickets with the execution price and frequently would provide "immediate feedback" on fills to EH or his assistant. Given the attention that Nicolas paid to the prices of stocks that EH was trading, Nicolas must have known that Kirlin was not giving EH best execution.

Nicolas also knew, or was reckless in not knowing, that the trading profits Kirlin earned were being generated by trading ahead of EH. Nicolas knew that the concessions he earned on the EH orders resulted when Kirlin executed EH's orders in a principal capacity and offset such principal trades with a like position in Kirlin's proprietary account.[37] And Nicolas admitted knowing that the Firm's trading desk was establishing proprietary positions "for the purpose[ ] of trading with [EH]." Given this knowledge, as well as Nicolas' awareness that EH's orders were being delayed and that Kirlin was not obtaining best execution for EH, the frequent and sizeable concessions Nicolas began to earn through servicing EH's account were red flags that Kirlin was generating trading profits by trading ahead of EH. If Nicolas never obtained actual knowledge of that fact, he was reckless in avoiding such knowledge.[38]

Nicolas's failure to disclose the trading ahead, the trading profits Kirlin was earning, and the fact that Kirlin was not obtaining best execution for EH created an obvious risk of misleading EH about the terms of his arrangement with Kirlin and about whether Kirlin was dealing with him fairly. Nicolas' scienter is even further apparent given that he knew that EH had a particular concern with trading costs and that the trading profits far exceeded the amounts of costs EH had agreed to pay.[39] Thus, we find that Nicolas' omissions of material facts were, at the least,

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[37] From October to December 1999, Nicolas earned $379,593 from servicing EH's orders, $347,336 of which was undisclosed trading profits.

[38] Nicolas argues that he had no reason to know that there was a scheme to defraud EH because EH never complained about bad fills. The preponderance of the evidence demonstrates, however, that Nicolas must have been aware of the fraudulent scheme even without a complaint from EH. Similarly, Nicolas argues that he "assume[d]" that, as a "sophisticated investor," EH would have understood that the Firm could earn trading profits, even if that was not disclosed to him. As explained above, however, while sophisticated investors might understand that a broker-dealer might earn trading profits in pure principal trades, such investors would not expect to be given inferior executions in riskless principal trades.

[39] *Cf. Donner Corp.*, 2007 SEC LEXIS 334, at *43-45 (holding that respondent recklessly failed to disclose material information "likely important to investors" where he knew about such information and that it had not been disclosed); *Dolphin and Bradbury, Inc*., Exchange Act Rel. No. 54143, 2006 SEC LEXIS 1592, at *41-44 (July 13, 2006) (holding that respondents

[Footnote continued on next page]

reckless. While it is not necessary to prove a motive to demonstrate scienter,[40] the substantial profits that Nicolas earned through the scheme gave Nicolas an obvious motive not to disclose material information to EH.

For these reasons, the record demonstrates that Nicolas acted with scienter when he participated in the fraudulent scheme and made material omissions.

b. Cruz

The preponderance of the evidence demonstrates that Cruz acted with scienter. Cruz had no explanation for Kirlin's ability to make trading profits executing EH's orders and claimed that he never inquired into it. While Cruz acknowledges that *someone* called Kirlin's trading desk ahead of transmitting EH's orders for execution and delayed EH's order tickets for execution, he denies being that person. As explained below, however, we find that Cruz was one of the persons, if not the sole person, who tipped off Kirlin's trading department and knowingly transmitted orders placed by EH that were delayed.

Martinez testified that Kirlin's trading department often established the proprietary positions that offset EH's orders based on so-called "proprietary orders" that Kirlin brokers or branch liaisons, such as Cruz, called in to the trading department. Martinez also testified that Cruz was his "main liaison" to brokers in the San Francisco office and that he "mostly" dealt with Cruz. The Hearing Panel implicitly found that Martinez's testimony in this regard was credible, and Cruz has not pointed to substantial evidence demonstrating otherwise. Although Cruz attempts to minimize Martinez's testimony, it is highly probative of Cruz's participation in the fraudulent scheme. Not only does it directly relate to how Kirlin's trading desk was able—time and time again—to establish proprietary positions that perfectly matched EH's orders, it places Cruz at the center of that activity.

The record also shows that Cruz participated in processing many of the EH orders that were delayed. Cruz testified that his normal practice was to time-stamp order tickets that brokers brought to him for execution, and his handwriting appears on 99 of the 185 EH order tickets. Cruz also admitted that "99 percent of the time," he would have called the Syosset trading desk to execute orders that Nicolas brought to him, and that he spoke with Martinez nearly every day during the relevant period.

This evidence demonstrates that Cruz was one of the persons, if not the sole person, who tipped the trading department about EH's orders and, thus, a person who knowingly forwarded

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[cont'd]

recklessly failed to disclose known information where they "must have appreciated" that investors would have been misled about risks without such disclosure).

[40] *John Montelbano*, Exchange Act Rel. No. 47227, 2003 SEC LEXIS 153, at *25 (Jan. 22, 2003) (where respondent acted with "requisite scienter, [his] personal motivation is irrelevant").

the EH orders that were delayed. By committing these deceptive acts, Cruz participated in the scheme with scienter. And while it is not necessary to prove a motive, Cruz stood to gain from participating in the fraudulent scheme. Cruz had a direct financial interest in the trading profits generated by EH's orders because Cruz earned 25 percent of the San Francisco branch's profits, and in 1999, the branch was profitable. In 1999, Cruz's total share of the San Francisco office's profits was approximately $300,000.[41]

Accordingly, there is ample circumstantial evidence that Cruz knowingly participated in the fraudulent scheme. Cruz makes numerous arguments that the preponderance of the evidence does not demonstrate that he tipped the trading department or delayed EH's orders. We have considered all of those arguments, and reject them. For example, Cruz argues that he could not have been an essential part of any fraudulent scheme because: (1) he was out of the office on four days (three days in Kirlin's San Diego office, and one day in Tampa, Florida) during which Kirlin executed seven of EH's orders that generated concessions; and (2) he handled only 99 of the 185 EH order tickets at issue.[42] However, these facts prove only that the fraudulent scheme did not always involve Cruz's filling out order tickets. They do not demonstrate that Cruz did not tip the trading department on the four days in question, or that Cruz did not participate in the scheme on the days when he was in the San Francisco office.[43]

But even if Cruz was not the tipper or if there were some innocuous explanation for Cruz's initial acts of tipping the trading department or forwarding delayed EH orders, Cruz either became aware that he was participating in a fraudulent scheme or was reckless in avoiding such knowledge. Cruz generally understood that trading profits were generated by executing trades with the customer on a principal basis. Cruz therefore must have also understood that, for Kirlin to execute EH's buy orders on a principal basis, Kirlin must have already obtained a long position of the same or larger size. Moreover, Cruz was admittedly aware of the sizeable and

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41 Cruz's argument that others, such as Nicolas, had a "much larger stake" in profiting from EH's trades does not alter the fact that Cruz also had a sizeable stake. Cruz also argues that the compensation he earned from EH's trades was "contingent at best," because he only got a percentage of the concessions if the branch office was profitable at year-end. In 1999, however, Cruz's compensation included a sizeable amount tied to branch profits. Moreover, the Commission has held that a motive to defraud can exist where the financial benefits from participating in that scheme are, at best, indirect. *See Jay Houston Meadows*, 52 S.E.C. 778, 784 n.12 (1996) (noting that respondent had an "obvious and strong incentive" to solicit investments in gas well drilling programs in which he held a participation interest where such programs could not be developed without additional investment).

42 Dorsey admitted that her handwriting appeared on 52 of the order tickets at issue. On the four days when Cruz was out of the office, Dorsey wrote up the order tickets for the seven EH orders executed on those days.

43 During his four days out of the office, Cruz was sometimes in Kirlin's San Diego office, where he had access to both Kirlin's phones and his own cell phone.

frequent trading profits that Kirlin was generating from EH's orders. Thus, Cruz must have realized that the Firm's execution of EH's orders was highly suspicious and either knew, or was reckless in avoiding knowledge, that the trading profits resulted from a fraudulent trading ahead scheme.[44]

Cruz suggests that he lacked scienter because he did not actually know whether EH had a false understanding of the costs he would pay to execute his trades. In this regard, Cruz notes that he was not a party to EH's and Nicolas's transactions costs agreement and that that agreement was silent as to the amount that Kirlin would earn when acting in a principal capacity. We disagree. Cruz knew, or consciously avoided knowledge, that Kirlin's trading profits resulted from an impermissible trading ahead scheme, he knew there was a costs agreement with EH, and he knew that the trading profits exceeded the costs that EH agreed to pay. For these reasons, even if Cruz lacked actual knowledge of whether EH understood he was paying costs in excess of the agreement, it was reckless for Cruz to avoid knowledge of that fact. Registered representatives may not deliberately ignore that which they have a duty to know,[45] and Cruz's duty to deal fairly with customers[46] required that he learn whether the trading profits were being disclosed to EH. *Cf. Daniel H. Lehl*, 51 S.E.C. 1156 (1994), *aff'd*, 90 F.3d 1483 (10th Cir. 1996) (holding that sales personnel had enough notice that they were charging excessive prices to "compel further inquiry on their part").

Cruz also argues (as does Nicolas) that he would not know whether trading profits would be earned until after EH's orders were executed. This is no excuse for failing to disclose the trading profits, because post-execution disclosure of these material facts would not have been difficult, considering that the profits would be known by the end of the day. *Cf. Geman*, 54 S.E.C. at 1246 n.43 (rejecting argument that there was no obligation to disclose to a customer material information that the representative would only know later in the day, where such disclosure would not "have been difficult").[47]

Accordingly, we conclude that Cruz participated in the scheme to defraud EH and made material omissions with scienter.

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[44] We reverse the Hearing Panel's finding that Cruz directed Dorsey to delay EH's orders or tip the trading desk. The preponderance of the evidence does not support this finding.

[45] *See Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969).

[46] Broker-dealers have a "duty to deal fairly with the public." *Meyer Blinder*, 50 S.E.C. at 1228 (citing cases).

[47] Moreover, we question whether Cruz in fact lacked actual knowledge that trading profits would be generated when he forwarded EH's orders. Martinez testified that the branches would identify whether a customer order should be executed on a principal basis. Martinez also agreed that, when he called branches and brokers back with information about filling "proprietary orders," that gave the branches and brokers "a pretty good indication" that subsequent customer orders would be filled on a principal basis.

c. Martinez

Martinez also denies that he acted with scienter. In this regard, Martinez denied knowing that the San Francisco office had EH's orders in hand when it requested that the Firm establish proprietary positions that were later used to offset these orders. The preponderance of the evidence demonstrates, however, that Martinez knew, or must have known, that he was participating in a scheme to defraud EH and omitting material information from EH.

Time and time again, Martinez handled large orders from EH, typically involving stocks in which Kirlin did not make a market, that Martinez was able to offset perfectly with positions in the Firm's inventory and generate trading profits. Martinez claimed that Kirlin's remarkable ability to earn such profits stemmed from Kirlin's practice of allowing brokers to establish and work against proprietary positions. Martinez admitted, however, that when the San Francisco office called in a "proprietary order," he expected that that office would later call in a customer order that would be filled with the securities in the Firm's inventory. Martinez also conceded that the San Francisco office was consistently able to offset the Firm's proprietary positions with customer orders.[48] Based on these circumstances, it would have been impossible for Martinez not to understand that the San Francisco office already had EH's orders in hand when it called to establish a proprietary position or that Martinez's subsequent executions of EH's orders were riskless principal transactions for which trading profits could not be earned.

Indeed, Martinez's actions demonstrate that he knew that Kirlin had an EH order in hand when he established the proprietary positions that would be used to offset EH's orders. Such intra-day proprietary positions often exceeded the Firm's excess net capital. It is highly unlikely that Martinez would have placed such relatively large orders, and jeopardize the Firm's liquidity, without the comfort of knowing that Kirlin already had an offsetting order from EH. Similarly, it is unlikely that, without such knowledge, Martinez would have taken no steps to minimize Kirlin's exposure when the prices of the proprietary positions were moving adverse to Kirlin. Moreover, because Martinez knew that he was generating trading profits by trading ahead of EH's orders and executing EH's orders in a riskless principal capacity, Martinez also must have known that such trading profits necessarily meant that he was not obtaining best execution for EH.

Martinez argues that he lacked scienter because he oversaw approximately 2,000 trades per day, and the handful of EH orders that he processed did not stand out as suspicious. Martinez essentially admitted, however, that the EH orders were not lost in the shuffle. Martinez participated in numerous EH trades, whether that involved writing down information on the EH

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[48] Martinez explained that the San Francisco office's abilities were not unique to the Kirlin organization. Martinez testified that when he received a proprietary order from a branch office, he expected that the branch office would ensure that the Firm would be "flat" by the end of the day and that there were, in fact, very few times when the proprietary orders were not closed out by the end of the day.

trade ticket or executing the trade. Martinez testified that when the San Francisco office called in a customer order, it would identify the customer and whether the trade should be executed in a principal capacity. Martinez further testified that, in the fourth quarter of 1999, if an order came in with an account number from one of EH's accounts, he would have recognized it as EH's trades. Martinez also was aware that EH was the biggest client of the San Francisco office. Indeed, Erik Klinger ("Klinger"), a FINRA special investigator, testified that of the 45 proprietary trades exceeding $1 million that Kirlin executed between July 17 and December 31, 1999, 38 of them were with EH. In fact, Martinez explained that if he had a large block of stock that he wanted to sell, such as from the PTJP hedge fund, he would first contact Cruz, who would call EH to complete the order.[49] We therefore reject Martinez's argument that his daily transaction volume caused him not to notice Kirlin's suspicious trading patterns with EH.

Therefore, we conclude that Martinez knew that the only reason why trading profits were being generated from EH's orders and losses were being avoided was because he trading ahead of EH's orders and not obtaining best execution for EH. Martinez also knew, therefore, that by failing to ensure that the confirmations disclosed the differences between EH's price and Kirlin's price, he was confirming the trades without disclosing material information.[50] Accordingly, we find that Martinez had the requisite scienter.

4. Respondents' Miscellaneous Defenses

Nicolas and Cruz argue that because Exchange Act Rule 10b-10 requires broker-dealers, not individual representatives, to disclose the trading profits in riskless principal transactions, they are somehow absolved of any liability for material omissions. We disagree. The antifraud provisions in Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and Section 17(a) of the Securities Act apply to "persons," and not simply to broker-dealers. Nothing in Exchange Act Rule 10b-10 purports to carve out any exceptions to a person's obligations under the antifraud laws to disclose material information, or assign the responsibility to disclose certain material information only to broker-dealers.[51]

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[49] Moreover, even where Martinez was not handling an EH trade, Martinez would monitor through BRASS how much of the Firm's trading capital was committed and was aware of the status of large proprietary positions obtained by the other traders.

[50] Martinez admitted knowing that, in a riskless principal transaction, a broker-dealer is required to disclose the difference between the price that the broker-dealer obtained and the price paid by the customer.

[51] We also note that the disclosure requirements of Exchange Act Rule 10b-10 do not provide a safe harbor from fraud charges. *Meyer Blinder*, 50 S.E.C. at 1229 n.59. As the preliminary note to Exchange Act Rule 10b-10 explains, "[t]he requirements under this section that particular information be disclosed is not determinative of a broker-dealer's obligation under the general antifraud provisions of the federal securities laws to disclose additional information to a customer at the time of the customer's investment decision."

Nicolas argues that he should not be held accountable for fraud because "many, many brokers" failed to disclose to their customers Kirlin's trading profits. However, "the fact that others engage in violative behavior does not excuse similar conduct." *Ralph Joseph Presutti*, 52 S.E.C. 832, 837 (1996).

Cruz argues that, although he never told EH about the trading profits that Kirlin earned in principal trades and never told Nicolas to make such disclosure, Cruz cannot be held responsible for Kirlin's omissions because his "communications with EH were negligible," he played no role in preparing the confirmations or daily reports sent to EH, and he was not charged with aiding and abetting liability. As explained below in Part IV.C, however, by approving the information that was included on the confirmations, Cruz did play a role in preparing the confirmations and communicated with EH through them. Moreover, Cruz's attempt to pin all blame only on those who directly communicated with EH ignores that Exchange Act Rule 10b-5 makes actionable not just material omissions but also "employ[ing] any device, scheme, or artifice to defraud" or "engag[ing] in any act, practice, or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[52] Exchange Act Rule 10b-5(a) and (c).

Finally, in a strawman argument, Cruz suggests that the findings that he is liable for fraud are somehow based on a *respondeat superior* theory, and then argues that *respondeat superior* holds only employers liable for their employees' conduct. We make no finding, however, that Cruz is liable for fraud based on *respondeat superior*. Rather, Cruz is liable for fraud based on his own actions.[53]

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Accordingly, we find that respondents participated in a fraudulent scheme and made material omissions, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Rules 2120 and 2110.[54]

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[52] Cruz also argues that he was only "tangentially" involved in the trades. As our discussion above demonstrates, however, we find that Cruz's involvement in EH's trades amounted to an intentional participation in a fraudulent scheme.

[53] In addition to the elements addressed above, a violation of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act also requires a showing that a person used any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. The record demonstrates that respondents communicated with EH via the mails and the telephone, which satisfies this element of the violations. *SEC v. Hasho*, 784 F. Supp. 1059, 1106 (S.D.N.Y. 1992). There also is no dispute that the conduct satisfied the requirement that the conduct be "in connection with" a securities transaction.

[54] Our findings concerning the fraud violations reflect our understanding of how the fraudulent scheme was implemented, which included a failure to provide EH with best execution and the issuance of false confirmations. As the following two sections (Parts IV.B and IV.C)

[Footnote continued on next page]

B. Best Execution

The Hearing Panel found that Martinez failed to obtain best execution for EH's orders, in violation of NASD Rules 2320 and 2110. We affirm the Hearing Panel's findings.

NASD Rule 2320(a) governs the duty to provide best execution and provides as follows:

> In any transaction for or with a customer . . ., a member and persons associated with a member shall use 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 market conditions.[55]

NASD Rule 2320(f) provides that the obligation to obtain best execution "exist[s] not only where the member acts as agent for the account of his customer but also where retail transactions are executed as principal and contemporaneously offset." "The duty of best execution requires a broker-dealer to seek to obtain for its customer's order the most favorable terms reasonably available under the circumstances," including executing customers' trades "at the best reasonably available price." *Knight Sec., L.P.*, Exchange Act Rel. No. 50867, 2004 SEC LEXIS 2938, at *2 n.3 (Dec. 16, 2004) (findings made in settled case).

As explained above, the manner in which Kirlin executed the 100 profitable principal trades ensured that Kirlin would not obtain best execution for EH. *Cf. Certain Market Making Activities on NASDAQ*, 53 S.E.C. 1150, 1163-64 (1999) (settled case) (finding best execution violations where market makers "favor[ed] . . . [their] own interests over the interests of its customers," including instances where market makers "delayed the execution of large customer orders in order to trade first for their own account at more favorable prices"). For the principal trades in which Martinez directly participated, Martinez is responsible for Kirlin's violations of its best execution obligation.[56] Accordingly, we find that Martinez failed to obtain best execution for EH, in violation of NASD Rules 2320 and 2110.

[cont'd]

demonstrate, we have independently considered and analyzed the allegations in the complaint that Martinez failed to provide best execution and that respondents issued false confirmations to EH.

[55] Since the conduct at issue, NASD Rule 2320 has been amended in ways that are not material to this proceeding.

[56] We reverse the Hearing Panel's finding, however, that Martinez was also primarily accountable for the instances in which other Kirlin traders failed to obtain best execution for EH. Martinez admitted that, as head equity trader, he had supervisory responsibility for traders' compliance with regulatory responsibilities, but the complaint charged Martinez only with

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C. False Confirmations

The Hearing Panel held that respondents caused Kirlin to issue false confirmations to EH in violation of Section 10(b) of the Exchange Act and Exchange Act Rule 10b-10(a)(2) thereunder, and NASD Rules 2210, 2230, 3110, and 2110. We affirm these findings to the extent they concern the fact that the confirmations omitted the differences between the price Kirlin charged EH to execute his orders and the price Kirlin paid or received when establishing its offsetting proprietary positions.

Exchange Act Rule 10b-10(a)(2)(ii)(A) provides, in pertinent part, that a broker or dealer is required to disclose if it is acting as a principal and, if so, to disclose:

> [i]n the case where such broker or dealer is not a market maker in an equity security and, if, after having received an order to buy from a customer, the broker or dealer purchased the equity security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the broker or dealer sold the security to another person to offset a contemporaneous purchase from such customer, *the difference between the price to the customer and the dealer's contemporaneous purchase (for customer purchases) or sale price (for customer sales).* (Emphasis added.)

See Geman, 54 S.E.C. at 1245-49. The purpose of this rule, which requires the disclosure of price differences in riskless principal transactions, is to "enable customers to make their own assessments of the reasonableness of transaction costs in relation to the services offered by broker-dealers." *Marc N. Geman*, 54 S.E.C. 1226, 1246 (2001) (*citing Securities Confirmations*, Exchange Act Rel. No. 15219, 1978 SEC LEXIS 566 (Oct. 6, 1978)), *aff'd*, 334 F.3d 1183 (10th Cir. 2003).

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primary liability for the best execution violations. "[W]hereas a supervision failure connotes derivative responsibility for the misconduct of others, a respondent's 'active and central role' in the matter connotes a finding of violation based on the underlying conduct." *Dist. Bus. Conduct Comm. v. Hattier, Sanford & Reynoir*, Complaint No. C05950049, 1996 NASD Discip. LEXIS 47, at *27 (NASD NBCC Oct. 29, 1996) (*citing Anthony J. Amato*, 45 S.E.C. 282 (1973)), *aff'd in relevant part*, 53 S.E.C. 426 (1998), *aff'd*, 163 F.3d 1356 (5th Cir. 1998). Although the Hearing Panel emphasized that Martinez was the principal in charge of the trading department, there is no evidence that Martinez played an active or central role in the trades in which other traders failed to obtain best execution for EH.

Confirmations that fail to comply with Exchange Act Rule 10b-10 can also violate NASD Rule 3110. That rule provides that "[e]ach member shall make and preserve books [and] records . . . as prescribed by [Exchange Act] Rule 17a-3" and NASD rules. Exchange Act Rule 17a-3(a)(8) requires a broker-dealer to maintain "[c]opies of confirmations of all purchases and sales of securities." The Commission has held that "[r]equirements to maintain records encompass the requirement that such records be accurate." *Fox & Co. Inv., Inc*., Exchange Act Rel. No. 52697, 2005 SEC LEXIS 2822, at *30 (Oct. 28, 2005).[57]

Confirmations also must comply with NASD Rule 2210(d), which governs the content standards of "communications with the public."[58] That rule provides that communications with the public may not include misleading statements or omit facts that lead the communication to be misleading.[59] *See* NASD Rule 2210(d)(A) & (B).

The record amply demonstrates that respondents violated these rules. Kirlin executed numerous EH orders in a riskless principal capacity, yet did not disclose in the confirmations the difference between its price and EH's price, as required by Exchange Act Rule 10b-10(a). In addition, by omitting the price differences, the confirmations were misleading. The confirmations falsely implied that such trades were made on a principal basis, not a riskless principal basis; that EH was incurring only the agreed-upon transaction costs; and that Kirlin was obtaining the best execution for EH's orders, in violation of NASD Rule 2210(d).

We affirm in part the Hearing Panel's findings that Martinez was responsible for omitting the price differences from numerous confirmations. Martinez admitted executing numerous EH transactions. After he executed a trade, Martinez caused the trading department to report information about those trades that the clearing firm used to generate confirmations. As explained above, Martinez knew or must have known that trading profits were being earned and losses were being avoided in riskless principal transactions, and that such information should have been disclosed in the confirmations. Thus, Martinez played a direct role in failing to disclose the price differences and trading profits from the confirmations.[60] *Hattier, Sanford, &*

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[57] NASD Rules 2210, 2230, and 3110 apply both to members and persons associated with members. NASD Rule 0115.

[58] The confirmations and daily reports sent to EH were "communications with the public." During the relevant period, NASD Rule 2210(a) defined "communications with the public" to include "correspondence," which meant "any written letter or electronic communication prepared for delivery to a single current or prospective customer, and not for dissemination to multiple customers or the general public." NASD Rule 2210(a) (NASD Manual 1999).

[59] The quoted language is the current version of NASD Rule 2210(d)(1). Although NASD Rule 2210(d)(1) has been amended since the conduct at issue, the amendments are not relevant to this proceeding.

[60] Unlike the Hearing Panel's findings, we find that Martinez is responsible for false confirmations only for those trades in which he participated. The complaint charged Martinez

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Reynoir, 53 S.E.C. 426, 431 (1998) (holding those persons who had "involvement in the issuance of the confirmations" responsible for inaccurate confirmations), *aff'd*, 163 F.3d 1356 (5th Cir. 1998).

We also affirm the Hearing Panel's findings that Nicolas omitted the price differences from confirmations. Although Nicolas played no role in confirming the price differences on the formal confirmations, he nevertheless provided numerous unofficial confirmations that failed to disclose the trading profits earned on riskless principal trades.

Finally, we affirm the Hearing Panel's findings that Cruz is responsible for the Firm's failure to provide accurate confirmations. As a person who tipped the trading desk and forwarded delayed orders, Cruz essentially knew that the Firm was executing EH's orders as riskless principal trades, and that the price differences should be disclosed to EH. Cruz testified that, on trades for which he was responsible, he would verify with the trading department information that should appear on the confirmations. Because Cruz bore some responsibility for the omissions of price differences in the confirmations, we hold him responsible for these failures.[61] At the very least, as one who tipped the trading department, Cruz had enough notice of the trading irregularities that he should have inquired into whether the confirmations were providing accurate disclosure. *Cf. Lehl*, 51 S.E.C. 1156 (1994) (holding that sales personnel had enough notice that they were charging excessive prices to "compel[ ] further inquiry on their part").

Accordingly, we find that Martinez, Nicolas, and Cruz were responsible for issuing confirmations that violated Exchange Act Rule 10b-10, and NASD Rules 2210(d), 3110 and 2110.

D. The Hearing Panel's Other Findings of Violations

The Hearing Panel made numerous other findings of violations, including that: (1) respondents, in numerous cross trades, failed to disclose the name of the person from whom the security was purchased or sold and the amount of remuneration the broker-dealer received from the other person, as required by Exchange Act Rule 10b-10(a)(2) and NASD Rules 2230(b), 2210(d), 3110, and 2110; (2) that Martinez caused Kirlin to inaccurately disclose in

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only with primary liability, not supervisory liability. There is insufficient evidence that Martinez played an active and central role in the false confirmations that Kirlin's other traders generated. *See Hattier, Sanford & Reynoir*, 1996 NASD Discip. LEXIS 47, at *27.

[61] Unlike the Hearing Panel's findings, our findings in this regard are limited only to the EH principal trades in which Cruz directly participated. The complaint charged Cruz only with primary liability, not supervisory liability. There is no evidence that Cruz had an active or central role in the transactions that Dorsey handled, or that Cruz directed Dorsey to omit price differences from the confirmations.

confirmations its trading capacity on nine trades, in violation of Exchange Act Rule 10b-10(a)(2), NASD Rules 2230, 2210(d), 3110, and 2110; (3) that respondents caused Kirlin to fail to make and keep accurate records of EH's orders, in violation of Section 17(a) of the Exchange Act and Exchange Act Rules 17a-3(a)(6), 17a-3(a)(7), and 17a-4, and NASD Rule 2110; and (4) that Martinez made various trade reporting violations, in violation of NASD Rules 4632, 6130, 6420 and NASD Rule 2110.

After a thorough review of the record, we reverse all such findings.[62] In the interest of brevity, we exercise our discretion not to present the extensive and detailed discussion that would otherwise be required to explain our rationale.

V. Sanctions

For respondents' violations of the antifraud provisions, the Hearing Panel barred all three respondents. The Hearing Panel did not impose separate sanctions for any other violations. We affirm the Hearing Panel's sanctions.[63]

For intentional or reckless misrepresentations or material omissions of fact by an individual, the FINRA Sanction Guidelines ("Guidelines") recommend a fine between $10,000 and $100,000 and a suspension in any or all capacities for a period of 10 business days to two years or, in egregious cases, a bar.[64] For intentional or reckless best execution violations, the Guidelines recommend a fine between $20,000 and $200,000 and a suspension of the responsible individual for 10 business days to two years. For egregious best execution violations, the Guidelines recommend imposing a bar and a fine in excess of $200,000.[65] There are no Guidelines for false confirmations, but there are Guidelines for Use of Misleading Communications with the Public. Those Guidelines recommend, in cases involving numerous

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62 Our reasons are varied. With only de minimis exceptions, the record does not support most of the Hearing Panel's findings of false confirmation violations (except as found otherwise above), books and records violations, and trade reporting violations. In addition, the complaint does not contain allegations concerning a limited number of the Hearing Panel's findings. Furthermore, the Hearing Panel did not squarely address one particular allegation of books and recordkeeping violations, and we decline to consider that issue sue sponte.

63 Unlike the Hearing Panel's approach, however, we aggregate respondents' violations for purposes of imposing single sanctions because they essentially "stemmed from a continuous course of action" to defraud EH. *See Dep't of Enforcement v. J. Alexander Sec., Inc*., Complaint No. CAF010021, 2004 NASD Discip. LEXIS 16, at *69 (NASD NAC Aug. 16, 2004), *aff'd*, *Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558 (July 6, 2005).

64 *FINRA Sanction Guidelines* 93 (2007), http://www.finra.org/web/groups/enforcement.documents.enforcement/p011038.pdf [hereinafter *Guidelines*].

65 *Id.* at 52.

acts of intentional or reckless misconduct over an extended period, a fine of $10,000 to $100,000 and a suspension of up to two years or a bar.[66] We also consider the Principal Considerations in Determining Sanctions when assessing the appropriate sanctions.[67]

The record demonstrates that each respondent's conduct was egregious. As the Commission has emphasized, "conduct that violates the antifraud provisions of the federal securities laws is especially serious and subject to the severest of sanctions under the securities laws." *Marshall E. Melton*, Exchange Act Rel. No. 48228, 2003 SEC LEXIS 1767, at *29-30 (July 25, 2003). In addition, the record demonstrates numerous aggravating factors. Respondents' fraudulent trading ahead scheme involved numerous transactions and a pattern of misconduct.[68] Respondents engaged in the scheme over a period of three months.[69] The nature of the scheme involved a concealment of misconduct, such as respondents' failure to execute EH's orders fully and promptly and Martinez's failure to obtain best execution.[70] Respondents' fraudulent scheme directly injured a member of the investing public, and the extent of that customer harm, at nearly $700,000, was substantial.[71] As we discussed in detail above, respondents participated in the fraudulent scheme with scienter.[72] Both Cruz and Nicolas also received a percentage of the trading profits generated from executing EH's orders.[73]

Nicolas makes a variety of arguments that a bar is too severe. Nicolas argues that he has no prior disciplinary history. The NAC has made clear, however, that "[w]hile the existence of a

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66 *Id.* at 85.

67 *Id.* at 6-7, 52.

68 *Id.* at 6 (Principal Considerations in Determining Sanctions No. 8).

69 *Id.* at 6 (Principal Considerations in Determining Sanctions No. 9).

70 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 10).

71 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 11)

72 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

73 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 17). Martinez challenges the Hearing Panel's finding that his activities involved a potential benefit, and he argues that he "in no way profited" from the scheme. We agree with Martinez that the record does not demonstrate how his conduct resulted in the potential for monetary or other gain. The Hearing Panel noted that Martinez testified that he expected to earn a substantial bonus for his performance in 1999. Martinez also testified, however, that his bonus expectation was based on his "market-making trading," and most of EH's trades did not involve securities in which Kirlin was a market-maker. But while Martinez may not have had the potential to benefit from the scheme, the nature of his misconduct and the aggravating factors still lead us to conclude that his conduct was egregious.

disciplinary history is an aggravating factor when determining appropriate sanctions, its absence is not mitigating." *Dep't of Enforcement v. Cuozzo, Jr.*, Complaint No. C9B050011, 2007 NASD Discip. LEXIS 12, at *38 (NASD NAC Feb. 27, 2007). Nicolas also argues that a bar is excessive because it punishes him for a "systemic firm wide problem" of payments of concessions to brokers. The Commission, however, has "made clear that misconduct by others at a firm does not excuse misconduct of a particular respondent." *Brian L. Gibbons*, 52 S.E.C. 791, 794 n.13 (1996), *petition denied*, 112 F.3d 516 (9th Cir. 1997) (Table). Nicolas also argues that he poses no threat to continue the current wrongdoing because he no longer works for Kirlin and is compensated differently by his current employer. Considering the gravity of Nicolas' misconduct, the fact that Nicolas has a new employer does not demonstrate that he could not again engage in fraudulent conduct.

Martinez argues that his conduct was only "indirect at best" compared to Nicolas and Cruz's actions. As our findings above demonstrate, however, the fraudulent scheme could not have succeeded without Martinez's knowing participation in trading ahead of EH and not giving EH best execution.

Martinez and Nicolas argue that Anthony Kirincic (Kirlin's president), Kirlin, and Dorsey, received lesser sanctions for their related conduct. Martinez further argues that, because the record does not demonstrate that he profited from his conduct, he should not receive as severe a sanction as Nicolas and Cruz, who did profit. The Commission has repeatedly rejected attempts by respondents to compare the sanctions imposed against them to the sanctions imposed against others. "The appropriate sanction . . . depends on the facts and circumstances of each particular case." *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *44 (Nov. 8, 2006), *appeal pending*, No. 07-1002 (D.C. Cir., filed Jan. 3, 2007). Furthermore, the disciplinary actions against Kirincic, Kirlin, and Dorsey involved settlements, and the Commission has "repeatedly stated that pragmatic considerations may justify lesser sanctions in negotiated settlements." *Id*. at *44-45.

To remedy the egregious nature of respondents' conduct, we find that it is necessary to bar each respondent in all capacities. Such sanctions are needed to protect investors from future fraudulent conduct by respondents, and to deter others from engaging in fraudulent conduct.

VI. Conclusion

Accordingly, we hold that: (1) respondents employed a scheme to defraud EH and made material omissions, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, Section 17(a) of the Securities Act, and NASD Rules 2120 and 2110; (2) Martinez failed to obtain best execution for EH's orders, in violation of NASD Rules 2320 and 2110; and (3) Nicolas, Cruz, and Martinez caused Kirlin to issue false confirmations, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-10(a)(2), and NASD Rules 2210, 3110, and

2110.[74] For these violations, we bar Nicolas, Cruz, and Martinez in all capacities. The bars are effective upon issuance of this decision.

We affirm the Hearing Panel's order that Martinez pay $3,780.54 in costs, that Nicolas pay $3,780.53 in costs, and that Cruz pay $3,780.53 in costs. We also impose appeal costs of $1,236.42 on Martinez, $1,236.42 on Nicolas, and $1,236.42 on Cruz.[75]

On Behalf of the National Adjudicatory Council,

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Marcia E. Asquith
Senior Vice President and Corporate Secretary

[74] We reverse the findings that: (1) respondents caused the Firm to issue confirmations that violated NASD Rule 2230; (2) respondents failed to maintain accurate books or records, in violation of Section 17(a) of the Exchange Act and Exchange Act Rules 17a-3(a)(6), 17a-3(a)(7), and 17a-4, and NASD Rule 2110; and (3) that Martinez failed to report transactions, in violation of NASD Rules 4632, 6130, 6420, and 2110.

[75] We have considered and reject without discussion all other arguments advanced by respondents.