INITIAL DECISION RELEASE NO. 280
ADMINISTRATIVE PROCEEDING
FILE NO. 3-11716

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of	:	
	:	INITIAL DECISION
THOMAS J. DONOVAN	:	April 12, 2005

APPEARANCES: Michael K. Lowman and Natasha Vij for the Division of Enforcement, Securities and Exchange Commission

Respondent Thomas J. Donovan, pro se

BEFORE: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision bars Thomas J. Donovan (Donovan) from association with any broker or dealer. Donovan was previously enjoined from violating the antifraud provisions of the securities laws, based on his involvement in a fraudulent trading scheme.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) initiated this proceeding with an Order Instituting Proceedings (OIP) against Donovan on October 21, 2004, pursuant to Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act). Donovan was served with the OIP on November 24, 2004.

The undersigned held a one-day hearing on February 15, 2005, in New York City. The Division of Enforcement (Division) called two witnesses, Brian Delaney (Delaney) and Respondent Donovan. Delaney, who is incarcerated, testified by telephone. Donovan called Delaney and a second witness, and testified in his own case. Twenty-two exhibits were admitted into evidence.[1]

[1] Citations to the Division's and Donovan's exhibits, and to the hearing transcript, will be noted as "Div. Ex. __," "Resp. Ex. __," and "Tr. __," respectively.

The findings and conclusions in this Initial Decision are based on the record. Preponderance of the evidence was applied as the standard of proof. See Steadman v. SEC, 450 U.S. 91 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the following post hearing pleadings were considered: (1) the Division's March 25, 2005, Proposed Findings of Fact and Conclusions of Law and Brief in Support of Proposed Findings of Fact and Conclusions of Law; (2) Respondent's March 28, 2005, post hearing filing; and (3) the Division's April 8, 2005, Reply Brief. All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

The OIP alleges that Donovan was enjoined by default on September 27, 2004, from violating the antifraud provisions of the federal securities laws and fined, based on his wrongdoing while associated with broker-dealers, Knight Securities, L.P. (Knight), and Andover Brokerage, L.L.C. (Andover). Donovan argues that he was never properly served with the complaint in the injunctive proceeding and that, in any event, he was a minor participant in the fraudulent scheme operated by Delaney that was the basis for the injunction.

II. FINDINGS OF FACT

A. THE INJUNCTION

Donovan was (and is) permanently enjoined from violating Section 17(a) of the Securities Act of 1933 (Securities Act) and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and ordered to pay a civil penalty of $90,000. SEC v. Delaney, No. 2:03-CV-4206 (JWB) (D.N.J. Sept. 27, 2004); Div. Ex. 2. The injunction was obtained by default. Div. Ex. 2. Donovan testified that he was not served with the Commission's complaint but that he was aware that the civil proceeding had been filed. Tr. 158-59. The record is unclear as to the facts of the service of the complaint.[2] However, it is not necessary to determine such facts in this proceeding. While relevant to an appeal or request to vacate the injunction, they are not relevant to this proceeding.

[2] A process server personally delivered the complaint at Donovan's address, 361 88th Street, Brooklyn, NY 11209, to a person described as "his roommate, James Sweeney, a person of suitable age and discretion" on January 20, 2004, and mailed a copy to Donovan on January 21, 2004. Div. Ex. 16. Donovan stated that Sweeney is not his roommate, but rather lives in the upstairs apartment, and that he never received the papers from Sweeney. Tr. 12-13. Donovan testified that he never received the Division's complaint and explained the fact that he called the Division's lawyers shortly after January 20, 2004, due to publicity about the case. Tr. 158-59. He testified that he interpreted the lawyers' telling him that he had to file an answer as referring to his Wells statement. Tr. 159.

B. DELANEY'S FRAUDULENT SCHEME

Donovan was associated with Knight, a broker-dealer, as an equities trader from 1996 to September 2001. Tr. 121; Div. Ex. 3 at 4. He was associated with Andover, a broker-dealer, as a registered representative from approximately October 2001 to February 2002. Tr. 124; Div. Ex. 3 at 3. While at Knight, he was subordinate to and friendly with Delaney. Tr. 32, 57, 93, 161. Delaney was a trader and market-maker in specific stocks at Knight. Tr. 31, 38. Delaney was subject to the supervision of Randall Taylor (Taylor), who had authority over all the traders at Knight.[3] Tr. 33-34. Delaney and Taylor were partners in various business ventures, and Taylor fell behind in payments he was supposed to make toward those ventures. Tr. 33, 35, 45. Taylor discovered that Delaney had concocted a scheme that Delaney euphemistically described as "capturing the spread."[4] Tr. 35-36, 42-44. He ordered Delaney to operate the scheme to produce profits to make up for the shortfall in his payments. Tr. 36, 45-47, 56.

The scheme was as follows: Delaney placed orders in an accomplice's E*TRADE account to buy stocks at or near the bid, followed shortly by orders to sell the same stocks at or near the ask. He then executed the contra side of the orders in Knight accounts that he controlled. Tr. 36-42, 52-53. Thus, Delaney followed the maxim of "buy low and sell high" in placing orders in the accomplice's account and turned the maxim on its head when committing Knight's capital. Tr. 52-53, 73. The guaranteed profits in the accomplice's account were then funneled through Delaney to the Delaney-Taylor business ventures. Tr. 78, 117, 139-46. To avoid detection, Delaney placed the buy and sell orders in the accomplice's account in the men's room at Knight via a Palm Pilot and restricted his activities to days when he was making a profit in his legitimate trading to mask the losses in the Knight accounts. Tr. 55-56, 71.

Delaney selected stocks for the scheme that were on his list, were thinly-traded, and had a large spread, and for which Knight was the market-maker with the highest volume. Tr. 37, 72-73. Trades for a stock on his list for which Knight was the market-maker with the highest volume were automatically routed to him. Tr. 37-38. He selected thinly-traded stocks to reduce the likelihood that an unrelated market-maker might make bids or offers that would interfere with the orders he placed in furtherance of his scheme. Tr. 38-39.

Delaney first operated the scheme with the connivance of an outside investor whose cooperation he obtained by threatening him with financial ruin if the Delaney-Taylor ventures collapsed. Tr. 47-51. Eventually the investor refused to continue to participate in the scheme,

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[3] Taylor declined to appear at the hearing as required by a subpoena obtained at the instance of Respondent Donovan. Resp. Ex. 2 (discussed at Tr. 15, 81-82, 119). According to Donovan's prehearing witness list, he had intended to elicit testimony from Taylor to the effect that Donovan's departure from Knight was amicable.

[4] The "spread" is the difference between the "bid" and "ask" prices. The "bid" is the (lower) price that a dealer would pay for a security, and the "ask" is the (higher) price for which he would sell it. Barron's Dictionary of Finance and Investment Terms 48 (4th ed. 1995).

and Delaney recruited Donovan in his place, shortly before Donovan left Knight. Tr. 56-58, 65, 94. The scheme ended in February 2002, when Delaney left Knight. Tr. 79-80, 82-83.

Donovan's active involvement in Delaney's scheme included opening two E*TRADE accounts in his own name, allowing Delaney to use them, and transferring the profits to Delaney according to Delaney's instructions.[5] Donovan opened the first account (# 4912-2287) in October 2001. Tr. 127-32; Div. Ex. 8A. In filling out the account opening documents Donovan provided a false address as well as other answers that masked his connection to the securities industry. Tr. 129-133; Div. Ex. 8A. Delaney funded the account with a check for $250,000; Donovan deposited the check in his bank account and then ordered the bank to wire $249,000 to the E*TRADE account. Tr. 132. Delaney's activities and the funding were switched to a second E*TRADE account (# 4969-6510) that Donovan opened on Delaney's instructions in January 2002.[6] Tr. 147; Div. Ex. 9. Donovan provided a correct address for this account but gave a misleading negative answer when asked whether his employer was a broker-dealer.[7] Tr. 147-53; Div. Ex. 9A at ET0233. Donovan periodically forwarded the profits from Delaney's "capturing the spread" trading to him on his instructions. Tr. 139-45. Donovan considered the accounts to be Delaney's and testified that he did not look at the account statements that he received. Tr. 134, 138. Donovan knew that Delaney was using the accounts to conceal his trading from Knight and to circumvent Knight's compliance procedures by ensuring that Knight would not receive duplicate confirmations of his trading. Tr. 136, 140. There is no indication in the record that Donovan tried to avoid involvement in Delaney's scheme or to dissuade him from continuing the scheme.

Delaney's scheme caused Knight an estimated $1,178,475 in losses, essentially to benefit the Delaney-Taylor business ventures. Div. Ex. 18 at 1. Donovan received a benefit amounting to about $29,000: He entered a settlement with Knight of a lawsuit and arbitration arising out of Delaney's scheme by which he was allowed to retain $25,000 that he had previously withdrawn

[5] Delaney testified that Donovan also executed four trades, on Delaney's instructions, on the Knight side of the transactions and that he witnessed one of the four purported executions. Tr. 59-65, 97-98, 112-114; Div. Ex. 12 at KS0001-2. Donovan suggested in his questioning (at Tr. 101-02, 115) that the trades could have been entered by someone other than himself. Delaney conceded that his testimony could not be corroborated. Tr. 114-15. Delaney's testimony is uncorroborated, and his credibility is lowered by the fact that he was convicted of a crime of moral turpitude arising out of the same facts. Accordingly, the record does not support a finding that Donovan entered orders on the Knight side of the transactions.

[6] Delaney feared that Knight might have learned about his scheme by receiving duplicate confirmations from the first account. Tr. 69, 147. He instructed Donovan to switch the trading to a new account, telling him that the change was for accounting purposes. Tr. 146-47.

[7] Donovan was associated with Andover, but he explained, sophistically, that he distinguished between "associated" and "employed." Tr. 150-52.

from the E*TRADE accounts to pay his lawyer and to withdraw an additional $4,000.[8] Tr. 157; Div. Ex. 17 at 1-2.

Delaney was convicted on his plea of guilty of securities fraud and wire fraud based on the facts of his trading scheme. Tr. 30, 35. He is currently incarcerated, serving an eighteen-month sentence. Tr. 30.

III. CONCLUSIONS OF LAW

Donovan has been permanently enjoined "from engaging in or continuing any conduct or practice in connection with [broker or dealer] activity, or in connection with the purchase or sale of any security" within the meaning of Sections 15(b)(4)(C) and 15(b)(6)(A)(iii) of the Exchange Act. Even if he is appealing his injunction, the pendency of an appeal does not preclude "follow-up" action based on the injunction. Joseph P. Galluzzi, 78 SEC Docket 1125, 1130 n.21 (Aug. 23, 2002).

IV. SANCTIONS

The Division requests that Donovan be barred from association with any broker or dealer. This sanction will serve the public interest and the protection of investors, pursuant to Section 15(b)(6) of the Exchange Act. It accords with Commission precedent and the sanction considerations set forth in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981). When the Commission determines administrative sanctions, it considers:

> the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Id. (quoting SEC v. Blatt, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)).

The scheme caused enormous losses, and Donovan's involvement continued for several months. Thus, his actions were recurring and egregious. Although Donovan did not mastermind the scheme, his scienter is indicated by his admission that he lent his name to accounts that he considered Delaney's and that he knew that Delaney was using the accounts to circumvent Knight's compliance procedures. Consistent with his defense of the charges against him, he has not fully acknowledged the wrongful nature of his conduct. Opportunities for future violations may be circumscribed because of the injunction. Nonetheless, a bar is essential to avoid the possibility of future violations. There are no extraordinary mitigating circumstances in this case to warrant a lesser sanction.

[8] Additionally, Delaney testified that he forgave a $5,000 debt and that he allowed Donovan to engage in a "capturing the spread" transaction to counterbalance $15,000 or $16,000 in losses from his trading at Andover. Tr. 58, 75-76. However, Delaney's testimony is uncorroborated, and his credibility is low.

A bar is consistent with Commission precedent in litigated proceedings against a respondent who has been enjoined from violating the antifraud provisions of the securities laws. See Michael J. Markowski, 74 SEC Docket 1537 (Mar. 20, 2001); Seaboard Investment Advisers, Inc., 54 S.E.C. 1111 (2001); Martin R. Kaiden, 54 S.E.C. 194 (1999); Robert Sayegh, 54 S.E.C. 46 (1999); John Francis D'Acquisto, 53 S.E.C. 440 (1998); Demitrios Julius Shiva, 52 S.E.C. 1247 (1997); Timothy Mobley, 52 S.E.C. 592 (1996); David M. Haber, 52 S.E.C. 201 (1995).

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on March 7, 2005, and corrected on March 25, 2005, to clarify the description of Division Exhibit 19. See Thomas J. Donovan, Admin. Proc. No. 3-11716 (A.L.J. Mar. 25, 2005) (unpublished).

VI. ORDER

IT IS ORDERED that, pursuant to Section 15(b) of the Securities Exchange Act of 1934, THOMAS J. DONOVAN IS BARRED from association with any broker or dealer.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

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Carol Fox Foelak
Administrative Law Judge