



## I.

On April 12, 2005, the Securities and Exchange Commission (“Commission”) entered an Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b)(6), 21C and 11(b) of the Securities Exchange Act of 1934 and Rule 11b-1 Thereunder (“OIP”) against respondent Patrick J. McGagh, Jr. (“McGagh”).

## II.

McGagh has submitted an Offer of Settlement (“Offer”) in these administrative proceedings, 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 him and the subject matter of these proceedings, which are admitted, McGagh consents to the entry of this Order Making Findings, Imposing Remedial Sanctions, and Imposing a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b)(6), 21C and 11(b) of the Securities Exchange Act of 1934, and Rule 11b-1 Thereunder as to Patrick J. McGagh, Jr. (“Order”), as set forth below.

## III.

On the basis of this Order and McGagh’s Offer, the Commission finds<sup>1</sup> that:

### FACTS

1. McGagh is one of twenty respondents in pending administrative and cease-and-desist proceedings, file number 3-11893, who have been charged with fraudulent and other improper trading during the period from at least 1999 through June 30, 2003, while they were acting as specialists on the New York Stock Exchange (“NYSE”).
2. McGagh, age 41, acted as a specialist on the NYSE at Van der Moolen Specialists USA, LLC (“Van der Moolen”) from at least January 1, 1999 to approximately March 2004 (the “Relevant Period”).
3. During the Relevant Period, McGagh was the specialist in the following securities: Nortel Networks Corp. (“NT”) (from January 1999 to January 2001) and Pfizer, Inc. (“PFE”) (from May 2001 to approximately April 2003, with absences from the panel where that security was traded in February 2002 and March 2002).

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<sup>1</sup> The findings herein are made pursuant to McGagh’s Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

4. As a specialist, McGagh had an obligation to serve public customer orders over the proprietary interests of the firm with whom he was formerly employed, Van der Moolen. In his role as a specialist, McGagh had a general duty to match executable public customer or “agency” buy and sell orders and not to fill customer orders through trades from Van der Moolen’s own account when those customer orders could be matched with other customer orders. McGagh violated this obligation by filling orders through proprietary trades rather than through other customer orders, through two types of improper trading referred to herein as “interpositioning” and “trading ahead.”
5. Interpositioning involves a two-step process that allows the specialist to generate a profit for the specialist firm from the spread between two opposite trades. Interpositioning can take various forms. In one form, the specialist purchases stock for the specialist firm’s proprietary account from the customer sell order, and then fills the customer buy order by selling from the specialist firm’s proprietary account at a higher price – thus locking in a riskless profit for the specialist firm’s proprietary account. A second form of interpositioning involves the specialist selling stock into the customer buy order, and then filling the customer sell order by buying for the specialist firm’s proprietary account at a lower price – again, locking in a riskless profit for the specialist firm’s proprietary account. In both forms of interpositioning, the specialist participates on both sides of the trade, thereby capturing the spread between the purchase and sale prices, disadvantaging at least one of the parties to the transaction.
6. Trading ahead involves a practice whereby the specialist fills an agency order through a proprietary trade for the specialist firm’s proprietary account – and thereby improperly ‘steps in front’ of, or ‘trades ahead’ of, another agency order – simply to allow the specialist firm to take advantage of market conditions promptly. Unlike interpositioning, the practice of “trading ahead” does not necessarily involve a second specialist trade for the specialist firm’s proprietary account into the opposite, disadvantaged agency order. For example, in a declining market, a specialist may “trade ahead” by filling a market buy order by selling stock from the specialist firm’s proprietary account in front of an agency market sell order. In so doing, the specialist would lock in a higher price for the proprietary trade, then fill the agency sell order *after* the proprietary trade, and thereby force the agency market sell order to accept a slightly lower price as the price of the stock fell.
7. During the Relevant Period, in NT and PFE, McGagh knowingly or recklessly engaged in approximately 20,043 instances of interpositioning, locking in a riskless profit of approximately \$3,271,406 for his firm’s proprietary account at the expense of customer orders, and approximately 4,014 instances of trading ahead, causing approximately \$1,178,892 in customer harm.
8. On May 12, 2006, McGagh pled guilty to one count of securities fraud, in U.S. v. Joseph Bongiorno, et al., 05 Crim. 390 (S.D.N.Y.), stemming from the same conduct

as that charged in the OIP as it relates to PFE. On October 13, 2006, McGagh was sentenced to 27 months imprisonment and assessed a \$250,000 fine. McGagh paid the fine in full on November 1, 2006. McGagh is currently incarcerated in the satellite prison camp at the Federal Correctional Institution – McKean in Bradford, Pennsylvania.

## **APPLICABLE LAW**

### **Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 Thereunder**

9. The antifraud provisions of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit, among other things, any schemes to defraud or fraudulent or deceptive acts and practices in the offer or sale (Section 17(a)) or in connection with the purchase or sale (Section 10(b) and Rule 10b-5) of securities. Basic, Inc. v. Levinson, 485 US 224, 235 n.13 (1988) (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) (en banc)). To prove a violation of Section 17(a)(1) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, the Commission must prove that the respondent acted with scienter. Aaron v. SEC, 446 U.S. 680, 691 (1980). Scienter may be established by proof of conscious behavior or recklessness on the part of the respondent. In re Scholastic Corp. Sec. Litig., 252 F.3d 63, 74 (2d Cir. 2001); SEC v. U.S. Environmental, Inc., 155 F.3d 107, 111 (2d Cir. 1998), cert. denied, 526 U.S. 1111 (1999). Scienter need not be shown in order to establish violations of Sections 17(a)(2) and (3) of the Securities Act. Aaron v. SEC, 446 U.S. 680, 696-97 (1980).
10. As a result of the described conduct above, McGagh willfully violated Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

### **Section 11(b) of the Exchange Act and Rule 11b-1 Thereunder**

11. Section 11(b) of the Exchange Act and Rule 11b-1 thereunder impose various limitations on the operations of specialists, including limiting a specialist's dealer transactions to those "reasonably necessary to permit him to maintain a fair and orderly market."
12. Where specialists make trades for their firm's proprietary accounts that are not "reasonably necessary to permit [such specialists] to maintain a fair and orderly market," and "were not effected in a manner consistent with the rules adopted by [the pertinent national securities exchange]," they have violated Section 11(b) and Rule 11b-1 of the Exchange Act. See In the Matter of Albert Fried & Co. and Albert Fried, Jr., 1978 WL 196046, S.E.C. Release No. 34-15293 (Nov. 3, 1978).

13. Several NYSE rules prohibit a specialist from trading ahead of a customer order, as well as from engaging in interpositioning, and require agency orders to be matched whenever possible, consistent with a specialist's duty to maintain a fair and orderly market.
14. NYSE Rule 104 (Dealings by Specialists), which sets forth specialists' obligations, prohibits specialists from trading for their own accounts unless it is reasonably necessary to maintain a fair and orderly market. This is known as the negative obligation. Rule 104 states in relevant part: "No specialist shall effect . . . purchases or sales of any security in which such specialist is registered . . . , unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market."<sup>2</sup>
15. NYSE Rule 92 (Limitations on Members' Trading Because of Customers Orders) generally prohibits a member from entering a proprietary order to buy (or sell) a security while in possession of an executable buy (or sell) agency order that could be executed at the same price. During the Relevant Period, Rule 92 stated in relevant part:

No member shall personally buy . . . any security . . . for his own account or for any account in which he is . . . interested . . . while such member personally holds or has knowledge that his member organization holds an unexecuted market order to buy such security . . . for a customer.<sup>3</sup>

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<sup>2</sup> Rule 104.10(3), which describes specialists' affirmative obligations, also expands on the negative obligation:

Transactions on the Exchange for his own Account effected by a member acting as a specialist must constitute a course of dealings reasonably calculated to contribute to the maintenance of price continuity with reasonable depth, and to minimizing of the effects of temporary disparity between supply and demand, immediate or reasonably to be anticipated. Transactions not part of such a course of dealings . . . are not to be effected.

<sup>3</sup> Rule 92 was amended on January 7, 2002 to read in relevant part:

[n]o member or member organization shall cause the entry of an order to buy (sell) any Exchange-listed security for any account in which such member or member organization or any approved person thereof is directly or indirectly interested ("a proprietary order"), if the person responsible for the entry of such order has knowledge of any particular unexecuted customer's order to buy (sell) such security which could be executed at the same price.

16. Similarly, NYSE Rule 92 also applies to the specialist buying or selling a security while holding an unexecuted market buy or sell order, as well as to circumstances where the specialist holds unexecuted customer limit orders at a price that could be satisfied by the proprietary transaction effected by the specialist.
17. NYSE Rule 123B (Exchange Automated Order Routing Systems) requires specialists to cross orders received over the DOT system. Rule 123B(d) states in relevant part: “a specialist shall execute System orders in accordance with the Exchange auction market rules and procedures, including requirements to expose orders to buying and selling interest in the trading crowd and *to cross orders before buying or selling from his own account.*” (Emphasis added).
18. NYSE Rule 401 requires NYSE members to “adhere to the principles of good business practice in the conduct of his or its business affairs.” Similarly, NYSE Rule 476(a)(6) provides sanctions if NYSE members are adjudged guilty of “conduct or proceeding inconsistent with just and equitable principles of trade.”
19. As a result of the conduct described above, McGagh willfully violated all of the aforementioned NYSE rules as well as Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

#### IV.

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in McGagh’s Offer.

Accordingly, it is hereby ORDERED that:

1. Pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, McGagh shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, and Sections 10(b) and 11(b) of the Exchange Act and Rules 10b-5 and 11b-1 thereunder.
2. Pursuant to Section 15(b)(6) of the Exchange Act, McGagh be, and hereby is, barred from association with any broker or dealer.

Any reapplication for association by McGagh will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against McGagh, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-

regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

By the Commission.

Nancy M. Morris  
Secretary