

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 59505 / March 4, 2009

ADMINISTRATIVE PROCEEDING
File No. 3-13394

In the Matter of

Goldman Sachs Execution & Clearing, L.P.
and SLK-Hull Derivatives LLC,

Respondents.

ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS,
MAKING FINDINGS, AND IMPOSING
REMEDIAL SANCTIONS AND A
CEASE-AND-DESIST ORDER
PURSUANT TO SECTIONS 15(b)(4)
AND 21C OF THE SECURITIES
EXCHANGE ACT OF 1934

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Goldman Sachs Execution & Clearing, L.P. and SLK-Hull Derivatives LLC (collectively, “Respondents”).

II.

In anticipation of the institution of these proceedings, Respondents have 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 them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 (“Order”) as set forth below.

III.

On the basis of this Order and Respondents' Offer, the Commission finds¹ that:

A. RESPONDENTS

1. **Goldman Sachs Execution & Clearing, L.P.** ("GSEC") is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. GSEC is an indirect wholly owned subsidiary of The Goldman Sachs Group, Inc. ("GS"), and a member of the American Stock Exchange ("AMEX"), the Chicago Board Options Exchange ("CBOE") and the Philadelphia Stock Exchange ("PHLX," and together with the CBOE and the AMEX, the "Exchanges"). Prior to January 14, 2005, GSEC was known as Spear, Leeds & Kellogg LP ("Spear Leeds"). GS's securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act.

2. **SLK-Hull Derivatives LLC** ("SHD") is a wholly owned subsidiary of GS. During the period relevant to this Order, SHD was a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act, and a member of the AMEX, CBOE and PHLX. During the period relevant to this Order, Spear Leeds and SHD each acquired, merged with, or conducted joint venture operations with other specialist firms. A certain portion of the conduct that forms the basis of the findings herein took place at those predecessor firms or joint venture entities. As used herein, the terms "GSEC," "SHD" and Respondents refer to GSEC and SHD, respectively, as well as their predecessor firms and joint venture entities.

B. FACTS

Summary

3. This matter involves violations by GSEC and SHD of their basic obligation as specialists to serve public customer orders over their own proprietary interests. As specialist firms on each of the Exchanges,² GSEC and SHD had a general duty to match executable public customer or "agency" buy and sell orders and not to fill customer orders through trades from the firms' own accounts when those customer orders could be matched with other customer orders. From 1999 through 2005 (the "Relevant Period"), GSEC and SHD violated this obligation by filling orders through proprietary trades rather than through other customer orders, thereby causing customer orders to be disadvantaged by approximately \$6 million.

4. By effecting proprietary transactions that were not part of a course of dealings reasonably necessary to maintain a fair and orderly market, GSEC and SHD violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder. Respondents also violated the following Exchange rules

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

² On the CBOE, specialist firms like GSEC and SHD are known as Designated Primary Market-Makers, or DPMs.

in effect during the Relevant Period: AMEX rules 150(a), 150(b), 155 and 170(d); CBOE rules 8.80 and 8.85; and PHLX rules 1020(c), 1019 and 707.

Overview of Specialists' Obligations

5. On each of the Exchanges, specialist firms are responsible for the quality of the markets in the securities in which individual specialists are registered. A specialist is expected to maintain, insofar as is reasonably practicable, a “fair” and “orderly” market. A “fair” market is one that, among other things, affords no undue advantage to any participant. An “orderly” market is characterized by regular, reliable operation, with price continuity and depth, in which price movements are accompanied by appropriate volume, and unreasonable price variations between sales are avoided.

6. Specialists have two primary duties: performing their “negative obligation” to execute customer orders at the most advantageous price with minimal dealer intervention, and fulfilling their “affirmative obligation” to offset imbalances in supply and demand.³ Specialists participate as both broker (or agent), absenting themselves from the market to pair executable customer orders against each other, and as dealer (or principal), trading for the specialists’ dealer or proprietary accounts when needed to facilitate price continuity and fill customer orders when there are no available contra parties to those orders.

7. Whether acting as brokers or dealers, specialists are required to hold the public’s interest above their own and, as such, are prohibited from trading for their dealers’ accounts ahead of pre-existing customer buy or sell orders that could be executed against each other. When matchable customer buy and sell orders are received by the specialists – generally delivered either through one of the Exchange’s order processing systems to a specialist’s workstation, or, under certain circumstances, by floor brokers gathered in front of specialists’ workstations (“the crowd”) – specialists are required to act as agent and cross or pair off those orders and to abstain from participating as principal or dealer.

Improper Proprietary Trading by GSEC and SHD

8. During the Relevant Period, GSEC and SHD breached their duty to refrain from dealing for their own accounts while in possession of executable buy and sell customer orders. Instead, GSEC and SHD effected improper proprietary trades that disadvantaged customer orders.

9. On each of the Exchanges, GSEC and SHD specialists possessed or had access to information concerning customer orders on both sides of the market. Where there are matchable orders on both sides of the market, specialists are obligated to “pair off” or cross the buy and sell orders by executing each side of the market for identical prices and in commensurate order quantities. In numerous instances, however, GSEC and SHD specialists did not “pair off” or cross

³ A specialist’s obligations on the Exchanges also included acting as a market maker, and the Exchanges’ rules generally required a specialist to provide continuous quotations for each option for which it acted as a specialist.

these buy and sell orders with each other. Sometimes, GSEC and SHD specialists did this by effecting a proprietary trade with an order that arrived electronically through the order processing system. At other times, GSEC and SHD specialists effected improper proprietary trades with orders that came in from the crowd. In either case, the disadvantaged order was an order that the GSEC and SHD specialists should have paired with the other order, instead of filling that other order through a proprietary trade retained by the specialist. The violative conduct took three basic forms described in paragraphs 10-12 below.

10. *Trading Ahead.* In certain instances, GSEC and SHD specialists filled one agency order through a proprietary trade for their firm's account while a matchable agency order was present on the opposite side of the market, thereby improperly "trading ahead" of such opposite-side executable agency order. The customer order that was traded ahead of was then disadvantaged when it was subsequently executed at a price that was inferior to the price received by the firm's proprietary account. For example, if a specialist has present on his book, at the same time, a marketable customer order to buy five contracts of an options series and a marketable customer order to sell five contracts of the same options series, the specialist would be obligated to pair off those matchable orders. Trading ahead would occur if the specialist filled the sell order from the firm's proprietary account at \$5.00 per share per contract, and then subsequently executed the buy order at the inferior price of \$5.05 per share per contract. In this example, the buy order received a price inferior to that to which it was entitled (\$5.00) and the customer was disadvantaged by \$25.00 (5 contracts x \$0.05 per share per contract x 100 shares per contract).

11. *Interpositioning.* In certain instances, after trading ahead, GSEC and SHD specialists also traded proprietarily with the matchable opposite-side agency order that had been traded ahead of, thereby "interpositioning" themselves between the two agency orders that should have been paired off in the first instance. By participating on both sides of trades, the specialist captured the spread between the purchase and sale prices, thereby disadvantaging the other parties to the transactions. Interpositioning occurred in a relatively small number of instances.

12. *Trading Ahead of Unexecuted Open or Cancelled Orders.* In certain instances, GSEC and SHD specialists traded ahead of opposite-side executable agency orders, as described in paragraph 10 above, but the unexecuted orders were left open until the end of the trading day, or were cancelled by the customer prior to the close of the trading day before receiving an execution. Because these orders were never executed, the calculation of customer harm for this type of misconduct was based on a formula that incorporated certain economic assumptions. A substantial amount of the customer harm discussed in paragraph 13 below relates to these unexecuted or cancelled orders.

13. During the Relevant Period, GSEC and SHD engaged in tens of thousands of violative trades of the three types described in paragraphs 10-12, resulting in overall customer disadvantage of approximately \$6 million across the Exchanges. Because of limitations in the source data maintained by the Exchanges, the calculation of the amount of customer disadvantage sometimes required the use of certain analytic formulas. The majority of the customer disadvantage relates to violative trading that occurred between 1999 and 2002.

C. APPLICABLE LAW

Section 11(b) of the Exchange Act

14. 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." Section 11(b) and Rule 11b-1 require a national securities exchange to promulgate rules that allow a member to register as a specialist and to act as a dealer. Under Rule 11b-1(b), if the Commission finds, after appropriate notice and opportunity for hearing, that a specialist has for any account in which he has an interest "effected transactions... which were not part of a course of dealings reasonably necessary to permit such specialist to maintain a fair and orderly market," the Commission may impose sanctions.

15. Where specialists effect trades for their accounts that are not "reasonably necessary to permit [such specialists] to maintain a fair and orderly market," they have violated Section 11(b) and Rule 11b-1 of the Exchange Act. See *In the Matter of LaBranche & Co. LLC*, Exchange Act Release No. 49500, 2004 WL 626573, at *6 (Mar. 30, 2004); *In the Matter of Weiskopf, Silver & Co.*, Exchange Act Release No. 17361, 1980 WL 22091, at *2 (Dec. 10, 1980); *In the Matter of Albert Fried & Co. and Albert Fried, Jr.*, Exchange Act Release No. 15293, 1978 WL 196046, at *6 (Nov. 3, 1978).⁴

16. Here, GSEC and SHD violated their negative obligation by engaging in the three types of conduct described in paragraphs 9 through 11 above. Accordingly, GSEC and SHD willfully⁵ violated Section 11(b) of the Exchange Act and Rule 11b-1 thereunder.

Exchange Rules

17. Several AMEX, CBOE and PHLX rules prohibit the same conduct as is prohibited by Section 11(b) of the Exchange Act and Rule 11b-1 thereunder. These rules effectively prohibit a

⁴ The obligation to maintain a fair and orderly market "has a broader reach than the prohibition of 'fraud' and, thereby, imposes stricter standards of integrity and performance on specialists." *Albert Fried*, 1978 WL 196046, at *5. A transaction not reasonably necessary to maintain a fair and orderly market has been defined as one "not reasonably calculated to contribute to the maintenance of price continuity [on the exchange] and to minimize the effects of temporary disparity between supply and demand." *Weiskopf*, 1980 WL 22091, at *2 n.5 (quoting Exchange Act Release No. 1117 at 2 (March 30, 1937)).

⁵ A willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "also be aware that he is violating one of the Rules or Acts." *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

specialist from trading ahead of, or interpositioning between, eligible customer orders, and require agency orders to be matched whenever possible.

AMEX

18. AMEX Rule 150(a) (Purchases and Sales While Holding Unexecuted Market Order) states that “No member shall (1) personally buy or initiate the purchase of any security on the Exchange for his own account...while such member personally holds...an unexecuted market order to buy...or (2) personally sell or initiate the sale of any such security on the Exchange for any such account, while he personally holds...an unexecuted market order to sell.”

19. AMEX Rule 150(b) (Purchases and Sales While Holding Unexecuted Limit Order) states that: “No member shall (1) personally buy or initiate the purchase of any security on the Exchange for any such account, at or below a price at which he personally holds... an unexecuted limited price order to buy such security...or (2) personally sell or initiate the sale of any security on the Exchange for any such account, at or above the price at which he personally holds... an unexecuted limited price order to sell such security.”

20. AMEX Rule 155 (Precedence Accorded to Orders Entrusted to Specialists) requires that a specialist “give precedence to orders entrusted to him as an agent before executing at the same price any purchase or sale in the same stock for an account in which he has an interest.”

21. AMEX Rule 170(d) (Registration and Functions of Specialists) imposes upon specialists the obligation to refrain from engaging in transactions for his own account “in the securities in which he is registered” unless that conduct constitutes “a course of dealings reasonably calculated to contribute to the maintenance of price continuity with reasonable depth, and to the minimizing of the effects of temporary disparity between supply and demand, immediate or reasonably to be anticipated, in either the full lot or the odd lot market.” The rule goes on to provide that: “Transactions in such securities not part of such a course of dealings are not to be effected by a specialist for his own account.”

22. GSEC and SHD violated each of the aforementioned AMEX rules by reason of the activities set forth in paragraphs 10 through 12 above.

CBOE

23. CBOE Rules 8.80 (DPM Defined) and 8.85 (DPM Obligations) require that a CBOE specialist cede priority to customer orders which the specialist represents as agent.

24. GSEC and SHD violated each of the aforementioned CBOE rules by reason of the activities set forth in paragraphs 10 through 12 above.

PHLX

25. PHLX Rule 1020(c) (Registration and Functions of Options Specialists) states, in relevant part: “A specialist or his member organization shall not effect... purchases or sales of any option in which such specialist is registered, ... unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market.”
26. PHLX Rule 1019 (Precedence Accorded to Orders Entrusted to Specialists) provides: “A specialist shall give precedence to orders entrusted to him as an agent in any option in which he is registered before executing at the same price any purchase or sale in the same option for an account in which he has an interest.”
27. PHLX Rule 707 (Conduct Inconsistent with Just and Equitable Principles of Trade) provides that specialists “shall not engage in conduct inconsistent with just and equitable principles of trade.”
28. GSEC and SHD violated each of the aforementioned PHLX rules by reason of the activities set forth in paragraphs 10 through 12 above.

D. CONCLUSION

29. GSEC and SHD willfully committed violations of Section 11(b) of the Exchange Act, and Rule 11b-1 thereunder, as described above.

IV.

In view of the foregoing, the Commission finds that it is appropriate and in the public interest to impose the sanctions specified in the Offer submitted by GSEC and SHD.

Accordingly it is hereby ORDERED that:

- A. Pursuant to Section 21C of the Exchange Act, GSEC and SHD cease and desist from committing or causing any violations and any future violations of Section 11(b) of the Exchange Act, and Rule 11b-1 thereunder.
- B. Pursuant to Section 15(b)(4) of the Exchange Act, GSEC and SHD are hereby censured.
- C. Respondents shall, within ten days of the entry of the Order, jointly pay disgorgement of \$6 million to the Commission. 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 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 GSEC and SHD as Respondents in these proceedings, the file number of these proceedings, a copy

of which cover letter and money order or check shall be sent to David Rosenfeld, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, New York, 10281.

D. It is further ordered that Respondents shall, within ten days of the entry of the Order, jointly pay a civil money penalty in the amount of \$1.2 million 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 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 GSEC and SHD as Respondents in these proceedings, the file number of these proceedings, a copy of which cover letter and money order or check shall be sent to David Rosenfeld, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 3 World Financial Center, New York, New York, 10281. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes.

By the Commission.

Elizabeth M. Murphy
Secretary