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*Head of the Line*

# Client Comes First? On Wall Street, It Isn't Always So

Investing Own Money, Firms  
Can Misuse Knowledge  
Of a Big Impending Order


Mischief in the 'Back Books'

By ANN DAVIS

Staff Reporter of THE WALL STREET JOURNAL

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When a mutual-fund company asked brokerage firm Knight Securities to get it 600,000 shares of a fiber-optic stock, traders at Knight quickly swung into action.

A half-dozen traders -- figuring the big order would push up the price of the stock -- quickly began buying some for accounts that benefited their firm and themselves, according to testimony in a National Association of Securities Dealers arbitration.

The buying may have affected the price the client ultimately had to pay for the stock, **JDS Uniphase**, according to people familiar with the trading records. They say the traders in some cases sold their newly bought stock to the client, Oppenheimer Funds. According to testimony, it was sold to the client at a markup, a move that may have taken money out the pockets of mutual-fund shareholders.

The NASD's regulatory arm has examined Knight's trading from the period in question, March 2001, and other periods. It and the Securities and Exchange Commission are expected to levy a penalty against Knight soon. Knight, which has since changed management, testified that the trades weren't improper, didn't disadvantage the client, and followed typical industry practice. Oppenheimer declined to comment.

The incident points to one of the hardest-to-eradicate conflicts of interest on Wall Street. Securities laws generally require brokerage firms to put the client first. But it's an open secret that they or individual traders sometimes take advantage of their role as middleman to profit, at clients' expense, from what they

know about clients' investing intentions.

The potential harm to investors has risen as securities firms step up so-called proprietary trading: investing the firm's own money in stocks, bonds or other instruments. Firms say they have firewalls to divide this trading from operations that pick up sensitive client information. But pressure to relax those barriers has grown as margins have shrunk in Wall Street's traditional business of handling trades. Commissions on big institutional trades, once 15 cents a share, now are less than a nickel.

To compensate, securities firms increasingly look to proprietary trading. Analysts estimate that business provides 10% of profits at many top firms, and 20% or more at **Goldman Sachs Group Inc.**, double the percentage five years ago. Goldman declines to comment on the figure.

Most proprietary trading is quite legitimate. But traders are constantly learning about major clients' investment plans -- big enough plans to move markets. And though it's clearly illegal to misuse this knowledge, some on Wall Street "have come to believe it's their God-given right to use information about orders to make money," says Mark Loehr, former co-head of Schwab Soundview Capital Markets, now part of Switzerland's **UBS AG**.

One area where abuses can occur is in prearranged securities sales. ([See a related article](#)<sup>1</sup>.)

Some firms in the brokerage business are essentially "just paying an entry fee to get access to a lot of smart people," said David Williams, who runs a trading firm that serves as an alternative to big Wall Street brokers, at an industry panel last spring.

The SEC hasn't weighed in yet on some of the most controversial proprietary-trading activities. But as part of a stepped-up review of Wall Street conflicts of interest, it has asked firms for their internal reports on any incidents involving potential misuse of client data, according to Wall Street legal officials.

Several kinds of brokerage behavior potentially harmful to clients have grown more pervasive in recent years, according to traders, firms' compliance officials and regulatory cases. Here are three of them:

### **Trading Ahead**

Sometimes, brokers fill a customer's order only after making their own trades in the same security. Doing so, called trading ahead, delays execution of the order and leaves the client vulnerable to price swings, at a time when its order should have already been satisfied. Trading ahead may be for the benefit of a securities firm or an individual broker or trader at the firm.

This year, the New York Stock Exchange censured Goldman Sachs and one of its former brokers, Karl Zachar. It said his trading resulted in potential gains for himself of over \$600,000 "to the detriment of Firm customers."

Mr. Zachar, as part of a high-profile team in Boston, helped manage billions of dollars for hundreds of wealthy clients. With some of this money, 30 to 40 of the clients authorized Goldman to make

discretionary investments in securities.

Mr. Zachar sometimes placed trades with a Goldman trading desk but waited several hours to identify for whom he was acting, according to the NYSE regulatory actions. The exchange said he used this tactic for five months ended in May 2001, enabling him to allocate trades that came out well to himself or his family, and less-favorable ones to clients.

Goldman and Mr. Zachar settled the NYSE actions without admitting or denying wrongdoing. Goldman paid a \$175,000 fine. It says it fired Mr. Zachar after discovering his trading activity. Mr. Zachar, who didn't respond to phone calls or an e-mail, was barred from the securities business for 15 months.

A person familiar with the case says Goldman later told clients it was crediting them for "incorrectly booked" trades. Goldman says that "any" clients who potentially suffered harm were made whole" and that what happened with Mr. Zachar isn't relevant to its trading practices with institutional clients.

A broker's job, in effect, is to stand in line for a customer to get sought-after merchandise. But it's easy to take some of that merchandise for oneself first -- and hard for a client to know when this has happened. Even when regulators catch up with such behavior, the penalties sometimes are light.

In a case brought this year, the NASD cited five instances in May 2002 when Cantor Fitzgerald filled stock orders on the Nasdaq for its own account while it left the clients who wanted to make the same trade exposed to potential market swings. One client had to wait seven minutes -- a long time in an electronic market -- for its order to be filled.

In this instance, the Cantor customers still got the price they had sought. So the NASD levied a fine of just \$8,000 for that portion of a broader case, says Steve Luparello, a market-regulation official with the NASD. Cantor declined to comment.

In September, the NYSE censured **Royal Bank of Canada's** RBC Dain Rauscher brokerage unit for entering proprietary orders for itself while it had client orders that weren't yet filled. The NYSE fined RBC \$80,000 for that and other violations occurring in 2001 and 2002. RBC declined to comment.

The NASD in recent months has moved to tighten rules concerning self-dealing when filling client orders. It has suggested that the SEC bar firms from allocating better prices on a given trade to themselves rather than to a client, even if the client ends up getting the price it wanted.

### **Predicting Trades**

Some securities firms use sophisticated analysis and software to try to anticipate customer moves and profit from that knowledge before customers act.

Firms or individual traders sometimes know about stock positions that clients have built up, as well as when these clients periodically reassess their holdings. The traders sometimes make educated guesses as to what such a client will do next and try to jump into the market ahead of time. "Pre-hedging," this tactic is sometimes called.

This can benefit a client if the firm is merely buying stock to be in position to fill an anticipated order. But if the securities firm is buying for its own account, the client may end up the loser, later getting a poorer price than otherwise.

The problem often arises when an institutional client asks several brokerage firms to bid on a big trade it is planning, without disclosing the actual transaction. There's a lag before the client actually places the order. In the meantime, the brokers approached have some idea of what's about to happen.

In April 2002, a fund manager contacted **Deutsche Bank** AG to sound out its interest in handling a large stock trade. The manager wanted to know how much the bank's Morgan Grenfell securities unit would charge to handle a trade on the London Stock Exchange of £65 million, or about \$125 million, worth of stocks, according to a regulatory order. The money manager was soliciting a "blind bid." It provided limited information, including that the trade would involve 55 stocks in the FTSE 100 Index. Until the money manager chose a broker, it wouldn't identify the stocks or say whether it was a buyer or a seller.

But Morgan Grenfell traders correctly guessed the identities of seven stocks and that the fund manager was going to buy them, says the regulatory order, from the U.K.'s Financial Services Authority. It says that for 18 minutes before Morgan Grenfell won the bid, its traders -- armed with the belief that a big buyer was poised to push up demand for those stocks -- purchased them for its own account. Their actions drove one issue, **Daily Mail & General Trust**, 10% higher before the client's order for that stock was filled, says the FSA.

The regulator in March fined Deutsche Bank £190,000, or about \$366,000. It also ordered the bank to disclose to clients in the future if it planned to trade in advance of winning their bids.

Deutsche Bank says it "takes its obligations to its customers very seriously and therefore regrets the misunderstanding with an experienced institutional customer." It adds that clients continue to give it a high rating for its order execution and willingness to risk its own capital to fill their orders.

The case unleashed a debate about how brokers should handle blind bids on giant trades of multiple stocks at once, known as program trades. U.S. laws, while barring firms from front-running actual orders, don't explicitly prohibit trying to do so with orders not yet placed. Still, says the SEC's market-regulation chief, Annette Nazareth: "The closer you are to understanding that a customer is going to imminently place an order, the more you would have an obligation to act in the best interest of that customer."

One firm, UBS, told clients this year that it wouldn't trade on information it learns in advance of winning a blind bid. But Deutsche Bank and Goldman Sachs, both major participants in blind bids, made clear to clients that what they learn about future transactions may be fodder for their own trading.

Deutsche Bank told clients in a letter that it "may take into account information you provide...and information held regarding your previous trading activity" to trade in advance of orders.

The bank maintains it has a right to start buying and selling right away to "mitigate our exposure, and as a result be competitive in pricing." The winner of a blind bid often has to put capital at risk, by temporarily owning some of the large number of securities to be traded.

Goldman says that pre-hedging "enables us to offer liquidity to our clients at a more reasonable rate," but that it won't do it if clients instruct it not to.

Some clients are indeed resisting. Barclays Global Investors, a money-management unit of **Barclays** PLC, says it has warned brokers in both the U.S. and the U.K. that any information it gives them to decide whether to bid must not be used to take action in the market.

## Back Books

The unit of a securities firm that handles proprietary trading often is walled off from customer activity. But besides regular proprietary trading, some firms hand over chunks of their cash to traders housed on or near the big floor where sales brokers constantly receive client orders and sometimes shout them out.

The traders who run such accounts -- called "back books" -- often get to keep a percentage of the profits the accounts earn. They aren't allowed to trade in a stock while the firm is actively handling an order for that stock. Nonetheless, they have the advantage of being very close to the market -- aware of the buzz about individual stocks, the general tenor of the market and what some of the smartest big investors are doing.

Securities firms view back books, also called proprietary accounts, as a perk to help keep top traders from leaving for lucrative jobs at hedge funds or other private investment pools. In recent years, firms including Goldman, Merrill Lynch & Co., **Citigroup** Inc. and **Credit Suisse** First Boston have given proprietary accounts to traders situated within divisions that receive clients' orders.

Though this is legal, it must be closely watched to ensure that "the proprietary trading isn't based on customer orders," says the NASD's Mr. Luparello. "Back books are a convenient place for abuse to be hidden." SEC enforcement chief Stephen Cutler, at a securities-law panel in New York last month, said traders who do both proprietary and customer trading present "a very problematic issue" that's "very difficult to grapple with." Many firms say they try to situate traders with proprietary accounts out of earshot of the main floor.

Merrill Lynch, according to some of its former traders, placed a small proprietary-trading operation last year just 20 feet or so from traders who call out customer orders. The firm said the traders are "separate" from the "football-field-size" main trading floor. "They don't have access to customer information and are subject to daily surveillance," a spokeswoman said. She said the reason they weren't put somewhere else entirely was that the firm viewed its placement as sufficiently separate.

Wellington Management Co. complained to Merrill last year that its back-book traders could trade on knowledge of pending orders. Merrill sought to reassure the big Boston money manager, saying the accounts were small and unlikely to affect stock prices. Trading officials at Wellington declined to comment.

Back books were at issue in the Knight Securities trading in JDS Uniphase that was aired in an NASD arbitration. The firm, a unit of **Knight Trading Group Inc.**, let traders who have back books keep as much as 25% or 30% of the accounts' profits, one trader testified.

According to testimony of Knight's former head of stock sales, Robert Stellato, who brought the arbitration claim, at least six traders began buying JDS shares for their back books right after Oppenheimer Funds placed its large order for JDS stock.

Mr. Stellato testified that there was "great concern" among the people who receive customers' orders "that if the regulatory authorities ever looked at the back books of this firm that the firm was going to be locked up."

He had complained to his bosses about various types of alleged improper trading, and he said his complaints were the reason he was asked to leave the firm. Knight said his job performance was the issue. The arbitration case concerned Mr. Stellato's claim for money he thought Knight owed him.

The arbitration panel turned him down on the money issue, aside from a small pay miscalculation. The panel didn't rule on the substance of his allegations of improper trading at Knight.

Instead, back books are expected to be among the subjects of final enforcement orders coming from the SEC and the NASD's enforcement arm. Knight has tentatively agreed to pay \$79 million to settle the matter, without admitting or denying the findings. The actions broadly allege that Knight failed to properly supervise back books and delayed filling client orders in order to trade for itself -- pocketing tens of millions of dollars.

The penalty is expected to include a restitution fund of about \$41 million, going to high-profile clients such as Fidelity Investments and **T. Rowe Price Group Inc.**, among others.

Write to Ann Davis at [ann.davis@wsj.com](mailto:ann.davis@wsj.com)<sup>2</sup>

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