

NASDAQ PHLX LLC
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2015045755513

TO: Nasdaq PHLX LLC
c/o Department of Enforcement
Financial Industry Regulatory Authority (“FINRA”)

RE: Douglas A. Sanzone, Respondent
Former General Securities Principal
CRD No. 1646194

Pursuant to Rule 9216 of Nasdaq PHLX LLC (“Phlx”) Code of Procedure, I, Respondent Douglas A. Sanzone (“Sanzone” or “Respondent”) submit this Letter of Acceptance, Waiver and Consent (“AWC”) for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, Phlx will not bring any future actions against Respondent alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of Phlx, or to which Phlx is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by Phlx:

BACKGROUND

Sanzone entered the securities industry in 1988. In July 2011, Sanzone and several business partners founded broker-dealer Bayes Capital LLC (CRD No. 159644) (“Bayes” or the “firm”). Bayes became registered with Phlx on June 15, 2015. Sanzone registered with Phlx as, *inter alia*, a General Securities Principal (“GP”) at Bayes on June 15, 2015. Bayes filed a Uniform Request for Broker-Dealer Withdrawal (Form BDW) on May 4, 2018, and its registration with Phlx was terminated on June 1, 2018. Sanzone’s registration with Phlx at Bayes was also terminated on June 1, 2018. On July 2, 2018, the firm filed a Form U5 on behalf of Sanzone. On May 22, 2019, FINRA sent a letter to Sanzone providing written notice of inquiry to Sanzone on behalf of FINRA and Phlx, among others, for the conduct at issue here.

Sanzone is not currently employed in the securities industry and is not registered or associated with any Phlx member firm. He remains subject to Phlx’s jurisdiction pursuant to Phlx Rule 9110(d).

RELEVANT DISCIPLINARY HISTORY

Sanzone does not have any disciplinary history with the U.S. Securities and Exchange Commission (“SEC”), any state securities regulators, Phlx, or any other self-regulatory organization (“SRO”).

OVERVIEW

Between November 2014 and July 2, 2018, Bayes was a small firm that had approximately five employees. Sanzone and the firm’s former Chief Executive Officer (“CEO”) and Chief Compliance Officer (“CCO”) (the “Business Partner”) were two primary decision-makers at the firm. At all relevant times, whether through the delegation of supervisory responsibility from his Business Partner or by virtue of becoming the firm’s CEO and CCO in December 2016, Sanzone was responsible for establishing and maintaining the firm’s supervisory system in relation to achieving compliance with rules prohibiting manipulative trading and compliance with Rule 15c3-5 of Section 15(c)(3) of the Securities Exchange Act of 1934 (the “Market Access Rule”).

The firm’s business was initially limited to agency trading on behalf of institutional customers. In November 2014, Sanzone and his Business Partner expanded the firm’s business to include providing direct market access for an unaffiliated broker dealer (“BD1”). BD1’s customers included unregistered foreign day trading entities. One of BD1’s customers was an unregistered foreign-day trading entity and non-FINRA/SRO member, Customer X, which was under common ownership and control with the firm’s third-party, market access control vendor (the “Market Access Control Vendor”). Although this expanded business significantly changed Bayes’s business activities and trading volume, Sanzone failed to enhance the firm’s supervisory system, including its written supervisory procedures (“WSPs”), to achieve compliance with applicable federal securities laws and regulations and Phlx rules prohibiting manipulative trading. The firm also failed to establish and implement a system of risk management controls and WSPs reasonably designed to manage the financial, regulatory, and other risks of this business. As a result of these failures, Customer X, first through BD1, then through another introducing broker (“BD2”), and later as a direct customer of the firm, engaged in various forms of potentially manipulative trading, including, but not limited to, layering¹ and spoofing.²

¹ Layering is a form of market manipulation that typically includes placement of multiple limit orders on one side of the market at various price levels at or away from the National Best Bid and Offer (“NBBO”) that are intended to create the appearance of a change in the levels of supply and demand. In some instances, layering involves placing multiple limit orders at the same or varying prices across multiple exchanges or other trading venues. An order is then executed on the opposite side of the market and most, if not all, of the multiple limit orders are immediately cancelled. The purpose of the multiple limit orders that are subsequently cancelled is to induce, or trick, other market participants to enter orders due to the appearance of interest created by the orders such that the trader is able to receive a more favorable execution on the opposite side of the market.

² Similar to layering, spoofing involves placement of non-bona fide orders, generally inside the existing NBBO, with the intention of briefly triggering some type of response from another market participant, followed by cancellation of the non-bona fide order, and the entry of an order on the other side of the market.

Accordingly, during the period of June 15, 2015 through June 1, 2018 (the “Relevant Period”), Sanzone violated Phlx Rules 748 and 707.

FACTS AND VIOLATIVE CONDUCT

Applicable Rules

1. Phlx Rule 748 requires, *inter alia*, members to establish, maintain, and enforce WSPs, and a system for applying such WSPs, to supervise the types of businesses in which members engage in and to supervise the activities of all registered representatives, employees, and associated persons. The WSPs and the system for applying such procedures must be reasonably designed to prevent and detect, insofar as practicable, violations of the applicable securities laws and regulations, including the Phlx By-Laws and rules. Phlx Rule 748 also requires that persons with supervisory control reasonably discharge their duties and obligations in connection with such supervision and control to prevent and detect, insofar as practicable, violations of the applicable securities laws and regulations, including the Phlx By-Laws and rules.
2. Phlx Rule 707 prohibits an associated person from engaging in conduct inconsistent with just and equitable principles of trade. A violation of Phlx Rule 748 also constitutes a violation of Phlx Rule 707.
3. In 2010, the SEC adopted the Market Access Rule to require that broker-dealers with market access appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system. The Market Access Rule establishes specific requirements for broker-dealers providing market access, including that such firms establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, or other risks of its business. The Market Access Rule further specifies the required elements for risk management controls and supervisory procedures and mandates that the controls and procedures be under the direct and exclusive control of the broker-dealer.
4. In the Adopting Release of the Market Access Rule, as well as subsequent guidance, the SEC explained that the Market Access Rule requires market access providers to perform “appropriate due diligence” on their market access control vendors. The due diligence may include, *inter alia*, a review of publicly available information about the ownership and material business relationships of market access control vendors and market access customers, follow up on any information that may indicate a lack of independence between market access control vendors and market access customers, and requests to market access control vendors and market access customers to certify

their independence from each other.³

*Sanzone and his Business Partner Launched Bayes's
Direct Market Access Business Without Conducting Appropriate
Due Diligence on the Market Access Control Vendor, BD1 and Customer X*

5. Between November 2014 and July 2, 2018, Bayes was a small firm that provided direct market access to U.S. securities markets for several of its customers. Prior to November 2014, the firm conducted an agency-only business for a handful of institutional customers. The firm did not provide direct market access, and its business was struggling financially.
6. Sanzone and his Business Partner were two primary decision-makers in all aspects of the firm's business between November 2014 and July 2, 2018. Sanzone was both an owner of the firm and the firm's Head of Trading. He succeeded his Business Partner as the firm's CEO and CCO in December 2016. Before Sanzone became the firm's CEO and CCO, his Business Partner had delegated supervisory responsibility to Sanzone for Bayes's supervisory program as it related to supervision of customer trading and compliance with the Market Access Rule.
7. In mid-2014, the Market Access Control Vendor presented the firm with a potentially lucrative package deal: Bayes would receive order flow routed from BD1 and its customers, including Customer X, so long as it used the Market Access Control Vendor's proprietary risk management system and controls to manage the firm's direct market access business. The package deal proposed by the Market Access Control Vendor should have raised concerns for Sanzone and his Business Partner about potential conflicts of interest between the Market Access Control Vendor and Customer X per the guidance set forth in the Adopting Release of the Market Access Rule.
8. For instance, prior to Bayes providing direct market access to BD1 and Customer X, Sanzone and his Business Partner received emails and other documents showing that the Market Access Control Vendor and Customer X were under common ownership and control. Neither Sanzone nor his Business Partner, however, took reasonable steps to mitigate the potential conflict of interest posed by allowing Customer X to route order flow through the Market Access Control Vendor's proprietary pre-trade risk controls.
9. In November 2014, without conducting appropriate due diligence with respect to the potential conflict of interest between the Market Access Control Vendor and Customer X, nor collecting any due diligence documentation relating to BD1 or BD1's unregistered foreign-day trading customers, Sanzone and his Business Partner

³ E.g., SEC, *Risk Management Controls for Brokers or Dealers with Market Access*, Release No. 34-63241 (Nov. 3, 2010); see also SEC Division of Trading and Markets, *Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access* (Apr. 15, 2014), available at <https://www.sec.gov/divisions/marketreg/faq-15c-5-risk-management-controls-bd.htm>.

launched Bayes's direct market access business pursuant to the package deal proposed by the Market Access Control Vendor. Thus, the Bayes began providing direct market access to day-trading groups that routed orders through BD1, including Customer X.

10. BD1, and in particular Customer X, immediately became the primary source of order flow and revenue to Bayes. In 2015 and 2016, order flow from BD1 generated over 92 percent of the firm's total commissions, with order flow from Customer X alone constituting approximately 60 percent of that order flow. The trading volume resulted in discounts and preferential pricing at various exchanges, which made this order flow more lucrative to the firm. Further, the revenues earned by the firm routing order flow from BD1, including Customer X, dwarfed revenues it earned from other customers.

*Sanzone Failed to Establish and Maintain
a Reasonably Designed Supervisory System and WSPs
to Manage and Supervise the Firm's Direct Market Access Business*

11. Pursuant to Bayes's December 2014 WSPs, Sanzone's Business Partner, the firm's then-CEO and CCO, was responsible for establishing and maintaining the firm's supervisory system and policies and procedures for all areas of the firm, including the direct market access business. Starting in November 2014, however, Sanzone's Business Partner delegated to, and wholly relied on, Sanzone to establish the firm's risk controls under the Market Access Rule, as well as to supervise and conduct trade surveillance of Bayes's direct market access business and customer trading activity. Sanzone was therefore required to take reasonable steps to achieve compliance with applicable Phlx rules and federal securities laws and regulations, by establishing and maintaining the firm's supervisory system, policies and procedures with respect to the firm's direct market access business, including: the firm's WSPs; to reasonably investigate red flags of potential misconduct (including potentially manipulative trading); and to take reasonable action when such misconduct has occurred.
12. Before Sanzone and his Business Partner launched the firm's direct market access business, FINRA had issued public guidance regarding risks related to foreign day traders manipulating U.S. markets.⁴
13. Sanzone, like his Business Partner, had no experience in establishing or managing a direct market access business. Sanzone also had no experience reviewing or supervising trade surveillance of high-volume, direct market access customer order flow or the order flow of foreign day traders.
14. In establishing the firm's market access controls and throughout the Relevant Period, Sanzone instead relied on guidance from the Market Access Control Vendor when setting its pre-trade controls to filter trading activity of direct market access

⁴ See FINRA's 2013 Priorities Letter (Jan. 11, 2013); see also FINRA's 2014 Priorities Letter (Jan. 2, 2014).

customers, including Customer X. Further, the Market Access Control Vendor had the ability, without requiring input or approval from Bayes, to suspend or re-enable access at an account level through its platform. The Market Access Control Vendor also had the exclusive ability to make intraday adjustments to the financial management controls within its platform. Moreover, Sanzone relied on guidance from BD1 with respect to setting the firm's market access controls and limits for individual accounts, including specifically with respect to Customer X.

15. Further, Bayes's supervisory system relied on (a) the Market Access Control Vendor's pre-trade risk controls and (b) Sanzone's manual review of reports generated by the vendor of rejected orders as the firm's supervisory system with respect to potentially manipulative trading activity by direct market access customers. The rejected orders, however, numbered in the millions. For example, from December 2014 through January 2016 alone, there were more than 5.4 million rejected orders on a pre-trade basis from BD1, a substantial portion of which may have related to potential layering or spoofing activity from Customer X. Despite the massive volume of rejected orders, there is only one documented instance in which Bayes contacted BD1 in relation to a review of a rejection report.
16. Neither Sanzone nor anyone else at Bayes conducted post-trade reviews for potentially manipulative trading by direct market access customers until approximately May 2016, after FINRA alerted the firm of its obligation to do so. Thereafter, Bayes hired a compliance analyst to be responsible for implementing and conducting the firm's post-trade reviews. The analyst, however, had no relevant experience or background in trade surveillance. The analyst reported directly to Sanzone, but Sanzone failed to reasonably supervise him. Sanzone never instructed the analyst to conduct testing of the post-trade reviews or their functionality. Nor did Sanzone know whether the analyst had ever conducted such testing. In addition to implementing the post-trade reviews, the analyst was also responsible for performing such reviews. Despite the analyst's lack of experience in trade surveillance, Sanzone failed to train him properly to perform such reviews.

Sanzone Failed to Reasonably Supervise Order Flow from BD1

17. In September 2015, less than a year after launching its direct market access business, Bayes started to receive the first of many regulatory inquiries regarding the firm's market access controls, supervisory procedures, and surveillances to detect and prevent potentially manipulative trading activity by direct market access customers.
18. Then, in February 2016, BD1 was censured and fined in settled disciplinary proceedings brought by FINRA and multiple exchange SROs for, *inter alia*, BD1's failure to supervise direct market access customers for potential layering, spoofing, and other trading violations. The disciplinary proceedings against BD1 were public, yet Bayes failed to perform any additional scrutiny of BD1's customers' account activity routed through Bayes.

19. On February 29, 2016, FINRA notified Bayes, including Sanzone, that it had determined that the firm's pre-trade risk management controls were not in compliance with the Market Access Rule, that the firm did not conduct reasonable post-trade analysis, and that the firm had failed to demonstrate direct and exclusive control of its direct market access business.
20. In July 2016, the firm updated its WSPs to include, among other things, a Market Access Committee ("MAC"), led by Sanzone, which became responsible for the firm's compliance with the Market Access Rule. The MAC was responsible for, *inter alia*, ensuring that no material business or other relationship with a market access customer existed that could interfere with the provision of effective risk management controls to Bayes. Despite the new WSPs, his role as the leader of the MAC, and information that should have put him on notice of the common ownership and control of the Market Access Control Vendor and Customer X, Sanzone continued to fail to take reasonable steps to ensure that the Market Access Control Vendor was independent from Customer X.
21. Despite the multiple red flags regarding potentially manipulative activity as described above, all of which Sanzone knew or should have known related to potentially manipulative activity involving order flow routed through BD1, Sanzone failed to perform reasonable supervisory oversight on order flow from BD1. Sanzone, therefore, allowed the potentially manipulative activity to continue.

Sanzone Failed to Reasonably Supervise Order Flow from BD2

22. In October 2016, Customer X moved its account from BD1 to BD2. Sanzone and his Business Partner thereupon established a market access arrangement with BD2, and BD2 started sending order flow to Bayes, including from Customer X.
23. BD2 had previously been censured and fined in a settled disciplinary proceeding brought by an exchange SRO in February 2015 for, *inter alia*, failing to have reasonable supervisory procedures and controls in place designed to achieve compliance with rules against potentially manipulative trading practices by market access customers. The disciplinary proceeding against BD2 was also public, yet Bayes failed to perform any additional scrutiny of BD2's customers' account activity routed through Bayes.
24. Despite the disciplinary proceeding against BD2, which Sanzone knew or should have known about, Sanzone failed to perform appropriate due diligence or supervisory oversight on order flow from BD2. As a result, Bayes continued to allow its direct market access customers to flood U.S. trading markets with potentially manipulative activity.

*Despite Red Flags, Sanzone Agreed to Take on
Customer X as a Direct Customer of Bayes*

25. In December 2016, Sanzone became the firm's CEO, a position he held through June 2018. From December 2016 through the end of the Relevant Period, as the firm's CEO, Sanzone retained responsibility for supervising the firm's direct market access business and trading activity.
26. In or about January 2017, BD2 requested that Bayes agree to have Customer X route its order flow directly to Bayes, rather than through BD2, because BD2 stated that it was concerned about risks relating to Customer X's order flow.
27. Despite concerns about potentially problematic order flow from Customer X and knowledge of the common ownership of Customer X and the Market Access Control Vendor, Sanzone agreed to take on Customer X as a direct customer of the firm. As a result, Customer X continued to route potentially manipulative trades to U.S. trading markets through Bayes.
28. Moreover, after onboarding Customer X as a direct customer, Sanzone did not make reasonable changes to the risk management controls supplied by the Market Access Control Vendor as they applied to Customer X's trading.
29. It was only in May 2017, after Sanzone and others at Bayes attended a meeting with FINRA and several exchange SROs regarding Customer X's problematic order flow, when Bayes terminated its relationship with Customer X. Bayes nonetheless continued providing direct market access to other customers who also routed potentially manipulative trades to U.S. trading markets until the firm ceased to operate in July 2018.
30. Based on the foregoing, during the Relevant Period, Sanzone violated Phlx Rules 748 and 707.

B. I also consent to the imposition of the following sanction:

A permanent bar in all capacities.

I understand that if I am barred or suspended from associating with any Phlx member, I become subject to a statutory disqualification as that term is defined in Section 3(a)(39) of the Securities Exchange Act of 1934, as amended. Accordingly, I may not be associated with any Phlx member in any capacity, including clerical or ministerial functions, during the period of the bar or suspension. *See* Phlx Rule 8310 and IM-8310-1.

The sanction imposed herein shall be effective on a date set by FINRA staff. Pursuant to IM-8310-3(e), a bar or expulsion shall become effective upon approval or acceptance of this AWC.

II.

WAIVER OF PROCEDURAL RIGHTS

I specifically and voluntarily waive the following rights granted under Phlx's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against me;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the Exchange Review Council and then to the SEC and a U.S. Court of Appeals.

Further, I specifically and voluntarily waive any right to claim bias or prejudice of the Chief Regulatory Officer, the Exchange Review Council, or any member of the Exchange Review Council, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

I further specifically and voluntarily waive any right to claim that a person violated the *ex parte* prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

I understand that:

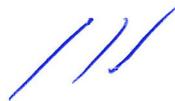
- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by FINRA's Department of Enforcement and the Exchange Review Council, the Review Subcommittee, or the Office of Disciplinary Affairs ("ODA"), pursuant to Phlx Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against me; and
- C. If accepted:
 - 1. This AWC will become part of my permanent disciplinary record and may be considered in any future action brought by Phlx or any other regulator

against me;

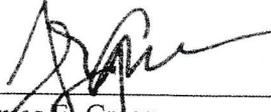
2. Phlx may release this AWC or make a public announcement concerning this agreement and the subject matter thereof in accordance with Phlx Rule 8310 and IM-8310-3; and
3. I may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. I may not take any position in any proceeding brought by or on behalf of Phlx, or to which Phlx is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects my right to take legal or factual positions in litigation or other legal proceedings in which Phlx is not a party.

I certify that I have read and understand all the provisions of this AWC and have been given a full opportunity to ask questions about it; that I have agreed to the AWC's provisions voluntarily; and no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce me to submit it.

23 May 2020
Date


Douglas A. Sanzone
Respondent

Reviewed by:


James E. Green
Counsel for Respondent
226 Sheridan Road
Winnetka, Illinois 60093

Accepted by Phlx:

May 29, 2020
Date

Elyse D. Kovar
Elyse D. Kovar, Senior Counsel
Robert A. Gomez, Principal Counsel
FINRA Department of Enforcement

Signed on behalf of Phlx, by delegated
authority from the Director of ODA