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KNIGHT'S SAGA: A COURT REJECTS THE SEC'S THEORY OF "BEST EXECUTION"

In an important case, the SEC claimed that a market-maker and certain employees violated their duty of "best execution" in transactions allegedly involving excessive profits, undisclosed mark-ups, and front-running. Despite the fact that the firm had settled with the SEC for substantial penalties and corrective action, the district court, in a 100-page opinion, dismissed all charges against the individuals as unproved.

By Jonathan S. Sack *

In 2004, Knight Securities, L.P., a leading market-maker of over-the-counter stocks, entered into a $66.5 million settlement with the Securities and Exchange Commission.[1] The allegations in the SEC's consent decree would lead an unsuspecting reader to conclude that Knight had engaged in a long-running scheme to take advantage of its institutional clients by overcharging them on numerous trades. But we now know the facts are very different.

In a stinging 100-page opinion, United States District Judge Joel A. Pisano, District of New Jersey, rejected *in toto* the SEC's charges of securities fraud against Kenneth Pasternak, the former CEO and Chairperson of Knight's Board of Directors, and John Leighton, the former head of Knight's institutional sales desk.[2] These were the same allegations leveled against Knight in the SEC's enforcement action.

Rather than settle with the SEC, Pasternak and Leighton chose to fight the charges. The case centered on 42 large institutional orders to buy or sell stock in which Knight allegedly failed to provide "best execution" by trading ahead of its clients, or "front-running." The SEC maintained that Knight had earned "excessive profits" on these orders but, in the court's view, failed to formulate a viable legal theory, much less prove a legal violation, despite years of investigation and discovery. As to 39 of the orders, the SEC failed to provide "a scintilla of evidence" to support its charges.[3] As to the remaining three orders, the SEC did not offer sufficient evidence to justify its "logical leap" as to the illegality of Knight's conduct.[4] The Commission has not appealed.

The case against Pasternak and Leighton faced a hurdle from the start: none of the institutions whose orders were at issue complained about Knight's execution, notwithstanding their detailed knowledge of

[1] Knight Securities, L.P. currently operates as Knight Equity Markets, L.P.

[2] Securities and Exchange Commission v. Pasternak and Leighton, 561 F. Supp.2d 459 (D.N.J. 2008).

[3] *Id.* at 517.

[4] *Id.* at 509.

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what was occurring in the market when the orders were executed.[5] Aware of this hurdle, the SEC nonetheless failed to secure other evidence, such as Knight employee testimony or industry data, to make its case.

While this author was not involved in the litigation and does not know what arguments Knight made to the SEC before its settlement, it is safe to assume that Knight made all or most of the arguments that prevailed in the district court. With the benefit of hindsight it is easy to say that Knight should have fought the SEC's unfounded theories. Yet, faced with the threat of a crippling enforcement action, Knight had little choice but to put the matter behind it. Typically, the spectre of protracted litigation with the government compels a public company, particularly a heavily regulated financial institution, to settle charges. Settlement allows a company to achieve a measure of closure and to focus attention on its business without the added scrutiny and distraction of defending charges brought by the government.

The district court's decision in *SEC v. Pasternak and Leighton* is not only an important analysis of "best execution" in the context of institutional trading; it also highlights the harsh reality that companies often settle government claims that lack substantial legal or factual support because of the consequences of choosing to litigate. The price that a public company challenging the government must pay, in public relations and lingering suspicion, is typically too high.

A reshaping of this landscape, removing the stigma of fighting the government, would be of benefit not just to companies and their employees and shareholders, but, I submit, to the government itself, for it would encourage more rigorous thinking about cases before charges are filed, and it would give even greater weight and effect to the victories the government does achieve.

KNIGHT AND ITS BUSINESS

Knight is a public company with an institutional sales business that handles large block orders to buy and sell stock for institutional customers. As a market-maker, Knight regularly holds an inventory of over-the-counter securities, which aids the execution of large orders for customers.[6]

A large number of the orders handled by Knight were on a "not-held" basis, which is typical of large institutional orders to buy or sell stock. Such orders allowed Knight discretion as to time and price in working the orders to achieve "best execution." This is in contrast to "held" orders, which were "held" to the market at the time the order was received and, consequently, had to be promptly executed at the prevailing market price. Once the not-held order was received by Knight, sales traders worked with the firm's market-making group to fill the order either with existing stock from Knight's inventory accounts or by purchasing the stock in the market.[7] The inventory accounts maintained by the firm's market-makers were used to fill both institutional and other customer orders, making it "very difficult or virtually impossible" to connect specific shares acquired or sold by the market-making group to specific orders from Knight's institutional customers.[8] Knight used its discretion as to "not-held" orders to take advantage of fluctuating market conditions, for example, by dividing large orders into numerous smaller orders, thereby providing best execution, and at the same time, earning profits for Knight.[9]

THE KNIGHT SETTLEMENT

In its enforcement action against Knight, the SEC alleged that from January 1999 through November 2000, Knight defrauded institutional customers by extracting excessive profits from many not-held orders. The SEC alleged that with respect to these orders Knight violated

[5] *Id.* at 508.

[6] *Id.* at 469-470.

[7] *In the Matter of Knight Securities, L.P.*, Securities Exchange Act of 1934 Release No. 50867, Admin. Proc. File No. 3-11771 (Dec. 16, 2004).

[8] *Id.* at 476.

[9] 561 F. Supp.2d at 467.

its duty to provide "best execution." According to the SEC,

> By delaying execution with the customer, Knight executed stock to the customer when the prevailing market price had moved significantly away from its acquisition cost – thereby yielding Knight greater profit at the expense of its customer. When the market moved unfavorably in relation to the position Knight had established pursuant to the institution's order, Knight executed trades with the customer at prices that still generated a profit for Knight.[10]

In the view of the SEC, these practices resulted in tens of millions of dollars in excessive profits for Knight.

In December 2004, without admitting or denying the SEC's findings, Knight agreed to pay more than $41 million in disgorgement of illegal profits, over $13 million in prejudgment interest, and $12.5 million in civil penalties. In addition, Knight agreed to retain an Independent Compliance Consultant to review its internal policies and procedures regarding its best execution obligations and compliance structure. Knight paid an additional $12.5 million in fines to settle a parallel NASD proceeding.[11]

In a press release regarding the settlement, Knight stated that a new management team was in place and that the company "understand[s] that we have a responsibility to our clients to provide superior trade execution services. We will continue to pursue our client-focused strategies to build Knight's business platform and future prospects."[12] Even though Knight did not admit the SEC's allegations, the settlement resulted in the usual wave of negative press for the company. In its report of the case, the *Wall Street Journal* entitled its article, "Client Comes First? On Wall Street, It Isn't Always So: Investing Own Money, Firms Can Misuse Knowledge of a Big Impending Order."[13]

THE SEC ACTION AGAINST PASTERNAK AND LEIGHTON

On the heels of its settlement with Knight, the SEC filed a complaint against Pasternak and Leighton in August 2005. The SEC asserted various counts of primary and secondary liability against the defendants. Specifically, the complaint alleged that Pasternak and Leighton willfully violated Section 15(c)(1)(A) of the Exchange Act by fraudulently failing to provide "best execution" to its institutional customers. The complaint also alleged that the defendants violated Section 17(a) of the Securities Act by failing to maintain and document required information on its trading records. As to secondary liability, the SEC asserted that the defendants aided and abetted Knight's violations of Sections 10(b), 15(c)(1)(A), and Section 17(a) of the Exchange Act, and the rules promulgated thereunder, by failing to reasonably supervise the institutional sales desk's leading sales trader. Finally, the complaint alleged that Pasternak, as CEO and Chairman of the Board, was liable as a "control person" for the alleged violations.[14]

After a three-week bench trial, the defendants moved for a judgment on partial findings pursuant to Federal Rule of Civil Procedure 52(c), arguing that the SEC had failed to establish any fraud for which the defendants would be liable. The SEC opposed the motion, and the district court heard oral argument on June 12, 2008. Ultimately, the court ruled on the entirety of the case, finding that the government had failed to present sufficient evidence to support its claims.

The SEC's case hinged on the actions of Knight's head trader, Joseph Leighton – the brother of defendant John Leighton. Specifically, the SEC alleged that Joseph committed securities fraud by engaging "in a pattern of fraud by trading for institutional customers using a method that concealed" the manner in which Joseph worked the orders and obscured the quality of the price received by the customers. According to the SEC, Joseph's methods included "improper front-running," whereby Joseph, holding an institutional order, would take a position in a security and delay the execution of the order to take advantage of fluctuating market conditions, with the ultimate goal of generating improper profits for Knight.[15]

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[10] Sec. Exch. Act Rel. No. 50867.

[11] Press Release, Securities and Exchange Commission, "Knight Settles and Agrees to pay $79 Million in Disgorgement and Penalties" (Dec. 16, 2004).

[12] Press Release, Knight Securities, LP, "Knight Trading Concludes Settlement With the SEC and NASD" (Dec. 16, 2004).

[13] Ann Davis, "Client Comes First? On Wall Street, It Isn't Always So: Investing Own Money, Firms Can Misuse

footnote continued from previous column…

Knowledge of a Big Impending Order," The Wall Street Journal (Dec. 16, 2004).

[14] 561 F. Supp.2d at 515.

[15] *SEC v. Pasternak*, CV 05-3905, Amended Complaint at ¶ 18; *SEC v. Pasternak*, 561 F. Supp.2d at 467.

The SEC argued that the defendants, in their supervisory capacities at Knight, owed an independent fiduciary obligation to disclose to Knight's institutional customers the profits made on orders worked by Joseph, and that the failure to inform the customers of these profits breached the defendants' fiduciary duty. As noted by the court, "the threshold inquiry is whether the SEC has proven that Joseph committed securities fraud." If the SEC failed to prove an underlying violation by Joseph, it could not prove its primary or secondary liability cases against either of the defendants.[16]

The SEC contended that it had sufficiently proven that Joseph committed securities fraud on several grounds: (1) Joseph earned "excessive" profits; (2) Joseph charged an undisclosed mark-up to Knight's customers; (3) Joseph manipulated his trading to fill institutional orders in a manner that unfairly captured profits for himself and Knight and amounted to "front-running"; and (4) Joseph did not properly report trades to the NASDAQ tape. The court addressed each of the SEC's contentions in a detailed review of the evidence, ultimately finding that the SEC had failed to prove any securities fraud violation by Joseph, and thus had failed to prove secondary liability on the part of Pasternak and Leighton.[17]

Excessive Profits

The SEC repeatedly characterized the profits earned by Knight as "excessive," "outrageous," "egregious," "unreasonable," and "obscene," citing Knight's 2000 Form 10-Q which represented a net trading revenue increase of 152 percent. The court rejected the SEC's characterizations of Knight's profits, however, stating that "the SEC did not present the Court with any proof that a statute, rule, regulation, or industry standard limits a market-maker's profits." In addition, the SEC introduced no expert testimony on this issue, and evidence did not establish the level of profits earned by other market-making firms during the same period of time. The court concluded not only that there was no evidence that Joseph earned excessive profits, but also that even assuming the profits exceeded "some unknown standard average," this did not mean that Joseph engaged in fraudulent conduct or that there was anything improper about the amount of profits earned by Joseph and Knight.[18] Knight, in the business of earning a profit, was entitled to be successful in its business, especially when it placed itself at risk for the sake of its customers.[19]

Undisclosed Mark-Up

The SEC argued that with respect to Joseph's trades, the mark-up was equal to the difference between the price Knight charged a customer to execute the trade and the price paid by Knight in purchasing the stock. The court found the SEC's calculation incorrect, noting that "mark-up," a term of art in the securities industry, is defined as the difference between the price charged to the customer and the prevailing market price. As to whether Knight had charged a mark-up – properly defined – the court found that the SEC had failed to offer proof of an identifiable mark-up, noting that, by definition, the not-held orders executed on a net basis by Joseph generally do not involve mark-ups, commissions, or fees. Further, the court opined that even if the SEC had been able to identify a specific mark-up charged by Joseph on his trades, the SEC had failed to prove that Joseph had an obligation to disclose those mark-ups. Rather, the court noted that a duty to disclose a mark-up arises only when a fiduciary relationship exists between the trader and customer or when the charged mark-up is excessive, yet neither circumstance applied to the facts of the case.[20]

Improper Front-Running

The SEC's next theory of securities fraud was that Joseph manipulated not-held orders to Knight's advantage and to the disadvantage of his customers. It referred to these actions as "front-running." In executing a not-held order, a trader is held to only two requirements: to use reasonable diligence to provide best execution and to execute a fair price when committing capital on the order. The court noted that NASD Rules permitted a trader to trade ahead of the institutional customer's order and that "the discretion granted in a not-held order 'means that the firm may trade at the same price or at a better price than that received by the discretionary order.'"[21]

The determination of whether a trader satisfies the best execution requirement is highly fact-sensitive. Courts consider factors such as the type of security traded, its price, volatility and liquidity, the size of the transaction, the market conditions at the time of the

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16 *Id.* at 503.

17 *Id.*

18 *Id.* at 505.

19 *Id.* at 510.

20 *Id.* at 506.

21 *Id.* at 484 (citing NASD Notice to Members 97-57 (Sept. 1997)).

transaction, the instructions given by the customer, and prices offered by other market-maker firms. Judge Pisano held that the SEC had failed to proffer sufficient evidence on any of these factors with respect to Joseph's trades and that he could not, therefore, find by a preponderance of the evidence that Joseph had violated either of the duties. In other words, on the key issue in the case – whether Knight had used its discretion to achieve "best execution" – the SEC had failed, in the court's view, to articulate the standard clearly and provide sufficient evidence to prove its case.

Improper Reporting of Trades

Finally, the SEC argued that Joseph, and other unnamed Knight sales traders, misused modifiers within the Automated Confirmation Transaction Service ("ACT") program, which obscured the quality of the execution prices. According to the SEC, Knight traders caused inaccurate and untimely reporting of trades to NASDAQ by, among other things, improperly inputting trades into Knight's trading system at prices that were different from the inside market at the time the trades were reported.[22] Once again, the court found that the SEC had provided minimal evidence as to the use or misuse of ACT modifiers, stating that "[a]bsent any proofs that Joseph, or Knight's traders, misused ACT modifiers, the SEC cannot establish that such misuse was part of a fraudulent manipulation or a violation of statutory reporting requirements."[23]

In the concluding paragraphs of his opinion, Judge Pisano did not mince words in rejecting the SEC's case. Stating that "the overwhelming evidence" indicated that the defendants and Knight "did nothing improper in executing" the trades at issue, the court rejected "the SEC's attempt to make an unregulated act of earning profits a securities fraud." The court stated, "[t]hroughout the trial, although given ample opportunity, the SEC failed to solidify its theory of the case, or present sufficient evidence to establish any element required by the various statutes it invokes in its Amended Complaint."[24]

LESSONS TO BE LEARNED

Knight's settlement with the SEC and the result in *SEC v. Pasternak and Leighton* are a lesson in the harm that can be done when the government does not clearly understand the facts and law, and when public companies are nonetheless compelled, as a practical matter, to settle unfounded allegations. In the present case, certain Knight employees who observed the two defendants came to the belief, apparently based on little more than a hunch, that the trading in question was improper due to the large profits earned.[25] The court likened the SEC's approach to that of these Knight employees insofar as the SEC concluded that the trading profits were excessive but failed to translate its conclusion into a viable theory of securities fraud.[26]

Unfortunately, the present environment does not really take into account the possibility that the government is wrong, especially when investigating companies engaged in complex financial transactions. The corporate scandals of the past five to 10 years have resulted in a presumption that corporations and their executives are deceptive and greedy. The media have often encouraged this perspective. The result is a system that does not support or foster healthy litigation of issues and, instead, pressures public companies to settle actions, even if unfounded. Even the prosecution of Arthur Andersen, which contributed to the firm's demise but was ultimately reversed by the U.S. Supreme Court on appeal, has not made the environment more receptive to corporations that challenge government charges.

Judge Pisano's opinion is valuable not only for its articulation of the best execution standard and the factors to be considered in determining whether that standard has been met, but also for laying bare how the government, even in an area of perceived expertise, can get the facts and the law wrong. One hopes that the government, the media, and ultimately corporations can benefit from decisions like that of Judge Pisano – the government by being open to healthy disagreement with corporations and their executives; the media by being less hasty in reaching conclusions as to corporate culpability; and corporations by being more confident in their ability to defend lawful behavior. Such open-mindedness and tolerance of dispute will be in short supply, but especially important, as we all address the recent collapse of financial markets and the inevitable search for those who may be criminally responsible.■

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[22] *In the Matter of Knight Securities, L.P.*, Securities Exchange Act of 1934 Release No. 50867.

[23] 561 F. Supp.2d at 510.

[24] *Id.* at 517.

[25] *Id.* at 496.

[26] *Id.* at 496, 509.