

NEW YORK STOCK EXCHANGE, INC.

EXCHANGE HEARING PANEL DECISION 04-146

September 21, 2004

GOLDMAN, SACHS & CO.
MEMBER ORGANIZATION

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Violated Exchange Rule 342 by failing to ensure compliance with Exchange rules and Federal securities laws relating to execution and allocation of customer orders; violated Exchange Rule 440 and SEC Regulations 240.17a-3 and 240.17a-4 by failing to make and preserve timely records relating to receipt and execution of customer orders – Consent to censure and \$175,000 fine.

Appearances:

For the Division of Enforcement
Allison A. Bishop, Esq.
Robert J. Meyers, Esq.

For the Respondent
Richard Klapper, Esq.

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An Exchange Hearing Panel met to consider a Stipulation of Facts and Consent to Penalty entered into between the Exchange's Division of Enforcement and Goldman, Sachs & Co. (the "Firm"), a member organization of the Exchange. Without admitting or denying guilt, the Firm consents to findings by the Hearing Panel that it:

- I. Violated Exchange Rule 342 in that it failed to establish reasonable and appropriate controls, including a separate system of follow-up and review, to ensure compliance with Exchange rules and Federal securities laws relating to execution and allocation of customer orders.
- II. Violated Exchange Rule 440 and SEC Regulations 240.17a-3 and 240.17a-4 by failing to make and preserve required and timely records relating to the receipt and execution of customer orders.

For the sole purpose of settling this disciplinary proceeding, and without the Firm admitting or denying the findings herein, the Division of Enforcement and the Firm stipulate to certain facts, the substance of which follows:

Background and Jurisdiction

1. The Firm is a New York limited partnership with its principal place of business in New York, New York. The Firm is a leading global investment banking and multi-

service brokerage firm that, among other things, trades securities for institutional and individual customers. The Firm is a member organization of the Exchange.

2. On June 21, 2001, the Firm filed a Uniform Termination Notice for Securities Industry Registration (“Form U-5”), reporting that Karl Zachar (“Zachar”), a former registered representative employed at the Firm’s Boston regional office, had been terminated on May 24, 2001 following an internal Firm investigation into violations of Firm policies and regulatory requirements concerning records of orders and possible conflicts of interest between Zachar’s personal trading and his trading for discretionary customer accounts. (Zachar is the subject of a separate disciplinary action concerning his activities at the Firm (HPD #04-93)).
3. The Firm investigated Zachar’s conduct during the course of an internal review of Zachar’s trading in his personal account and discharged Zachar as a result thereof.

Prior Discipline

4. In HPD 03-65, an Exchange Hearing Panel accepted a Stipulation and Consent entered into by the Firm and the Exchange in which the Firm consented to a finding, among other things, that the Firm engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on its research analysts. The Hearing Panel imposed the agreed upon penalty of a censure, total payment of \$110,000,000 and an undertaking.
5. In HPD 02-224, an Exchange Hearing Panel accepted a Stipulation and Consent entered into by the Firm and the Exchange in which the Firm consented to a finding, among other things, that the Firm failed to reasonably supervise and control its employees’ activities to assure compliance with Exchange rules and Federal securities laws relating to retention of electronic communications. The Hearing Panel imposed the agreed upon penalty of a censure, total payment of \$1,650,000 and an undertaking.
6. In HPD 94-167, an Exchange Hearing Panel accepted a Stipulation and Consent entered into by the Firm and the Exchange in which the Firm consented to a finding, among other things, that the Firm failed to establish and maintain appropriate procedures for supervision and control of the Firm’s equities trading desk for institutional customers, and failed to prepare and maintain appropriate records. The Hearing Panel imposed the agreed upon penalty of a censure, \$250,000 fine and an undertaking.

Summary of Violative Conduct

7. As set forth below, for the period of January through May 2001 (the “relevant period”), the Firm failed to reasonably supervise and control the activities of a registered representative who: (a) failed to timely supply account numbers or other

indication of beneficial ownership of trades, as required by Exchange rules and Federal securities laws; and (b) delayed allocation of several executed trades, which gave him the ability to watch the market and lock in profits as well as having the ability to allocate more favorable trades to his personal account to the detriment of Firm customers, which resulted in potential gains to Zachar of over \$600,000. The Firm also failed to ensure that its employees made and preserved required and timely books and records concerning these account designations and execution of customer orders.

Violative Conduct

8. Pursuant to Exchange Rule 342, member organizations are required, among other things, to provide for reasonable and appropriate procedures for supervision and control of their business activities and to establish a system for follow-up and review with respect to their compliance with Exchange rules and Federal securities laws. As detailed below, the Firm's supervisory systems and procedures were inadequate to prevent the violations set forth below.
9. Exchange Rule 342.16, in pertinent part, requires supervision of registered representatives to include reasonable procedures for review of registered representatives' dealings with customer accounts and transactions. Such policies and procedures should be in writing and be designed to reasonably supervise each registered representative.
10. Zachar was part of a sales team in the Firm's Boston regional office that consisted of several registered representatives and various administrative support personnel. The sales team was part of a Firm unit known as Private Client Services (the "Group" or the "Private Group"), which focused on high net worth customers.
11. The sales team to which Zachar belonged ranked as one of the highest production Private Client Services teams in the entire Firm, and Zachar was himself one of the top producers in the Boston regional office.
12. Zachar's responsibilities as a member of the team included soliciting new business, managing client accounts and trading for the 'Opportunistic Portfolio', which consisted of assets from the accounts of approximately 30 to 40 customers of the team's clients in the Private Group who wanted to take part in buying and selling securities on an opportunistic basis.
13. The Opportunistic Portfolio consisted of a small percentage of clients' assets, typically less than five percent, for which the sales team would effect transactions on a discretionary basis. Participation required not only sufficient liquid wealth to qualify financially, but also written authorization to allow the team to use discretion.
14. Trades for the Opportunistic Portfolio were effected by "bunched orders". A bunched or "block" order is defined as an order placed by a firm for one or more customers

- that encompasses the purchase or sale of shares of the same security, at the same time and with the same conditions; an “allocation” of such order is defined as the identification of the customer account or accounts for whom the bunched order has been made, and in the case of an order for more than one account, a listing of the shares to be distributed to the accounts identified.
15. During the relevant period, the Firm permitted registered representatives to enter trades by several methods. These included entering orders into an intra-Firm electronic order entry system known as “Order Book”, or by entering the order, by telephone, directly through one of the Firm’s trading desks, and using paper order tickets to reflect those telephone orders.
 16. In early 2000, the Firm introduced a new service desk called the Merchandising Desk. The purpose of this Desk was to make available to registered representatives in the Private Group research and other services similar to those provided to institutional clients.
 17. During the relevant period, Firm procedures did not require trades entered through the Merchandising Desk to be entered into the Firm electronic Order Book system by the registered representative.
 18. Securities and Exchange Commission Regulations 240.17a-3(a)(6) and (7) promulgated pursuant to the Securities and Exchange Act of 1934 (the “1934 Act”) requires, in relevant part, that a memorandum of each brokerage order be made which includes the time of entry and the account for which it is entered. The Regulations in pertinent part state that the time of entry “shall be deemed to mean when such member, broker or dealer transmits the order or instruction for execution or, if it is not so transmitted, the time when it is received.” In addition, the Regulations require a memorandum of each order received, showing the time of receipt, the terms and conditions of the order, and the account in which it was entered.
 19. Exchange Rule 440 requires that member firm organizations make and preserve books and records as the Exchange may prescribe and as prescribed by SEC Regulations 240.17a-3 and 240.17a-4.
 20. The Exchange issued Exchange Information Memo 00-19, dated July 21, 2000, which reiterated the requirements of Exchange Rules 410 and 440 and SEC Regulations 17a-3(a)(6) and (7). In noting the “significant number of violations” involving “phoned-in orders”, specific reference was made to block orders entered by telephone, and stated in relevant part, that “member organizations must ensure that the terms of each phone order are documented prior to, or contemporaneous with, the order’s transmission to the block desk”. The definition of ‘terms of the order’ includes all account designations as well as the number of shares to be allocated to each account.
 21. During the relevant period, Firm procedures required that for all orders called into a trading desk, the registered representative placing the order must prepare a

spreadsheet or order ticket time-stamped at or prior to the time the order was telephoned into the trading desk.

22. When utilizing a spreadsheet, registered representatives were required to identify each customer for whom an order was entered and the amount or percentage ordered for each customer, so that the accounts for which the trades were entered were timely identified. Further, after verbally entering an order, registered representatives were to give their time-stamped spreadsheets or order tickets, by no later than the end of the trading day, to sales assistants responsible for ensuring that trades were properly and timely allocated.
23. During the relevant period, Zachar entered trades for the Opportunistic Portfolio and his personal accounts by utilizing the Merchandising Desk; Zachar was virtually the only registered representative who utilized the Merchandising Desk for the purchase of securities and the only registered representative who used the Merchandising Desk to purchase securities in his own account.
24. While trading for his personal accounts as well as for client accounts, Zachar failed on a number of occasions to timely identify the accounts for which he placed orders through the Merchandising Desk and did not follow the Firm's procedures relating to entering orders and time-stamping on numerous occasions.
25. By placing orders through the Merchandising Desk for both customer and his personal accounts, and not simultaneously having spreadsheets or order tickets time-stamped at or before the time he telephoned the Merchandising Desk, Zachar was able to circumvent Firm procedures and enter purchase orders without providing the required account information necessary to identify the accounts receiving the securities. This had the further effect of delaying the allocation of orders. The Firm failed to timely detect these delays after Zachar began placing trades in this manner.
26. On several occasions during the relevant period, Zachar entered orders for various quantities of securities without timely identifying the accounts for which the securities would be allocated. For example, in three instances, Zachar failed to submit a time-stamped order ticket or spreadsheet identifying customer account allocation until over five hours had passed from the time he first telephoned the Merchandising Desk. These orders were ultimately allocated to the Opportunistic Portfolio.
27. The delays in allocation of executed orders gave Zachar the opportunity to place trades in customer accounts or his own accounts depending on market performance. This misconduct resulted in his ability to grant preferential treatment to his account to the detriment of customers' accounts. Specifically, the Firm identified seven instances of large stock purchases in Zachar's personal accounts between January 1 and May 8, 2001 that showed a profit at the end of the trading day on which Zachar placed the order. Zachar hedged this profit by purchasing deep "in the money" call options. Zachar's total potential profits on these seven purchases exceeded \$600,000.

28. The allocation delays described did not comply with the requirements of Exchange rules and SEC regulations set forth above, with respect to timely preparation of order tickets, account allocation information and preservation thereof.
29. When Zachar entered orders through the Merchandising Desk in the manner described above, he had the ability to enter orders for which the participating accounts were not designated prior to execution, which delayed the allocation of executed orders, and also resulted in inaccurate Firm books and records.
30. The Firm failed to reasonably supervise Zachar in connection with orders entered through the Merchandising Desk in that the Firm's oversight procedures to prevent or detect the delayed allocations did not include a separate mechanism, procedure or system of review to ensure that registered representatives such as Zachar actually completed a spreadsheet or order ticket (or entered the order through the Order Book system) at or before verbally entering orders through the Merchandising Desk.
31. Further, the Firm failed to have reasonable and appropriate procedures of supervision and control and a separate system of follow-up to ensure that orders entered and executed for customers through the Merchandising Desk were properly time-stamped and allocated in accordance with Exchange rules and Federal securities laws. The Firm failed to take reasonable steps to ensure that required records were made and preserved on a timely basis to ensure customer account identification at the time that registered representatives such as Zachar verbally placed orders through the Merchandising Desk.
32. In August 2000, prior to the relevant period, the Firm's Central Compliance Department conducted an annual sales practice and compliance review of the Boston office. The Compliance Department's Report, distributed in November 2000, identified time stamping and record keeping deficiencies as a primary finding, noting that it was not possible to ensure that all bunched orders (including those entered through the Firm's Order Book system) had been submitted with the required order breakdown, because the office had been unable to provide a large majority of order tickets related to bunched orders.
33. Accordingly, the Firm was on notice, prior to the relevant time period, that bunched orders (especially those entered via telephone with the trading desks) required enhanced Firm oversight, and the fact that the Boston office was having difficulty in maintaining required records related to bunched orders.

Other Factors Considered

34. The Firm has informed the Exchange, and the Exchange has considered the following circumstances in connection with the matters set forth above:

- a. The Firm discovered the violative conduct and promptly brought this matter to the Exchange's attention prior to filing Zachar's Form U-5. In addition the Firm fully cooperated with the Exchange's investigation of Zachar;
- b. The Firm compensated all customers potentially affected by this conduct in the total amount of \$875,500 on its own volition, notwithstanding the absence of any customer complaints to the Firm or specific evidence of economic injury to customers;
- c. The Firm has enhanced its policies and procedures by requiring all orders in equity securities to be entered into the Firm Order Book system, minimizing the possibility of this type of occurrence being repeated.

DECISION

The Hearing Panel, in accepting the Stipulation of Facts and Consent to Penalty, found the Firm guilty as set forth above by unanimous vote.

PENALTY

In view of the above findings, the Hearing Panel, by unanimous vote, imposed the penalty consented to by the Firm of a censure and a fine of \$175,000.

For the Hearing Panel

Milton M. Stein
Hearing Officer