UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 54148 / July 14, 2006

ADMINISTRATIVE PROCEEDING
File No. 3-12366

In the Matter of **Herzog, Heine, Geduld, LLC,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934**

I.

The Securities and Exchange Commission (the "Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 (the "Exchange Act") against Herzog, Heine, Geduld, LLC ("Herzog" or "Respondent").

II.

In anticipation of the institution of these proceedings, Herzog has submitted an Offer of Settlement (the "Offer"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over Herzog and the subject matter of these proceedings, which Herzog admits, Herzog consents to the issuance of this Order Instituting Administrative Proceedings, Making Findings and Imposing Remedial Sanctions Pursuant to Section 15(b) of the Securities Exchange Act of 1934 (the "Order"), as set forth below.

III.

FINDINGS

On the basis of this Order and Respondent's Offer, the Commission finds[1] that:

Respondent Herzog is a registered broker-dealer that, during the period from 1999 through 2000, had its principal place of business in Jersey City, New Jersey. From 1999 through 2000, Herzog was one of the largest Nasdaq market makers based on trading volume.[2]

Summary

During the period from January 1999 through at least June 2000, Herzog failed to provide best execution to customer orders that Herzog received from correspondent broker-dealer firms. Herzog, in its capacity as a market maker, assumed the duty of best execution by making written and oral statements to correspondent broker-dealer firms to the effect that it would provide best execution to orders routed to Herzog for execution.

Best execution generally requires a firm to execute customer orders on the most favorable terms reasonably available under the circumstances. Although Herzog traders were told by their supervisors that they had an obligation to provide best execution for all orders routed to the firm, various traders failed on numerous occasions during the relevant period to provide executions to Herzog's correspondent broker-dealer firms' customer orders on the best terms that were reasonably available for those orders.

Herzog provided to all of its traders access to a proprietary order execution system whose computer software enabled traders to efficiently execute orders, but the functions made available to traders in this order execution system were open to misuse and were in fact misused by various traders, resulting in executions at prices inconsistent with best execution. Herzog was aware that functions of its order execution system, if misused, could lead to execution of customer orders at inferior prices. During the relevant period, however, Herzog did not implement an adequate supervisory system to detect and prevent the resulting executions at prices inconsistent with best execution.

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1 The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

2 In June 2000, Merrill Lynch & Co., Inc. ("Merrill") acquired Herzog, Heine, Geduld, Inc. Herzog, however, continued to operate as a separate entity, with its own technical and compliance staff, and without substantial direction from Merrill, until at least early 2001. On August 31, 2001, Herzog, Heine, Geduld, Inc. merged with Herzog, Heine, Geduld, LLC, a Delaware limited liability company, in order to effect a change to its organizational form. The limited liability company assumed all of the assets and liabilities of Herzog, including its broker-dealer registration on file with the National Association of Securities Dealers ("NASD"). In late 2002, Merrill integrated Herzog's operations with those of its own. Herzog subsequently ceased trading operations, but remains registered with the Commission and maintains its broker-dealer registration with the NASD.

A failure to provide best execution to customer orders may violate Section 15(c) of the Exchange Act. In addition, Section 15(b)(4)(D) of the Exchange Act authorizes the Commission to sanction a broker or dealer that willfully violates any provision of the Exchange Act. Herzog is being sanctioned by the Commission for failing to provide best execution of customer orders received from its correspondent broker-dealer firms.

Herzog also failed to preserve email communications related to Herzog's business as such for the period from January 1999 to September 1999. Emails that are related to a broker-dealer's business as such must be preserved for not less than three years under the Commission's rules promulgated under Section 17(a)(1) of the Exchange Act. By failing to preserve the emails, Herzog violated Section 17(a)(1) of the Exchange Act and Exchange Act Rule 17a-4(b)(4).

Herzog Traders' Execution of Orders at Stale Prices and Prices Inconsistent with Best Execution

During the relevant period, January 1999 through at least June 2000, trading volume in Nasdaq stocks was at historically high levels and Herzog was one of the largest Nasdaq market makers. Herzog acted primarily as a wholesale Nasdaq trading firm. That is, it received most of its order flow from correspondent broker-dealer firms that directly received orders from customers. Herzog paid fees or rebates to the correspondent broker-dealer firms, and told the firms orally and in writing that it would execute the correspondent broker-dealer firms' customer orders on the "most favorable terms reasonably available under the circumstances."

Herzog's trading supervisors and the senior Herzog employees to whom they reported were responsible for ensuring that traders employed by Herzog provided best execution to orders routed to Herzog for execution. While supervisory personnel provided instructions concerning the firm's best execution obligation, the firm did not conduct formal training that was designed to ensure that traders had an adequate understanding of that obligation in the context of the functions of the Herzog order execution system. Herzog did not implement a sufficiently robust system of supervision of its traders with respect to fulfilling the firm's duty to provide best execution. For example, Herzog did not provide supervisory and compliance personnel with appropriate reports to permit a comparison between trader executions and contemporaneous bids, offers, and executions in the market.

During the relevant period, the majority of Herzog's orders were received electronically and were executed through Herzog's order execution system.[3] Generally, orders that did not exceed pre-established size limits -- the "bucket" size -- and that were immediately executable (i.e., market orders or other marketable orders) were executed automatically without trader intervention. Trader intervention, or manual execution, was typically

[3] Herzog also received orders telephonically. These orders were sometimes entered into the Herzog order execution system and thereafter treated as electronic orders. Alternatively, a trader could execute an order by voice (e.g., by telling the customer, "You're done at $25.") and then enter the terms of the execution into the Herzog order execution system for recordkeeping and reporting purposes.

required only when: (1) a marketable order exceeded the bucket size for automated execution; or (2) the automated execution process was turned off or otherwise disabled. When a marketable order exceeded the bucket size for automated execution and the automated execution process was enabled, the portion of the order up to the bucket size was executed automatically, and the unexecuted remainder of the order was sent to the trader with responsibility for trading in the security. It then fell to that trader to manually execute the remainder of the order. When the automated order execution process was turned off or otherwise disabled -- which could have been for one or more securities or for all securities for which Herzog made a market -- entire orders were routed to the responsible trader or traders for manual execution.

This Order addresses orders or remainders of orders that were manually executed by Herzog traders.[4] Herzog traders could manually execute orders using a number of functions of the Herzog order execution system. These functions permitted traders to select an order from among a group of orders displayed on a screen, and then to execute that order against Herzog's own market making account with no, or few, keystrokes and only two clicks of a computer mouse. These functions were located on the "Executable Orders" tab of the Herzog order execution system screen, which was commonly referred to as the "pending screen."

As the name suggests, the pending screen displayed orders that were immediately executable but had not yet been executed. This screen first became a part of the Herzog order execution system in 1998, and was in general use no later than the beginning of the relevant period. Though it underwent changes during its existence, the pending screen remained in use throughout the relevant period. The pending screen displayed customer orders awaiting execution in rows, each order in its own row. Each row showed, among other things, the time the order was received, the side of the order (buy or sell), the order quantity, the security symbol, and, if the order was a limit order, the customer's limit price. In an area below the rows of orders, the screen displayed two graphical buttons that permitted execution of the order, one labeled "Execute QIF," another labeled "Execute." In the next lower portion of the screen were two input fields, labeled "Quantity" and "Price."

In the executions at issue here, the trader's first step in manually executing an order was to select the order from its row by highlighting it with a mouse click. Highlighting the order caused the display of certain market and other information concerning the Nasdaq security in question. Most significant were three price displays related to the highlighted order. First, in the right half of a window that opened below the rows of customer orders and above the graphical "Execute" and "Execute QIF" buttons, the screen displayed the current inside bid and offer prices, that is, the National Best Bid and Offer (the "NBBO"),[5] for the

[4] Hereinafter, both "orders" and "remainders of orders" are simply called "orders."

[5] The NBBO is the highest bid price and lowest offer price currently available for a security, and is a factor considered in evaluating whether customer orders have received best execution.

highlighted security (labeled “Ins” for “Inside”).[6] This display was continuously updated as changes occurred in the inside bid and offer after the order was highlighted. Second, in the left half of the window that opened when the order was highlighted, the screen displayed the inside bid and offer that prevailed at the time the highlighted order was received by Herzog.[7] This price display was labeled “QIF,” standing for quote-in-force. Third, highlighting the order caused the “Price” field of the pending screen to display as a default price for the security, static as of the time the order was highlighted, the inside bid if the order was a sell order, or the inside offer if the order was a buy order.[8]

After highlighting an order, depending upon how much time had elapsed since the order was received, Herzog traders could use up to three functions on the pending screen to execute the order.[9] First, if fifteen seconds or less had elapsed since the time the order had been highlighted, the trader could simply click the graphical “Execute” button in the lower portion of the screen.[10] This action immediately executed the highlighted order at the price displayed in the “Price” field, which, as explained above, was the inside bid or offer that prevailed at the time the order had been highlighted. Second, if fifteen seconds or less had elapsed since the highlighted order had been received by Herzog, the trader could click the graphical “Execute QIF” button in the lower portion of the screen.[11] Clicking the “Execute QIF” button immediately executed the order at the inside bid or offer that prevailed at the time the order was received, that is, the “QIF” price. Third, the trader could manually override the default price in the “Price” field. To do so, the trader cleared the price that was automatically displayed in the “Price” field (the inside bid or offer at the time the order was highlighted), typed in an alternate price, and then clicked the “Execute” button (hereinafter, the “price override function”).

During the relevant time period, various Herzog traders misused the “Execute QIF” button and price override function to execute customer orders at stale prices that were less advantageous to the customers than the prices that Herzog traders reasonably could have obtained.

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6 The right half of the window also displayed: (1) the number of shares at the best bid and offer; (2) Herzog’s quote for the security, including the number of shares at its bid and offer; and (3) Herzog’s position in the security and the average cost of that position.

7 The left half of the window also displayed some background information about the order highlighted, such as the originating broker-dealer number and, if the highlighted order was a portion of an order, the original quantity of the order.

8 At the same time, the “Quantity” field displayed the number of shares in the highlighted order.

9 Other methods of order execution were possible, but they are not relevant to this Order.

10 Until October 2000, the “Execute” button functioned for fifteen seconds after an order was highlighted. Thereafter, the “Execute” button functioned for ten seconds (rather than fifteen) after an order was highlighted.

11 Prior to its removal in October 2000, the “Execute QIF” button functioned for fifteen seconds after an order was received by Herzog. However, Herzog system maintenance records indicate that the “Execute QIF” button functioned for thirty seconds (rather than fifteen), or even without a time limitation during portions of 1999.

With respect to the "Execute QIF" button, as discussed above, for up to fifteen seconds, the pending screen simultaneously displayed and enabled for immediate execution both the inside bid (or offer, if the order was to buy) at the time the order was highlighted -- displayed as the default price in the "Price" field -- and the inside bid (or offer) at the time the order was received, displayed as the "QIF" price. Because the inside bid (or offer) was continuously changing according to market forces, the inside bid (or offer) at the time the order was highlighted was sometimes better or worse for the customer than the inside bid (or offer) at the time the order was received. Various Herzog traders on numerous occasions used the "Execute QIF" button to execute orders at stale and inferior inside bids or offers that prevailed when the orders were received, when the inside bids or offers at the time the orders were highlighted were better for customers.

With respect to the price override function, various Herzog traders misused it by manually entering stale prices that were less advantageous to customers than the prices that the traders reasonably could have obtained. For example, on limit orders various Herzog traders cleared default prices that were better for the customer and manually entered inferior customer limit prices.[12] In other instances, various Herzog traders cleared default prices that were better for the customer and manually entered inferior "QIF" prices.[13]

Such misuse of the above-mentioned functions of the Herzog order execution system by various Herzog traders did not provide Herzog's correspondent broker-dealer firms with the best execution of customer orders that was then reasonably available.

Inadequate Preservation of Emails

Upon the initiation of the formal investigation of Herzog's execution practices, the staff, in January 2002, issued a routine subpoena to Herzog that requested relevant communications, including emails, for the period from January 1999 through the date of the subpoena. Herzog, however, was unable to produce any emails for the period from January 1999 through September 1999. Nor could it explain what happened to the emails. The inability to produce the emails hindered the staff's investigation.

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[12] The customer limit price was displayed for the trader in the row of information about the highlighted order.

[13] The inside bid or offer at the time the order was received was displayed as the "QIF" price. Thus, using the price override function, traders could defeat the time limitation on the "Execute QIF" button.

Herzog's Response to OCIE

In responding to an examination of its order executions begun in August 2000 by the Commission's Office of Compliance Inspections and Examinations ("OCIE"), Herzog did not provide complete and timely document production and did not ensure comprehensive and complete responses to requests made by the OCIE examiners. The examiners asked Herzog to respond to both written and oral questions concerning specific order executions. Those questions should have elicited, but did not elicit, a full description of the "Execute QIF" function and other functions of the order execution system employed by the Herzog traders who were responsible for the particular order executions reviewed by OCIE. In addition, OCIE requested a demonstration of the Herzog order execution system, but the demonstration Herzog provided did not include the "Execute QIF" button, which OCIE did not know about at that time and which was relevant to the specific order executions that Herzog knew were of concern to OCIE. OCIE's examination was adversely affected and unnecessarily prolonged by Herzog's failure to provide timely and complete responses to OCIE's requests for information.

In determining the appropriate resolution of this matter, the Commission considered, in addition to the underlying conduct, Herzog's response to the OCIE examination.

Legal Discussion

Failure to Provide Best Execution

A broker-dealer has a legal duty to seek to obtain best execution of customer orders at the most favorable terms reasonably available under the circumstances.[14] A failure to provide best execution may constitute a violation of Section 15(c)(1)(A) of the Exchange Act, which makes it unlawful for any broker or dealer to "effect any transaction in . . . any security by means of any manipulative, deceptive, or other fraudulent device or contrivance."[15] Herzog expressly represented to its correspondent firms that it would provide best execution of customer orders routed to it from the correspondent firms. During the relevant time period, however, various Herzog traders used the "Execute QIF"

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[14] *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 269-70 (3d Cir. 1998) (citing cases). *See also* Regulation NMS, Exchange Act Release No. 51808 (June 9, 2005), 70 Fed. Reg. 37,496, 37,538 (June 29, 2005); *In re Certain Market Making Activities on Nasdaq*, Exchange Act Release No. 40900 (Jan. 11, 1999), 1998 WL 919673 at *5 (settled case). Among the factors to be considered in determining whether best execution has been achieved are "order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market." *Newton* at 270 n. 2 (citation omitted). *See also* Payment for Order Flow, Exchange Act Release No. 34902 (Oct. 27, 1994), 59 Fed. Reg. 55,006, 55,008-55,009 (Nov. 2, 1994); Order Execution Obligations, Exchange Act Release No. 37619A (Sept. 6, 1996), 61 Fed. Reg. 48,290, 48,322 (Sept. 12, 1996).

[15] *Cf. Newton*, 135 F.3d at 269 (finding that a failure to provide best execution may be a violation of Section 10(b) of the Exchange Act). *See also In re Knight Securities, L.P.*, Exchange Act Release No. 50867 (Dec. 16, 2004) 2004 WL 2913488 at *8 (settled case); Disclosure of Order Routing and Execution Practices, Exchange Act Release No. 43084 (July 28, 2000), 65 Fed. Reg. 48,406, 48,425 (Aug. 8, 2000) ("False or misleading statements made by market centers to routing firms regarding execution quality, if material and made with the requisite state of mind, may be actionable under antifraud provisions.") (citations omitted).

and price override functions to execute customer orders at prices that were stale and inferior. On numerous occasions they used the "Execute QIF" and price override functions to execute customer orders received from correspondent broker-dealer firms at the price prevailing at the time of receipt of the order even when a superior execution was reasonably available at the inside bid or offer prevailing at the time that the order was highlighted (the Herzog system default price) and did so without regard to order size, trading characteristics of the security, speed of execution, clearing costs, or the cost and difficulty of executing the order in a particular market. By virtue of the foregoing conduct, Herzog failed to provide best execution of customer orders routed to Herzog by its correspondent broker-dealer firms and willfully violated Exchange Act Section 15(c)(1).

Inadequate Preservation of Emails

Section 17(a)(1) of the Exchange Act provides, among other things, that brokers and dealers "shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title." The records required under Section 17(a)(1) and the rules promulgated thereunder are "the basic source documents" of a broker-dealer and are "a keystone of the surveillance of broker[s] and dealers by [Commission] staff and by the securities industry's self-regulatory bodies."[16]

Pursuant to its authority under Section 17(a)(1), the Commission promulgated Rule 17a-4. Rule 17a-4(b)(4) requires a broker-dealer to "preserve for a period of not less than three years, the first two years in an easily accessible place . . . [o]riginals of all communications received and copies of all communications sent . . . by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such."[17] Rule 17a-4 is not by its terms limited to physical documents. The Commission has stated that internal email communications relating to a broker-dealer's "business as such" fall within the purview of Rule 17a-4 and that, for the purposes of Rule 17a-4, "the content of the electronic communication is determinative" as to whether that communication is required to be retained.[18]

The email communications that the staff requested from Herzog were records that the firm was required to preserve under Rule 17a-4. The firm failed to preserve these emails from January 1999 to September 1999. It had no explanation for its failure to preserve these emails. As a result of this conduct, Herzog willfully violated Section 17(a)(1) of the Exchange Act and Rule 17a-4(b)(4).

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16 *In re Deutsche Bank Securities, Inc., et al.*, Exchange Act Release No. 46937 (Dec. 3, 2002) 2002 WL 31687142 at *3 (settled case) (internal quotations and citations omitted).

17 Exchange Act Rule 17a-4(b)(4), 17 C.F.R. § 240.17a-4(b)(4).

18 *See* Reporting Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934, Exchange Act Release No. 38245 (Feb. 5, 1997), 62 Fed. Reg. 6469, 6472 (Feb. 12, 1997).

IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions specified in the Offer submitted by Herzog. Accordingly, it is hereby ORDERED that:

A. Respondent is hereby censured pursuant to Section 15(b)(4) of the Exchange Act.

B. IT IS FURTHER ORDERED that Respondent shall, within ten days of the entry of this Order, pay a civil money penalty of $1,500,000 to the United States Treasury. Such payment shall be: (A) made by United States postal money order, certified check, bank cashier's check or bank money order; (B) made payable to the U.S. Securities and Exchange Commission; (C) hand-delivered or mailed to the Office of Financial Management, Securities and Exchange Commission, Operations Center, 6432 General Green Way, Stop 0-3, Alexandria, VA 22312; and (D) submitted under cover letter that identifies Herzog as the Respondent in these proceedings and the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to Gregory G. Faragasso, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F Street, N.E., Washington, DC 20549-7553.

By the Commission

Nancy M. Morris
Secretary