

**THE NEW YORK STOCK EXCHANGE
OFFICE OF THE HEARING BOARD**

DEPARTMENT OF MARKET REGULATION,

Complainant,

v.

LEK SECURITIES CORPORATION,

Respondent.

HEARING BOARD DECISION

Proceeding No. 20110270056
Hearing Officer—MAD

November 14, 2013

Respondent Lek Securities Corporation (“LSC”) is censured and fined a total of \$775,000:

- **For violating NYSE Rules 476(a)(6) and 401, as described in Charges I and II, by introducing for execution on the NYSE odd-lot orders in a pattern of day trading that were prohibited by the NYSE’s odd-lot rules and policies; and for violating NYSE Rule 405(1), as described in Charge III, by failing to learn the essential facts relative to certain of its customers and its customers’ orders that it introduced for execution on the NYSE, LSC is censured and fined \$50,000.**
- **For willfully violating Section 12(k)(4) of the Securities Exchange Act of 1934 (“Exchange Act”), as described in Charge IV, and violating NYSE Rule 401, as described in Charge V, by introducing for execution on the NYSE short sale transactions in the common stock of financial services companies in contravention of the Securities and Exchange Commission’s September 18, 2008 Emergency Order, LSC is censured and fined \$75,000.**
- **For willfully violating Rules 204T(a), 204(a), 204T(b), 204T(c) and 204(c) of Regulation SHO under the Exchange Act, as described in Charges VI through IX, by (i) failing to timely close out fail-to-deliver positions in certain equity securities; (ii) accepting certain customer short sale orders in equity securities for which it had open fail-to-deliver positions while LSC and the customer were in the “penalty box”; and (iii) failing to timely notify its customers that it had open fail-to-deliver positions that had not been closed out, LSC is censured and fined \$50,000.**
- **For violating (i) NYSE Rule 70.40, as described in Charge X, by conducting “upstairs” operations in its booth premises on the NYSE**

Floor without prior approval from NYSE Regulation to conduct such business, and without adopting written procedures that were approved by NYSE Regulation; and (ii) NYSE Rule 2010, as described in Charge XI, by continuing to conduct, after being instructed by the NYSE to immediately cease and desist such activity, an “upstairs” operation from its booth premises on the NYSE Floor without having received regulatory approval, LSC is censured and fined \$100,000.

- **For violating NYSE Rule 123C, as described in Charge XII, by failing to comply with requirements governing the cancellation of market-on-close and limit-on-close orders, LSC is censured.**
- **For violating NYSE Rule 342, as described in Charge XIII, by failing to reasonably supervise and implement adequate controls, including a separate system of follow-up and review, designed to achieve compliance with NYSE Rules and policies, pertaining to the above violations, as well as “spoofing” activity, wash trading, and marking the close, LSC is censured and fined \$500,000.**

Appearances

For the DEPARTMENT OF MARKET REGULATION, Complainant, Michael W. Bautz, Esq., Steven M. Tanner, Esq., Lara M. Posner, Esq., New York, New York.

For Lek Securities Corporation, Respondent, Howard Schiffman, Esq., Ida Wurzinger Draim, Esq., Eric A. Bensky, Esq., and Rebecca Bianchi, Esq., SCHULTE ROTH & ZABEL, LLP, Washington, District of Columbia.

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DECISION

Lek Securities Corporation (“LSC”), a broker-dealer registered with the New York Stock Exchange (“NYSE”), engages in executing and clearing orders in equity securities, options, and futures on behalf of professional and institutional customers. LSC provides electronic access to its customers through its proprietary order management, routing, and execution system, which permits its customers to electronically access the various stock markets. This case began as a result of NYSE Regulation’s examination of LSC’s electronic order flow.

As a result of several investigations by NYSE Regulation and the Financial Industry Regulatory Authority (“FINRA”), FINRA’s Department of Market Regulation filed a Charging Memorandum against LSC, alleging 13 violations of NYSE Rules and policies, and a federal securities law.¹ The 13 Charges relate to six distinct topics: (1) LSC’s introduction of odd-lot orders² executed in a pattern of day trading;³ (2) short sale transactions executed by LSC’s customers while the Securities and Exchange Commission’s (“SEC”) September 18, 2008 Emergency Order (“September 18th Order”) was in effect; (3) LSC’s compliance with the requirements of Regulation SHO; (4) LSC’s routing of orders from the NYSE Floor to away markets (“BlueLine trading”) without prior approval; (5) LSC’s improper cancellations of Market-On-Close (“MOC”)⁴ and Limit-On-Close (“LOC”)⁵ orders; and (6) LSC’s supervisory systems and procedures.

¹ FINRA is handling this matter on behalf of NYSE Regulation pursuant to a Regulatory Services Agreement among NYSE Group, Inc., New York Stock Exchange LLC, NYSE Arca, Inc., NYSE Amex LLC (now NYSE MKT LLC), NYSE Regulation, and FINRA, which became effective June 14, 2010.

² A standard unit of trading, a round lot or a full lot, is generally 100 shares. An odd-lot order is an order for a size less than the standard unit of trading. NYSE Rule 55.

³ The NYSE defined “day trading” as the purchasing and selling, or selling and purchasing, of the same security on the same day. NYSE Rule 431(f)(8)(B)(i).

⁴ Market-On-Close orders are orders that “are to be executed in their entirety at the closing price. If not executed due to a trading halt or by its terms, e.g., buy minus or sell plus, the order will be cancelled.” NYSE Rule 123C(1).

LSC denies liability for the Charges and raises a number of defenses. LSC's defenses include the following: (1) certain NYSE rules either did not exist or were unenforceable during the time in question; (2) Market Regulation misapplied or misinterpreted the applicable rules and regulations; and (3) LSC properly allocated supervisory responsibility to its introducing broker through its clearing agreement. After careful consideration, the Hearing Panel rejects LSC's defenses.

The Hearing Panel finds that LSC committed the violations alleged in the Charging Memorandum and imposes sanctions. The findings and conclusions of the Hearing Panel are rooted in its determination that LSC failed in its obligation to know its customers, which prevented it from reasonably supervising its customer order flow. Many LSC customers were professional trading firms engaged in diverse short-term trading strategies. LSC was slow to implement controls for this type of order flow and in some cases failed altogether. LSC's supervisory failures also led to specific violations of the Securities Exchange Act of 1934 ("Exchange Act") and the NYSE rules. Each of LSC's violations, grouped according to the above six topics, is addressed below.

I. SUMMARY OF CHARGES

On February 21, 2012, Market Regulation filed the Charging Memorandum against LSC. On April 25, 2012, LSC filed its Answer and requested a hearing. The hearing was held in New York City on February 19-28, 2013.⁵ The Charges, grouped by topic, allege that LSC:

⁵ Limit-On-Close orders are orders that are "entered for execution at the closing price, provided that the closing price is at or within the limit specified." NYSE Rule 123C(2).

⁶ The Parties filed post-hearing briefs and findings of fact on April 19, 2013. Closing arguments were held on June 24, 2013. The SEC issued a No-Action Letter, *Request for No-Action Relief with Respect to Multi-day Pre-fail and Post-fail Credit under Rule 204 of Regulation SHO*, dated September 6, 2013 (hereinafter "No-Action Letter"). LSC filed a supplemental brief addressing the SEC's No-Action Letter on October 14, 2013, and Market Regulation filed its brief on October 21, 2013.

Odd-Lot Orders

- violated NYSE Rule 476(a)(6) by engaging in conduct inconsistent with just and equitable principles of trade in that it introduced for execution on the NYSE odd-lot orders in a pattern of day trading that were prohibited by the NYSE's odd-lot rules and policies;
- violated NYSE Rule 401 by failing to adhere to the principles of good business practice in that it introduced for execution on the NYSE odd-lot orders in a pattern of day trading that were prohibited by the NYSE's odd-lot rules and policies;
- violated NYSE Rule 405(1) by failing to learn the essential facts relative to certain of its customers and its customers' orders that it introduced for execution on the NYSE;

September 18th Order

- willfully violated Section 12(k)(4) of the Exchange Act by introducing for execution on the NYSE short sale transactions in the common stock of certain financial services companies in contravention of the September 18th Order;
- violated NYSE Rule 401 by failing to adhere to the principles of good business practice in that it introduced for execution on the NYSE a short sale transaction in the common stock of certain financial services companies in violation of the September 18th Order;

Regulation SHO

- willfully violated Rule 204T(a) of Regulation SHO under the Exchange Act by failing to timely close out fail-to-deliver positions ("Fails")⁷ in certain equity securities;
- willfully violated Rule 204(a) of Regulation SHO by failing to timely close out Fails in certain equity securities;
- willfully violated Rule 204T(b) of Regulation SHO by accepting certain customer short sale orders in equity securities for which it had open Fails while LSC and the customer were in the "penalty box", as the customer had not first borrowed such securities or entered into a bona fide arrangement to borrow the securities;
- willfully violated Rules 204T(c) and 204(c) of Regulation SHO by failing to timely notify its customers that it had open Fails that had not been closed out in accordance with Rules 204T(a) and 204(a);

⁷ Fails occur when either sellers fail to deliver or buyers fail to receive securities in time to settle a trade.

BlueLine Trading

- violated NYSE Rule 70.40 by conducting “upstairs” operations in its booth premises on the NYSE Floor without:
 - a) obtaining the required prior approval from NYSE Regulation to conduct such business;
 - b) adopting and implementing comprehensive written procedures and guidelines governing the conduct and supervision of such business; and
 - c) obtaining the required prior approval of its written procedures and guidelines from NYSE Regulation;
- violated NYSE Rule 2010 by failing to observe high standards of commercial honor and just and equitable principles of trade by continuing to conduct, after being instructed by the NYSE’s Division of Market Surveillance to immediately cease and desist such activity, an “upstairs” operation from its booth premises on the NYSE Floor without having received regulatory approval;

Market-On-Close And Limit-On-Close Orders

- violated NYSE Rule 123C by failing to comply with requirements governing the cancellation of MOC and LOC orders; and

Supervisory Systems And Procedures

- violated NYSE Rule 342 by failing to reasonably supervise and implement adequate controls, including a separate system of follow-up and review, designed to achieve compliance with NYSE Rules and policies, pertaining to:
 - a) odd-lot orders;
 - b) the September 18th Order;
 - c) compliance with Rules 204T and 204 of Regulation SHO;
 - d) conducting “upstairs” operations from its booth premises on the NYSE Floor without the required regulatory approval and without adopting the required stand-alone written supervisory procedures;
 - e) MOC and LOC orders; and
 - f) review of its electronic customer order flow to detect potential rule violations in connection with:
 - i) “spoofing” activity;
 - ii) wash trading; and
 - iii) marking the close.

II. FINDINGS OF FACT

A. Lek Securities Corporation

LSC is a registered broker-dealer,⁸ founded in 1990 by Samuel Lek (“Lek”), its Chief Executive Officer and Chief Compliance Officer (“CCO”). LSC is exclusively engaged in executing and clearing orders in equity securities, options, and futures on behalf of professional traders and institutional customers.⁹ LSC has a proprietary electronic order entry system, the ROX system (“ROX”),¹⁰ which enables its customers to route their orders through NYSE’s Super Designated Turnaround System (“SuperDOT”).¹¹ Although almost all of the customer orders are self-directed, LSC executes the orders and controls the lines from which the orders are transmitted.¹² To assist in its execution business, LSC became a member of National Securities Clearing Corporation (“NSCC”).¹³

B. Odd-Lot Orders

1. Regulatory Background

In 1991, the NYSE introduced a new odd-lot order system.¹⁴ The new odd-lot order system was designed to serve as an efficient and inexpensive order execution system for smaller

⁸ LSC is registered with the NYSE, NYSE Arca, FINRA, Commodity Futures Trading Commission, the SEC, and approximately 13 other regulatory organizations. Charging Memorandum ¶ 1; Answer ¶ 1; Hearing Tr. (Lek) at 1752.

⁹ Charging Memorandum ¶ 1; Answer ¶ 1.

¹⁰ “SuperDOT” was an electronic order routing system used by NYSE members to send orders directly to the trading post where the security was traded. NYSE Rule 123B.

¹¹ JX-9, at 2; JX-13, at 2. The ROX System began in 1992. Hearing Tr. (Lek) at 2317.

¹² JX-29, at 13; Hearing Tr. (Lek) at 1025, 2217.

¹³ Hearing Tr. (Lek) at 1751. NSCC provides clearing, settlement, risk management, central counterparty services and a guarantee of completion for certain transactions for virtually all broker-to-broker trades involving equities. It also nets trades and payments among its participants, thereby reducing the amount of securities and payments that need to be exchanged. CX-29, *Amendments to Regulation SHO*, Exchange Act Rel. No. 34-58773, at 6, n.14, 16, n.46.

¹⁴ NYSE Information Memo (“IM”) 91-29, *Odd-Lot Trading Practices* (July 25, 1991). The NYSE’s odd-lot system was decommissioned on July 27, 2010. See Exchange Act Rel. No. 34-62578.

investors who tend to place odd-lot orders.¹⁵ Under this system, odd-lot orders did not enter the NYSE's round-lot auction market. Instead, the NYSE's SuperDOT automatically assigned the specialist in the security to be the contra side of an odd-lot trade and execute the orders in accordance with NYSE Rule 124 pricing procedures.¹⁶

The odd-lot order system was dependent on the specialists' willingness to provide execution and price guarantees to odd-lot orders.¹⁷ Misuse of the system, such as using "the system as a day trading vehicle or as part of program trades to capture the bid-ask spread through odd-lot limit orders could reduce specialists' willingness to provide cost-efficient executions of odd-lot limit orders."¹⁸ To ensure that the NYSE's odd-lot system was used in a manner consistent with traditional odd-lot practices, the NYSE prohibited certain trading practices in the odd-lot system, including any pattern of odd-lot limit order activity that would suggest day trading.¹⁹ NYSE warned members that the new odd-lot order system "is not viewed as, and cannot be used as, a professional trading vehicle."²⁰

¹⁵ See IM 91-29; CX-3, IM 94-14, *Odd-Lot Trading Practices* (Apr. 18, 1994); CX-4, IM 04-14, *Odd-Lot Order Handling And Prohibited Trading Practices - Exchange Rules 124 And 411(B); "Know Your Customer" Requirements - Exchange Rule 405* (Mar. 19, 2004); CX-5, *Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Granting Accelerated Approval to Amendment No. 2 of a Proposed Rule Change Regarding an Information Memo on Odd-Lot Trading Practices*, Exchange Act Rel. No. 34-33678 (Feb. 24, 1994).

¹⁶ See NYSE IM 04-32, *Odd-Lot Pricing (Rule 124)* (June 17, 2004); NYSE Rule 124. Pursuant to NYSE Rule 124, the execution of odd-lot limit orders should occur at the price of the first round-lot transaction on the NYSE in the subject security after receipt of the order by the system, which was at or better than the limit price. The execution of odd-lot market orders would generally be at the price of the next round-lot transaction on the NYSE in the subject security following receipt of the order.

¹⁷ CX-5, at 3.

¹⁸ *Id.*

¹⁹ IM 91-29, IM 92-25; CX-3, CX-4, CX-5.

²⁰ CX-3, at 1.

2. LSC's Violative Odd-Lot Orders

LSC introduced odd-lot orders in a pattern of day trading for execution on the NYSE.²¹ The majority of the orders were limit orders that it received from Prestige Capital, LLC ("Prestige") and Pacific Coast Traders ("Pacific Coast"), in a pattern of day trading.²² Prestige and Pacific Coast, non-members of the NYSE, were customers of Dimension Securities LLC ("Dimension"), a non-member, introducing broker of LSC.²³ Prestige and Pacific Coast were also customers of LSC for order execution purposes. Each had completed LSC new account forms and agreements, and was assigned LSC account identifiers.²⁴

From April 1 to May 18, 2007, Prestige routed approximately 84,537 odd-lot orders in numerous securities to the NYSE in a pattern of day trading.²⁵ For example, on April 11, 2007, LSC transmitted to the NYSE approximately 1,619 odd-lot orders, 99% of which were limit orders, from Prestige in more than 200 securities in a pattern of day trading.²⁶ Each order was routed to the NYSE via ROX using mnemonics provided by LSC.²⁷

During the same time period, Pacific Coast routed approximately 84,510 odd-lot orders in numerous securities to the NYSE in a pattern of day trading.²⁸ For example,

²¹ CX-16-23, SOD Detail Data Extract Reports ("SOD Report"). SOD is an NYSE electronic database, an electronic record of all orders and executions. Hearing Tr. (Dalton) at 229. On the SOD Reports, "DL" represents day limit orders, and "M" represents market orders. Hearing Tr. (Dalton) at 234.

²² CX-16-23.

²³ JX-9, at 1-2.

²⁴ See CX-120, CX-121. Prestige was assigned account acronym "PC476A" and branch code "PKA." CX-23; JX-9; CX-120, at 2; Hearing Tr. (Lek) at 2212. This coding allowed LSC to identify Prestige's order flow. Hearing Tr. (Lek) at 920, 2209, 2212. The account acronym for Pacific Coast was PCKN. CX-22; JX-9; CX-121(a). This coding also allowed LSC to identify Pacific Coast's order flow. Hearing Tr. (Lek) at 920, 2209, 2212.

²⁵ CX-23; Hearing Tr. (Dalton) at 285-86.

²⁶ CX-8, CX-10; Hearing Tr. (Dalton) at 268-70; Hearing Tr. (Dalton) at 271-74.

²⁷ CX-23; JX-2, JX-9, at 4. The mnemonics assigned to Prestige included DIM, MNA and MNB. JX-2; Hearing Tr. (Dalton) at 271.

²⁸ CX-22; Hearing Tr. (Dalton) at 284-85.

on May 8, 2007, LSC transmitted to the NYSE approximately 2,604 odd-lot orders, 99% of which were limit orders, from Pacific Coast in a pattern of day trading.²⁹ Each order was routed to the NYSE via ROX using a mnemonic provided by LSC.³⁰

Prestige and Pacific Coast realized a combined profit, including commissions, of approximately \$146,000 from their odd-lot day trading.³¹ Because an NYSE Specialist acted as the contra party in odd-lot orders, Prestige's and Pacific Coast's profit was at the expense of an NYSE Specialist firm.

C. The September 18th Order

1. Regulatory Background

On September 18, 2008, the SEC issued the September 18th Order to address its continuing concern that short selling in certain securities may be causing sudden and excessive fluctuations of the prices of such securities so as to threaten fair and orderly markets.³² The September 18th Order prohibited the short selling of publicly traded common stock of 799 financial firms ("Included Financial Firms").³³ The September 18th Order was initially set to expire on October 2, 2008; however, the SEC extended its expiration date to October 8, 2008, three business days after the President of the United States signed the Emergency Economic

²⁹ CX-13, CX-15.

³⁰ CX-22; JX-9, at 2. The mnemonics assigned to Pacific Coast were PCT and PCU. JX-9; Hearing Tr. (Dalton) at 280.

³¹ CX-22, CX-23; Hearing Tr. (Dalton) at 281-82. LSC's profit on the above transactions totaled approximately \$7,000. Hearing Tr. (Lek) at 1899-1900.

³² CX-129, at 1, *Emergency Order Pursuant To Section 12(k)(2) of the Securities Exchange Act Of 1934 Taking Temporary Action To Respond To Market Developments*, Exchange Act Rel. No. 34-58592 (Sept. 18, 2008).

³³ CX-129. Additions and deletions were made to this initial list and published each day on the websites of the relevant exchanges. CX-142.

Stabilization Act of 2008 (H.R. 1424) on October 3, 2008.³⁴ Accordingly, the September 18th Order was in effect from September 19 through October 8, 2008.³⁵

2. LSC's Short Sales In Violation Of The September 18th Order

From September 19 through October 8, 2008, LSC effected approximately 6,468 short sale transactions (related to approximately 2,822 orders) on behalf of its customers in the common stock of certain Included Financial Firms in contravention of the September 18th Order.³⁶ The short sale transactions bypassed LSC's systematic controls for two reasons. First, LSC exempted certain customers when it created its controls to comply with the September 18th Order.³⁷ The exempted customers included: Dimension; Dimension Brokerage, LLC; Dimension Trading International; Diamond Carter Securities; Diamond Carter Trading, LLC; and Group One.³⁸

Second, when the SEC extended the September 18th Order, LSC neglected to change the expiration date in its systematic controls to the new October 8 expiration date.³⁹ From October 3 through October 8, 2008, no short sale order in the security of an Included Financial Firm was subject to LSC's systemic controls. Approximately 1,309 short sale transactions (related to

³⁴ CX-131, *Order Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Exchange Act Rel. No. 34-58723 (Oct. 2, 2008). The SEC made no further changes to the September 18th Order.

³⁵ Charging Memorandum ¶ 50; Answer ¶ 50.

³⁶ CX-26(a)-(m), spreadsheets provided by LSC of short sales of Included Financial Firms effected by LSC from September 19 through October 8, 2008; CX-125, e-mails and attachments from LSC to NYSE Regulation and Market Regulation; JX-13, letter to NYSE Regulation from LSC (June 3, 2009); Hearing Tr. (Brown) at 165-66.

³⁷ JX-20, at 6.

³⁸ JX-20, at 5-6. LSC's programing code reflects that the names of the exempted firms were typed into the computer coding to exclude those firms' transactions from the screening process. Hearing Tr. (Lek) at 959-60.

³⁹ JX-20, at 9; Hearing Tr. (Lek) at 961-62.

approximately 546 orders) of the 6,468 short sale transactions in securities of Included Financial Firms occurred between October 3 and October 8, 2008.⁴⁰

D. Regulation SHO

1. Regulatory Background

The SEC adopted Temporary Rule 204T of Regulation SHO as an “interim final temporary rule” on September 17, 2008,⁴¹ in response to continuing concerns regarding Fails⁴² and potentially abusive “naked” short selling⁴³ of equity securities. To address these concerns, Rule 204T imposed on participants of registered clearing agencies: (1) stricter close-out requirements under Regulation SHO for Fails resulting from sales of equity securities: (2) a penalty for failing to comply with the closing-out provisions: and (3) a requirement to notify customers of its Fails.

Rule 204T became permanent on July 31, 2009, and is now Rule 204 of Regulation SHO.⁴⁴ In adopting Rule 204, the SEC maintained the structure of Rule 204T with limited modifications.

⁴⁰ CX-26(k)-(m).

⁴¹ RX-18, *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Exchange Act Rel. No. 34-58572 (Sept. 17, 2008); RX-29, *Amendments to Regulation SHO*, Exchange Act Rel. No. 34-58773 (Oct. 17, 2008).

⁴² Participants of registered clearing agencies must deliver securities to a registered clearing agency for clearance and settlement on a sale in any equity security by settlement date, i.e., “the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.” Rule 204(g)(1). Generally, transactions in equity securities settle on the third business day after a trade is executed (T+3). Fails occur when a seller does not deliver securities to the buyer on settlement date.

⁴³ A “naked” short selling refers to selling short without having borrowed the securities to make delivery. RX-29, *Amendments to Regulation SHO*, Exchange Act Rel. No. 34-58773, at 3, n.3.

⁴⁴ *Amendments to Regulation SHO*, Exchange Act Rel. No. 34-60388 (July 31, 2009).

2. LSC Failed To Timely Close Out Fail-to-Deliver Positions

Participants of registered clearing agencies receive notification of their net security delivery obligations from the NSCC's Continuous Net Settlement ("CNS") system.⁴⁵ CNS nets participants' security obligations on a daily basis to one net long and short position in each security, and generates reports that provide participants with a complete record of security positions.⁴⁶ Accordingly, participants such as LSC are aware of their CNS Fails in each security.⁴⁷ Rules 204T and 204 require participants to close out their Fails to CNS within specific time periods.

(a) Long Sales

LSC had outstanding CNS Fails related to customer long sales in the following securities:

HTM, GW, NG, and AZ.⁴⁸

HTM

From October 31 to November 17, 2008, LSC had an outstanding Fail in HTM of between 6,200 and 150,000 shares.⁴⁹ On October 29, 2008, LSC's customer, a Canadian broker-dealer,⁵⁰ sold long 6,200 shares of HTM.⁵¹ The customer did not deliver the shares by the November 3 settlement date, which resulted in a 6,200 share Fail of HTM for LSC.⁵²

⁴⁵ RX-29, *Amendments to Regulation SHO*, Exchange Act Rel. No. 34-58773, at 16, n.46.

⁴⁶ *Id.* at 6, n.14.

⁴⁷ *Id.* at 6, n.14; 16, n.46.

⁴⁸ In the Charging Memorandum, the relevant period for violations of Rule 204T(a) of Regulation SHO relating to long sales was October 22, 2008, through July 7, 2009. The Charging Memorandum also alleged a violation of Rule 204(a) on August 14, 2009. Charging Memorandum ¶ 65. When addressing the Regulation SHO Charges relating to long sales, the Hearing Panel restricted its review to the evidence presented that pertained to the time periods delineated in the Charging Memorandum. None of the alleged long sale violations related to the transaction date of August 14, 2009. See Market Regulation's Findings of Facts at 14-21.

⁴⁹ CX-132.

⁵⁰ Hearing Tr. (Louis) at 1630.

⁵¹ CX-34.

⁵² CX-33, at 2; CX-34.

On October 30, 2008, the customer effected two long sales of HTM totaling 106,400 shares.⁵³ The customer did not deliver the shares by the November 4 settlement date, which increased LSC's Fail to 112,600 shares.⁵⁴

On October 31, 2008, the customer effected a long sale in the amount of 37,400 shares.⁵⁵ As a result of the customer's failure to deliver these shares on the November 5 settlement date, LSC's Fail increased to 150,000 shares.⁵⁶

LSC closed out its Fail when the customer delivered HTM shares. On November 7, 2008, the customer delivered 6,200 shares to LSC, which reduced LSC's net Fail to 143,800 shares.⁵⁷ On November 18, the customer delivered 143,800 HTM shares to LSC, which enabled LSC to close out its open HTM Fail.⁵⁸

GW

From December 5 through December 9, 2008, LSC had a net Fail in GW of between 199,900 and 200,000 shares.⁵⁹ On December 2, 2008, LSC's customer, a Canadian broker-dealer,⁶⁰ sold long 200,000 shares.⁶¹ The customer did not deliver the 200,000 shares on the December 5 settlement date, which resulted in a Fail for LSC of 200,000 shares.⁶² LSC closed

⁵³ CX-34.

⁵⁴ CX-33, at 3; CX-34.

⁵⁵ CX-34.

⁵⁶ CX-132.

⁵⁷ CX-34, CX-33, CX-132.

⁵⁸ CX-34, CX-33, CX-132.

⁵⁹ CX-28, CX-132.

⁶⁰ Hearing Tr. (Louis) at 1729.

⁶¹ CX-29.

⁶² CX-28, CX-132.

out its Fail on December 10, 2008, when the customer delivered 200,000 shares during the trading day on December 10.⁶³

NG

From January 13 through January 22, 2009, LSC had an outstanding Fail in NG of between 5,300 and 8,000 shares.⁶⁴ On January 8, 2009, LSC's customer effected a long sale of 6,000 shares.⁶⁵ The customer did not deliver the 6,000 shares on January 13, the settlement date.⁶⁶ As a result, LSC had a net Fail of 5,300 shares.⁶⁷ On January 15, 2009, the customer delivered the 6,000 shares to LSC, which closed out LSC's Fail.⁶⁸

On January 12, 2009, the customer sold long 253,800 shares of NG.⁶⁹ On January 15, the settlement date, the customer delivered only 245,800 of the 253,800 shares to LSC, 8,000 shares less than the total sale.⁷⁰ As a result, LSC had a net NG Fail of 7,700 shares.⁷¹ LSC closed out its Fail on January 23, 2009, when the customer delivered the remaining 8,000 NG shares.⁷²

AZ

LSC had an outstanding Fail in AZ during two time periods: May 1 through May 13, 2009, and May 29 through June 8, 2009.

⁶³ CX-29; Hearing Tr. (Louis) at 1617.

⁶⁴ CX-30, CX-132.

⁶⁵ CX-31.

⁶⁶ CX-31.

⁶⁷ CX-30, at 1; CX-132.

⁶⁸ CX-31.

⁶⁹ CX-31.

⁷⁰ CX-31.

⁷¹ CX-30, at 3; CX-132. LSC's net Fail in NG was 7,700 because it had received 300 shares from another customer.

⁷² CX-30, CX-31, CX-132.

From May 1 through May 13, 2009, LSC had a Fail in AZ of between 2,970 and 50,770 shares.⁷³ On April 17, 2009, LSC's customer, a German broker,⁷⁴ effected a long sale of 35,600 shares.⁷⁵ The customer did not deliver any shares on the April 22 settlement date. On April 23, the customer bought 18,830 shares, which were delivered on the April 28 settlement date.⁷⁶ On May 1, LSC had a Fail in AZ of 16,770 shares, the difference between the customer's long sale of 35,600 shares and its purchase of 18,830 shares.⁷⁷ LSC maintained a Fail until at least May 13.⁷⁸ On May 15, 2009, LSC closed out its Fail through its receipt of 90,000 AZ shares.⁷⁹

From May 29 through June 8, 2009, LSC had an outstanding Fail in AZ of between 25,830 and 28,830 shares.⁸⁰ On May 26, 2009, LSC's customer effected a long sale of 28,830 shares.⁸¹ The customer failed to make delivery to LSC on May 29, the settlement date, which caused LSC to have a Fail of 28,830 shares.⁸² On June 9, 2009, LSC closed out its Fail through the receipt of 28,900 AZ shares.

⁷³ CX-35, CX-132; RX-137, at 1-3.

⁷⁴ Hearing Tr. (Louis) at 1589, 1593-94.

⁷⁵ RX-137, at 6.

⁷⁶ *Id.*

⁷⁷ CX-35; RX-137, at 2, 5; Hearing Tr. (Louis) at 1596.

⁷⁸ CX-35, CX-132; RX-137.

⁷⁹ CX-36.

⁸⁰ CX-37, CX-132; RX-137.

⁸¹ RX-137, at 6.

⁸² CX-37, CX-132; RX-137, at 6.

(b) Short Sales

LSC had outstanding CNS Fails related to short sales in the following securities: LEN, FRD, VWO, YAVY, SPG, MRGE, SSW, CVO, MSJ and MBI.⁸³

LEN

On February 26 and February 27, 2009, LSC had an outstanding Fail in LEN of between 9,000 and 16,200 shares.⁸⁴ Three LSC customers had effected short sales in LEN totaling 10,000 shares,⁸⁵ but only one customer delivered 1,000 shares on the February 26 settlement date.⁸⁶ As a result, LSC had a net Fail of 9,000 shares on February 26.⁸⁷ A Fail remained open until March 2, when LSC received 20,000 borrowed LEN shares.⁸⁸

FRD

From February 27 through March 17, 2009, LSC had an outstanding Fail in FRD of between 1,305 and 5,740 shares.⁸⁹ On February 24, LSC's customer, a broker-dealer,⁹⁰ sold short 8,105 shares; and, on February 26, borrowed 4,900 shares relative to such sale.⁹¹ As of the

⁸³ In the Charging Memorandum, the relevant periods for violations of Rules 204T(a) and 204(a) of Regulation SHO relating to short sales was February 23 through July 7, 2009, and July 31 through September 4, 2009. Charging Memorandum ¶ 70. When addressing the Regulation SHO violations relating to short sales, the Hearing Panel restricted its review to the evidence presented that pertained to the time periods in the Charging Memorandum.

⁸⁴ CX-132.

⁸⁵ CX-51.

⁸⁶ CX-50, at 1.

⁸⁷ CX-50, CX-51, CX-132.

⁸⁸ CX-50, CX-51, CX-132.

⁸⁹ CX-44, CX-132.

⁹⁰ Hearing Tr. (Louis) at 1728-29.

⁹¹ CX-44, at 1; CX-45.

February 27 settlement date, the customer had not delivered any additional shares, which resulted in a Fail of 3,205 shares for LSC.⁹² LSC's Fail remained open until March 17, 2009.⁹³

VWO

From May 7 through May 11, 2009, LSC had an outstanding Fail in VWO of between 10,480 and 10,580 shares.⁹⁴ On May 4, 2009, LSC's customer, a broker-dealer,⁹⁵ sold short 10,580 shares of VWO.⁹⁶ On May 7, the settlement date, the customer did not deliver any shares, which resulted in LSC having a Fail of 10,580 shares.⁹⁷ On May 12, LSC closed out its Fail when the customer delivered 40,780 shares from a May 7 purchase.⁹⁸

YAVY

From May 6 through May 29, 2009, LSC had an outstanding Fail in YAVY of between 1,000 and 1,200 shares.⁹⁹ On May 1, 2009, LSC's customer sold short 1,000 shares.¹⁰⁰ On May 6, the settlement date, the customer did not deliver any shares, which caused LSC to have a Fail of 1,000 shares.¹⁰¹ That Fail remained open until June 1, when LSC received 1,200 YAVY shares as a result of a May 27 purchase by its customer that settled on June 1.¹⁰²

⁹² CX-44, at 1; CX-132.

⁹³ CX-44, CX-132.

⁹⁴ CX-46, CX-132.

⁹⁵ Hearing Tr. (Louis) at 1729.

⁹⁶ CX-47.

⁹⁷ CX-46, CX-132.

⁹⁸ CX-46, CX-47, CX-132.

⁹⁹ CX-48, CX-132.

¹⁰⁰ CX-49.

¹⁰¹ CX-48, at 1; CX-132.

¹⁰² CX-49, CX-132.

SPG

From June 4 through June 12, 2009, LSC had an outstanding Fail in SPG of between 850 and 3,577 shares.¹⁰³ One of LSC's customers, a broker-dealer,¹⁰⁴ sold short and purchased SPG shares between June 3 and June 8 in the following quantities:¹⁰⁵

<u>Trade Date</u>	<u>Short Sales</u>	<u>Purchases</u>	<u>Settlement Date</u>
June 3	2,400	---	June 8
June 4	700	1,800	June 9
June 5	2,155	77	June 10
June 8	200	2,078	June 11

On June 8, 2009, the settlement date for the June 3 short sale of 2,400 shares, the customer failed to deliver any shares, which caused LSC to have a net Fail of 1,950 shares.¹⁰⁶ An SPG Fail remained open until June 15, when LSC received a sufficient amount of shares from customer purchases on June 8 and 10.¹⁰⁷

MRGE

From June 4 through June 17, 2009, LSC had an outstanding Fail in MRGE of between 10,671 and 25,671 shares.¹⁰⁸ On June 1, 2009, LSC's customer sold short 13,000 shares.¹⁰⁹ On the June 4 settlement date, the customer did not deliver any shares, which caused LSC to have a

¹⁰³ CX-55, CX-132; RX-137.

¹⁰⁴ Hearing Tr. (Louis) at 1728-31.

¹⁰⁵ CX-56, at 2-3; RX-137, at 17-18.

¹⁰⁶ CX-55, at 3; CX-132; RX-137.

¹⁰⁷ CX-55, CX-56, CX-132; RX-137, at 2.

¹⁰⁸ CX-52, CX-132; RX-137.

¹⁰⁹ CX-54; RX-137, at 2.

Fail of 13,000 shares.¹¹⁰ LSC continued to have a Fail until June 18, when it received 32,000 borrowed MRGE shares.¹¹¹

SSW

From July 1 through July 13, 2009, LSC had an outstanding Fail in SSW of between 800 and 9,800 shares.¹¹² One of LSC's customers sold short and purchased SSW shares between June 26 and July 6 in the following quantities:¹¹³

<u>Trade Date</u>	<u>Short Sales</u>	<u>Purchases</u>	<u>Settlement Date</u>
June 26	800	---	July 1
June 30	5,500	500	July 6
July 1	5,000	5,600	July 7
July 2	2,200	600	July 8
July 6	11,400	11,400	July 9

On July 1, the customer did not deliver any shares related to its June 26 short sale, which caused LSC to have a Fail of 800 shares.¹¹⁴ On July 6, the customer did not deliver any shares related to its June 30 net short sale of 5,000 shares, which caused LSC's Fail to increase to 5,800 shares.¹¹⁵ A Fail remained open at LSC through July 13, 2009.¹¹⁶

CVO

LSC had outstanding Fails in CVO during three time periods in 2009: June 4 through July 20, August 18 through August 26, and September 3 through at least September 18.¹¹⁷

¹¹⁰ CX-52, at 1; CX-132; RX-137, at 2.

¹¹¹ CX-53, CX-132; RX-137.

¹¹² CX-59, CX-132; RX-137, at 2-3.

¹¹³ CX-60; RX-137, at 25-27.

¹¹⁴ CX-59, CX-132.

¹¹⁵ CX-59, CX-132.

¹¹⁶ CX-59, CX-132.

¹¹⁷ CX-132.

From June 4 through July 20, 2009, LSC had an outstanding Fail in CVO of between 2,000 and 4,000 shares.¹¹⁸ On June 1, LSC's customer sold short 2,000 shares.¹¹⁹ On June 4, the settlement date, the customer did not deliver any shares, causing LSC to have a Fail of 2,000 shares.¹²⁰ The Fail remained open until July 21 when LSC received 4,000 borrowed shares.¹²¹

From August 18 through August 26, 2009, LSC had a Fail in CVO of between 7,000 and 57,000 shares.¹²² On August 14, LSC's customer sold short 11,000 shares.¹²³ On August 19, the settlement date, the customer did not deliver any shares, causing LSC to have a net Fail of 7,000 shares.¹²⁴ From August 14 through August 21, the customer sold short additional shares, which caused LSC's Fail to increase to 57,000.¹²⁵ A Fail remained open until August 27, when LSC closed out its Fail through the receipt of borrowed shares.¹²⁶

From September 3 through at least September 18, 2009, LSC had an outstanding Fail in CVO of between 429 and 14,979 shares.¹²⁷ On August 31, 2009, LSC's customer sold short 2,300 shares.¹²⁸ On September 3, the settlement date, the customer did not deliver any shares, which caused LSC to have a net Fail of 2,229 shares.¹²⁹ The customer sold short additional

¹¹⁸ CX-61, CX-132.

¹¹⁹ CX-61; RX-137

¹²⁰ CX-61, at 1; CX-132.

¹²¹ CX-61, CX-62, CX-132; RX-137, at 20.

¹²² CX-63, CX-132.

¹²³ CX-63, at 1; RX-137.

¹²⁴ CX-63, at 1; CX-132.

¹²⁵ CX-63.

¹²⁶ CX-63, CX-64, CX-132; RX-137, at 22.

¹²⁷ CX-65, CX-132.

¹²⁸ CX-66; RX-137.

¹²⁹ CX-65, at 1; CX-132.

shares on September 1, September 14, and September 15.¹³⁰ On September 17, the customer purchased 95,000 shares.¹³¹ A Fail remained open until September 22, 2009, when the customer's purchase of the 95,000 shares settled.¹³²

MSJ

From August 5 through August 21, 2009, LSC had an outstanding Fail in MSJ of between 4,000 and 13,000 shares.¹³³ One of LSC's customers, a broker-dealer,¹³⁴ sold short and purchased MSJ shares between August 3 and August 6 in the following quantities:¹³⁵

<u>Trade Date</u>	<u>Short Sales</u>	<u>Purchases</u>	<u>Settlement Date</u>
August 3	6,000	1,000	August 6
August 4	5,000	---	August 7
August 6	5,200	2,200	August 11

On August 6, the customer did not deliver the 5,000 shares from its net sale on August 3, which caused LSC to have a Fail of 5,000 shares.¹³⁶ On August 7, the customer did not deliver the 5,000 shares from the August 4 short sale, which caused LSC's Fail to increase to 10,000 shares.¹³⁷ On August 11, the customer did not deliver the 3,000 shares from its net sale on August 6, which again increased LSC's Fail to 13,000 shares.¹³⁸ Between August 7 and August 19, the customer gradually began buying shares, which settled between August 12 and August 24.¹³⁹

¹³⁰ CX-66.

¹³¹ *Id.*

¹³² CX-66, CX-132.

¹³³ CX-67, CX-132.

¹³⁴ Hearing Tr. (Louis) at 1732.

¹³⁵ RX-137, at 30-32.

¹³⁶ CX-67, at 1; CX-132; RX-137, at 4.

¹³⁷ CX-67, at 2; CX-132.

¹³⁸ CX-67, at 3; CX-132.

¹³⁹ RX-137, at 31-32; CX-67, CX-68.

Ultimately, LSC closed its Fail on August 24, when the customer's purchases on August 19 settled.¹⁴⁰

MBI

From August 25 through September 4, 2009, LSC had an outstanding Fail in MBI of between 11,500 and 12,500 shares.¹⁴¹ On August 22, a LSC customer sold short 50,000 shares and purchased 37,500 shares, resulting in a net sale of 12,500 shares.¹⁴² On August 26, 2009, the settlement date, the customer did not deliver the shares, which caused LSC to have a Fail of 12,500 shares.¹⁴³ LSC's Fail remained open until September 8, 2009, when LSC received 12,500 borrowed MBI shares.¹⁴⁴

3. LSC Effected Short Sales While In The "Penalty Box"

Rule 204T(b) of Regulation SHO restricts a participant's ability to effect additional short sales in stocks for which it has an open Fail (i.e., the participant is in the "penalty box"). From approximately February 23 to July 7, 2009,¹⁴⁵ LSC effected short sales when it had Fails to CNS in the following stocks: FRD, YAVY, MRGE, SSW, and CVO.¹⁴⁶ During that time period, LSC sent emails to its correspondents, "checking" if they had available shares;¹⁴⁷ however, there was

¹⁴⁰ CX-68, at 1; CX-132; RX-137.

¹⁴¹ CX-132.

¹⁴² CX-70.

¹⁴³ CX-69, at 1; CX-70, CX-132.

¹⁴⁴ CX-70, CX-132; RX-137, at 34.

¹⁴⁵ At the hearing and in its post-hearing brief, Market Regulation presented evidence of "penalty box" short sale transactions from July 8 through September 15, 2009; however, the Charging Memorandum charged LSC with violating Rule 204T(b) and referenced a review period of February 23 through July 7, 2009. Accordingly, the Hearing Panel restricted its review to the evidence presented that pertained to that time period.

¹⁴⁶ JX-33, at 3, letter from Lek Securities Corporation to Market Regulation (Sept. 8, 2010).

¹⁴⁷ See, e.g., JX-33, at 18, 20, 33, 36 (LSC's request to have correspondent "check[]" on FRD on March 2, March 4, March 5, and March 6, 2009).

no evidence that LSC actually borrowed shares or entered into a bona fide arrangement to borrow shares prior to effecting the short sales in FRD, YAVY, MRGE, SSW, and CVO.

FRD

LSC was in the “penalty box” for FRD from no later than March 2 through March 17, 2009.¹⁴⁸ During that time period, LSC effected the following short sales for its customer: 2,150 shares on March 4; 900 shares on March 6; and 700 shares on March 10.¹⁴⁹

YAVY

LSC was in the “penalty box” for YAVY from no later than May 7 through May 29, 2009.¹⁵⁰ On May 13, 2009, LSC effected a YAVY short sale for its customer in the amount of 200 shares.¹⁵¹

MRGE

LSC was in the “penalty box” for MRGE from no later than June 5 through June 17, 2009.¹⁵² During that time, LSC effected the following short sales for its customer: 3,000 shares on June 5; 3,500 shares on June 8; 4,500 shares on June 10; 3,000 shares on June 11; and 1,000 shares on June 12.¹⁵³

¹⁴⁸ *Id.* at 3 (LSC’s correspondence to Market Regulation reflects its penalty period beginning on February 27, 2009).

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* (LSC’s correspondence to Market Regulation reflects its penalty period beginning on May 6, 2009).

¹⁵¹ *Id.*

¹⁵² *Id.* (LSC’s correspondence to Market Regulation reflects its penalty period beginning on June 4, 2009).

¹⁵³ CX-54; JX-33; RX-137.

SSW

LSC was in the “penalty box” for SSW from July 1 through July 13, 2009.¹⁵⁴ During that time, LSC effected the following short sales for its customer: 2,200 shares on July 2; 11,400 shares on July 6; and 4,000 shares on July 7.¹⁵⁵

CVO

LSC was in the “penalty box” for CVO from no later than June 5 through July 20, 2009.¹⁵⁶ LSC effected a 1,000-share short sale for its customer on June 5 and June 12, 2009.¹⁵⁷

4. LSC Failed To Notify Customers Of Open Fail-To-Deliver Positions

There is no evidence that LSC notified its broker-dealer customers that it had open Fails in any of the securities discussed above. In fact, as noted above, LSC continued to accept and effect short sale orders while in the “penalty box.” For example, while in the “penalty box” for FRD from March 2 through March 17, 2009, LSC effected three additional FRD short sales for a broker-dealer customer.¹⁵⁸

E. BlueLine Trading

1. Regulatory Background

On June 14, 2007, NYSE Rule 70 was amended to add supplemental section .40, which provides member organizations with authority to access other markets from a Floor broker’s booth premises subject to prior approval by NYSE Regulation, a practice commonly known as

¹⁵⁴ JX-33, at 3.

¹⁵⁵ *Id.*; RX-137. Pursuant to JX-33, LSC’s correspondence to Market Regulation, additional SSW short sales took place on July 8, July 9, and July 10, 2009; however, the Hearing Panel did not utilize those sales in making its findings as the Charging Memorandum used a review period that ended on July 7, 2009.

¹⁵⁶ JX-33, at 3 (LSC’s correspondence to Market Regulation reflects its penalty period beginning on June 4, 2009).

¹⁵⁷ *Id.*

¹⁵⁸ See *supra* footnotes 148 and 149 and accompanying text.

“BlueLine” trading. NYSE Rule 70.40 also requires that a firm adopt and implement comprehensive written procedures and guidelines governing the conduct and supervision of its BlueLine business, and that the written procedures be approved by NYSE Regulation before implementation.

The NYSE issued IM 07-77, *Requirements For Conducting “Upstairs” Operations From a Member Organization’s Booth Premises*, which described the member firm’s obligations to comply with NYSE Rule 70.40.¹⁵⁹ IM 07-77 stated that it had two purposes: (1) to advise firms that they may operate their booth premises on the Floor similar to their “upstairs” offices, “provided that the member organization has been approved to operate its booth in this manner by NYSE Regulation, Inc.,” and (2) to “provide guidance regarding the regulatory requirements for obtaining approval to enter agency orders from the [firm’s] booth premise.”¹⁶⁰ Among the requirements specified was the adoption and implementation of comprehensive written procedures and guidelines governing the conduct and supervision of business handled in the booth. A firm’s procedures “must be available as a stand-alone section of a firm’s written policies and procedures....”¹⁶¹ Moreover, these written procedures, and any subsequent changes, “must be reviewed by NYSE Regulation prior [to] their implementation.”¹⁶²

¹⁵⁹ JX-98, NYSE IM 07-77, *Requirements For Conducting “Upstairs” Operations From a Member Organization’s Booth Premises* (July 30, 2007).

¹⁶⁰ JX-98, at 1.

¹⁶¹ *Id.* at 2.

¹⁶² *Id.* at 3.

2. LSC's BlueLine Trading Without Prior NYSE Approval

LSC engaged in BlueLine trading without approval from NYSE Regulation.¹⁶³

Specifically, LSC admits that every month between June 2007 and October 2009, it engaged in BlueLine trading;¹⁶⁴ yet, it did not apply for BlueLine approval or submit its BlueLine procedures to NYSE Regulation until September 21, 2009.¹⁶⁵

In June 2009, FINRA staff discovered that LSC had been routing orders away from the NYSE Floor even though it had not been approved to engage in BlueLine trading.¹⁶⁶ On July 17, 2009, NYSE Regulation sent LSC a cease and desist letter ("C & D Letter"), notifying it that, absent approval, LSC was required to immediately cease and desist from all unapproved BlueLine trading activity or other unapproved trading in away markets from the NYSE Floor.¹⁶⁷ In response, a LSC compliance officer stated that LSC was "in the process of developing specific written supervisory procedures" and represented that "all such activity has ceased . . . as of the afternoon of July 17."¹⁶⁸ In subsequent letters, dated September 23 and October 9, 2009, LSC represented to FINRA that it had instructed its Floor brokers to stop routing all orders to away markets.¹⁶⁹ Contrary to LSC's representations to NYSE Regulation and FINRA, LSC continued

¹⁶³ Hearing Tr. (Lek) at 1925; JX-93, at 3. The only exceptions for firms that were previously routing orders to away markets were those that participated in one of two pilot programs in which firms were authorized to route orders to Nasdaq or NYSE Arca. See CX-116, NYSE IM 06-37, *Pilot Program for Transmitting Orders in NYSE Arca SM Listed Stocks From the NYSE Trading Floor* (May 19, 2006); CX-117, NYSE IM 05-88, *Pilot Program for Transmitting Orders in NASDAQ Stocks From the NYSE Trading Floor* (Nov. 10, 2005). LSC did not participate in either of these pilot programs. Hearing Tr. (DeGregorio) at 469; Hearing Tr. (Lek) at 2263-64; JX-93, at 3.

¹⁶⁴ Answer ¶ 105.

¹⁶⁵ JX-85.

¹⁶⁶ Hearing Tr. (Giberson) at 637-39; JX-71. In June 2009, FINRA conducted a sweep of all NYSE Floor broker firms that were not approved to engage in BlueLine trading, to determine whether they routed orders away from the NYSE Floor. Hearing Tr. (Giberson) at 635-36. As part of the sweep, a survey was sent to LSC asking, among other things, whether it had an Order Management System on the Floor of the NYSE that it used to route customer orders to other exchanges. JX-72.

¹⁶⁷ JX-73; Hearing Tr. (DeGregorio) at 469-70.

¹⁶⁸ Charging Memorandum ¶ 107; Answer ¶ 107; JX-75, at 2.

¹⁶⁹ Charging Memorandum ¶ 108; Answer ¶ 108; JX-83, JX-92.

to route hundreds of orders from its NYSE Floor booth to away markets until October 19, 2009.¹⁷⁰

F. Market-On-Close And Limit-On-Close Orders

1. Regulatory Background

During late 2008 and all of 2009, NYSE Rule 123C stated that MOC and LOC orders could be cancelled or reduced in size between 3:40 p.m. and 3:50 p.m. only to correct a legitimate error.¹⁷¹ Beginning in December 2008, the NYSE issued several Product Updates and an Information Memo relating to compliance with the prohibition against the cancellation of MOC and LOC orders after the cut-off time.

On December 12, 2008, the NYSE issued a Product Update that announced a “significant enhancement” to the handling of MOC and LOC orders. The December 12 Product Update stated that, effective December 22, 2008, the NYSE’s systems would be rejecting all MOC and LOC cancel requests sent after 3:40 p.m.¹⁷² A week later, the NYSE issued another Product Update postponing the enhancements discussed in the December 12 Product Update.¹⁷³

On February 20, 2009, the NYSE issued a Product Update that changed the manner in which the NYSE would handle the MOC and LOC orders from the method previously described in the December 12 Product Update. Specifically, the February 20 Product Update stated:

there will be a change in how the Exchange Systems will handle cancel requests
... the Exchange will block all MOC/LOC cancel requests *beginning at 3:50 PM*

¹⁷⁰ Answer ¶ 105; Hearing Tr. (Giberson) at 641-52; JX-83, JX-93, JX-96.

¹⁷¹ NYSE Rule 123C. Effective March 1, 2010, NYSE Rule 123C was amended to set the deadline for cancelling legitimate errors at 3:58 p.m.

¹⁷² JX-105, NYSE Product Update, *The NYSE Enhances MOC/LOC Handling for All Customers* (Dec. 12, 2008).

¹⁷³ JX-106, NYSE Product Update, *Market-on-Close and Limit-on-Close Handling Changes Postponed* (Dec. 19, 2008).

on all MOC/LOC orders entered before 3:40 PM Previously the Exchange Systems were going to begin blocking all cancel requests at 3:40.¹⁷⁴

The February 20 Product Update announced that this change would take effect on March 9, 2009.

On March 6, 2009, the NYSE issued IM 09-12, *New NYSE System Functionality for Handling Market-on-Close and Limit-on-Close Orders and Cancellations*, to advise members about changes governing the submission and cancellation of MOC and LOC orders, and to remind member organizations of their obligations with respect to the handling of MOC and LOC orders and cancellations.¹⁷⁵ IM 09-12 stated that “[t]his new functionality **does not** block cancellation requests between 3:40 and 3:50 p.m. Members and member organizations are reminded that Rule 123C permits cancellations of MOC/LOC orders during that period **only** to correct a legitimate error.”¹⁷⁶

2. LSC’s Improper Market-On-Close And Limit-On-Close Cancellations

From March 9 through April 22, 2009, LSC cancelled approximately 899 MOC and LOC orders after 3:40 p.m.¹⁷⁷ The cancellations occurred because LSC’s Chief Technology Officer changed the coding of LSC’s system so that it no longer blocked the late entry of MOC and LOC orders.¹⁷⁸

¹⁷⁴ JX-107, NYSE Product Update, *The NYSE Reschedules Enhanced MOC/LOC Handling for All Customers* (Feb. 20, 2009) (emphasis added).

¹⁷⁵ CX-119, at 2, NYSE IM 09-12, *New NYSE System Functionality for Handling Market-on-Close and Limit-on-Close Orders and Cancellations* (Mar. 6, 2009).

¹⁷⁶ *Id.*

¹⁷⁷ CX-115; Hearing Tr. (Roussel) at 399.

¹⁷⁸ Hearing Tr. (Paone) at 1416, 1421-22; JX-101, at 1 (letter from LSC to NYSE Regulation (Apr. 23, 2009)); JX-102 at 1; JX-103, at 1; JX-104, at 1; Answer ¶ 120.

The Technology Officer explained that, upon receiving the December 12 Product Update, he notified Lek, LSC's CCO, of the impending change.¹⁷⁹ He also contacted the NYSE to confirm that the NYSE would be handling the screening and rejecting of untimely MOC and LOC orders and cancellations.¹⁸⁰ When the NYSE issued subsequent Product Updates, the Technology Officer explained that he merely skimmed those notices looking for the revised implementation date of the previously announced changes.¹⁸¹ When he noticed the implementation date of March 9, 2009, in the February 20 Product Update, he disabled LSC's screening mechanism for untimely cancellations starting on March 9, 2009.¹⁸² The Technology Officer did not notice that further down in the February 20 Product Update, the NYSE had revised its plan to block MOC and LOC cancellations.¹⁸³ The Technology Officer testified he simply missed the change and made a mistake.¹⁸⁴

Several weeks later, on April 23, 2009, the NYSE notified LSC that NYSE's systems were not preventing cancellations of MOC and LOC orders between 3:40 p.m. and 3:50 p.m.¹⁸⁵ LSC's Technology Officer then reviewed the applicable Product Update, realized his mistake, and re-enabled LSC's screening mechanism.¹⁸⁶

G. Supervisory Systems And Procedures

For approximately three and a half years, from April 2007 through September 2010, LSC experienced supervisory deficiencies. Its supervisory deficiencies related to the following topics

¹⁷⁹ Hearing Tr. (Paone) at 1410.

¹⁸⁰ *Id.*; JX-104, at 1.

¹⁸¹ Hearing Tr. (Paone) at 1414-15.

¹⁸² *Id.* at 1415-16; JX-107.

¹⁸³ Hearing Tr. (Paone) at 1429; JX-107, at 1; JX-106.

¹⁸⁴ Hearing Tr. (Paone) at 1429.

¹⁸⁵ JX-100, at 2; JX-101, at 2.

¹⁸⁶ Hearing Tr. (Paone) at 1423-24.

and occurred at different time periods during the three and a half year span: (1) odd-lot orders; (2) the September 18th Order; (3) Regulation SHO; (4) BlueLine trading; (5) MOC and LOC orders; and (6) electronic order flow.

1. Odd-Lot Orders

IM 94-14 prohibited NYSE members from using the odd-lot limit order service for odd-lot trading in a pattern of day trading. Despite the fact that a high percentage of LSC's customers were day traders,¹⁸⁷ LSC did not have written supervisory procedures ("WSPs") to specifically address the prohibition of the introduction of odd-lot orders to the NYSE in a pattern of day trading. The entirety of LSC's odd-lot surveillance was contained in its ROX system.¹⁸⁸

Prestige's and Pacific Coast's odd-lot day-trading activity occurred in April and May 2007. Prior to June 2007, LSC's control procedures in ROX prevented the submission of odd-lot orders on the same side of the market from the same customer entered within 30 seconds of each other.¹⁸⁹ ROX did not and could not detect or prevent any of Prestige's and Pacific Coast's odd-lot day-trading activity.¹⁹⁰ As Lek acknowledged, ROX would not prevent the submission of odd-lot orders on opposite sides of the market entered by the same customer regardless of the time submitted.¹⁹¹ Further, none of the Prestige or Pacific Coast odd-lot orders was entered within 30 seconds of each other.¹⁹²

¹⁸⁷ Hearing Tr. (Lek) at 2048, 2290.

¹⁸⁸ JX-4, at 2; JX-11; Hearing Tr. (Lek) at 914.

¹⁸⁹ JX-4, at 2; JX-11. In June 2007, after the relevant odd-lot period, LSC amended its odd-lot procedures in ROX to double the waiting time between which successive odd-lot orders could be entered. JX-4, JX-7, JX-11; Hearing Tr. (Lek) at 911-12. Between June and November 2007, LSC further amended its procedures to prevent the entry of an odd-lot order if there was an unexecuted odd-lot order in the market from the same customer. JX-4, JX-7, JX-11; Hearing Tr. (Lek) at 913.

¹⁹⁰ CX-11.

¹⁹¹ Hearing Tr. (Lek) at 914.

¹⁹² CX-11.

Although Lek testified that he sits in the trading room and is adamant about his staff bringing suspicious trading activity to his attention,¹⁹³ Prestige's and Pacific Coast's trading activity went undetected. Further, when Prestige's or Pacific Coast's prohibited odd-lot day-trading activity occurred, LSC did not have a surveillance report to capture odd-lot limit orders in a pattern of day trading. In October 2010, more than three years later, LSC implemented a "post facto" surveillance report that was designed to review odd-lot trading activity for potential day trading by its customers.¹⁹⁴

Lek testified that he was unaware of the regulatory prohibition against trading odd-lot limit orders in a pattern of day trading,¹⁹⁵ which may be the reason for LSC's failure to have a supervisory system addressing such trading activity. According to Lek, the first time he became aware of the applicable Information Memos and the SEC Release relating to odd-lot day-trading activity was when Market Regulation provided the documents to him at the conclusion of NYSE's investigation.¹⁹⁶

2. The September 18th Order

To comply with the September 18th Order, LSC re-programmed ROX to prevent its customers from executing short sales in the securities covered by the ban.¹⁹⁷ When doing so, it built upon the existing structure it had in place to comply with Regulation SHO, whereby any short sale transaction entered into ROX would be routed automatically to LSC's stock loan desk,

¹⁹³ Hearing Tr. (Lek) at 1746-47.

¹⁹⁴ Hearing Tr. (Lek) at 1807.

¹⁹⁵ Hearing Tr. (Lek) at 927-28, 2227-28.

¹⁹⁶ *Id.*

¹⁹⁷ JX-20, at 3; Hearing Tr. (Lek) at 950, 952, 955-56.

which would then cancel any short sale order in the security of any Included Financial Firm and direct the customer to LSC's website, notifying the customer of the September 18th Order.¹⁹⁸

Despite LSC's attempt to comply with the September 18th Order, as discussed above, LSC permitted the execution of short sales of Included Financial Firms because it exempted certain customers from its controls and neglected to change the expiration date in its screening program when the SEC extended the September 18th Order.¹⁹⁹

LSC asserted that the features in ROX were tested in-depth prior to release.²⁰⁰ However, there was no evidence that LSC monitored the controls it put into place to comply with the September 18th Order. LSC has the ability to search all orders via a query; however, it never ran a query to determine the effectiveness of its controls for the September 18th Order.²⁰¹ In fact, LSC was not even aware of the approximately 6,468 short sale transactions in securities of Included Financial Firms that had bypassed LSC's controls during the time period that the September 18th Order was in effect.²⁰² The NYSE brought the short sale transactions to LSC's attention.²⁰³

3. Regulation SHO

LSC's compliance with Regulation SHO requirements is handled by its President.²⁰⁴ LSC's President failed to ensure that LSC complied with the requirements of Rules 204T and 204 between October 2008 and September 2009.

Regarding the closeout of Fails, LSC, through its President, provided excuses for LSC's failures to timely close out its Fails, such as the securities were "easy to borrow" or the Fails

¹⁹⁸ JX-20, at 3; Hearing Tr. (Lek) at 950, 952, 955-56.

¹⁹⁹ JX-20, at 5-6, 9; Hearing Tr. (Lek) at 961-62.

²⁰⁰ JX-29, at 12.

²⁰¹ Hearing Tr. (Lek) at 2299-300.

²⁰² Hearing Tr. (Lek) at 2300-01.

²⁰³ Hearing Tr. (Lek) at 2300-01.

²⁰⁴ Hearing Tr. (Louis) at 1446, 1448-49.

were too small.²⁰⁵ However, Rules 204T and 204 did not provide any exception for “easy to borrow” stocks or *de minimis* positions. LSC, through its President, failed to appreciate that Rules 204T and 204 require a participant to take affirmative action to close out its open Fails. LSC allowed its Fails to remain open beyond the time periods prescribed in Rules 204T and 204. As reflected in LSC’s trade data, at times it waited for its Fail to be closed out by a customer purchase – even if that meant that the Fail remained open for an extended period of time.²⁰⁶

LSC also failed to monitor its Fails and notify its broker-dealer customers of its open Fails. Its failure to monitor Fails and notify its customers resulted in additional short sales during time periods when LSC was in the “penalty box,” in violation of Rule 204T(b).

4. BlueLine Trading

LSC asserts conflicting positions regarding whether it had procedures addressing BlueLine trading. In LSC’s Answer, it admitted that it did not have WSPs pertaining to the issue of sending orders from the Floor to away markets, and that it failed to maintain WSPs specifically dealing with BlueLine trading.²⁰⁷ At the Hearing, LSC asserted that its supervisory systems covered all the necessary areas to enable it to receive BlueLine trading approval.²⁰⁸ Despite these inconsistent positions, it is clear that until September 21, 2009, LSC neither applied for BlueLine trading approval nor submitted its BlueLine procedures to NYSE Regulation.²⁰⁹ The SEC approved NYSE Rule 70.40 in June 2007. Although Lek testified that

²⁰⁵ RX-137, at 1-5.

²⁰⁶ See *supra* footnotes 99-102 and accompanying text.

²⁰⁷ Charging Memorandum ¶ 111; Answer ¶ 111.

²⁰⁸ Hearing Tr. (Lek) 1902-07; JX-77, JX-85, JX-86, JX-93.

²⁰⁹ JX-85.

“[w]e follow all the rules regardless of what we think about them,”²¹⁰ Lek determined that Rule 70.40 did not apply to LSC and LSC continued conducting its BlueLine trading business.²¹¹

LSC failed to monitor its BlueLine business. When NYSE Regulation issued LSC the C & D Letter, directing it to immediately stop its BlueLine trading activity until it obtained approval, LSC told the NYSE that “all such activity has ceased . . . as of the afternoon of July 17.”²¹² However, as LSC admitted, its BlueLine trading continued until October 2009.²¹³

5. Market-On-Close And Limit-On-Close Orders

LSC relied on an unregistered person to implement and monitor its supervisory control systems for MOC and LOC orders during March and April 2009.²¹⁴ Although Lek acknowledged that it was his responsibility as the CCO to ensure that LSC had a system to screen for late cancellations of MOC and LOC orders,²¹⁵ he relied on the Technology Officer to read and decipher regulatory Product Updates relating to the functionality of MOC and LOC orders. The Technology Officer informed Lek of his interpretation of the Product Updates and the changes he intended to make in light of the Product Updates.²¹⁶ There was no oversight or supervisory review for the changes the Technology Officer made to LSC’s supervisory control systems for MOC and LOC orders to ensure that the changes complied with the applicable regulatory guidance.

In addition to the Product Updates, the NYSE issued IM 09-12, reminding members of their obligations with respect to the handling of MOC and LOC orders and notifying them that

²¹⁰ Hearing Tr. (Lek) at 2239.

²¹¹ Hearing Tr. (Lek) at 2261.

²¹² Charging Memorandum ¶ 107; Answer ¶ 107; JX-75, at 2; JX-73; Hearing Tr. (DeGregorio) at 469-70.

²¹³ Answer ¶ 105; Hearing Tr. (Giberson) at 641-52; JX-83, JX-93, JX-96.

²¹⁴ Hearing Tr. (Paone) 1433, 1444.

²¹⁵ Hearing Tr. (Lek) at 2277-78.

²¹⁶ Hearing Tr. (Paone) at 1410; Hearing Tr. (Lek) at 2276-78.

the NYSE's system functionality does not block cancellation requests between 3:40 and 3:50 p.m.²¹⁷ The Technology Officer acknowledged that he had not read IM 09-12.²¹⁸ And Lek did not see the Information Memo until several weeks after LSC turned off its system to detect the cancels.²¹⁹

6. Electronic Customer Order Flow

LSC provided numerous customers with direct electronic access to the NYSE through ROX and the SuperDOT.²²⁰ LSC executed a large volume of orders.²²¹ According to Lek, LSC executed approximately one million orders a day for its customers.²²² Approximately 50% of LSC's order flow is attributable to its professional trading customers.²²³

Between June 2009 and March 2010, LSC failed to reasonably supervise and monitor its electronic order flow for spoofing, wash trading, and marking the close.

(a) Spoofing

"Spoofing" is a manipulative scheme whereby an order is placed by a market participant with the intention of briefly triggering a market movement from which the participant or others may benefit by trading the opposite side of the manipulative order.²²⁴ After causing a bid or offer

²¹⁷ CX-119.

²¹⁸ Hearing Tr. (Paone) at 1431.

²¹⁹ Hearing Tr. (Lek) at 2275.

²²⁰ Hearing Tr. (Lek) at 1761; Charging Memorandum ¶ 14; Answer ¶ 14. In mid-2009, SuperDOT was replaced by the NYSE's Super Display Book ("SDBK"). LSC's customers were able to transmit orders to the NYSE through LSC's SDBK system and SuperDOT connections. Charging Memorandum ¶ 80; Answer ¶ 80.

²²¹ Hearing Tr. (Lek) at 1753-55. Between January 2008 and September 2010, LSC processed 469,142,200 orders [transcript reflects a typographical error], including 173,732,464 buys, 140,465,944 long sales, and 31,401,022 short sales. Hearing Tr. (Lek) at 1754-55. The notational value of these orders was approximately \$938,284,400,000. Hearing Tr. (Lek) at 1755.

²²² Hearing Tr. (Lek) at 1753 (Lek's estimate regarding the volume of LSC's order flow related to the time period between 2007 and 2009).

²²³ Hearing Tr. (Lek) at 2287-88.

²²⁴ *SEC v. Kundrat and Smolinski*, Litigation Rel. No. 18894, 2004 SEC LEXIS 2160, at *1 (Sept. 23, 2004).

quote to move and obtaining an execution, a market participant would cancel his initial market-moving order.²²⁵

NYSE Regulation received complaints from designated market makers regarding order entry and cancellations in certain securities that were transmitted by LSC.²²⁶ NYSE Regulation began investigating the trading and identified the following trading activity.²²⁷

Security	Date	# of Orders Cancelled	Volume Cancelled	Side of Pre-market Activity
Precision Drilling Trust (PDS)	6/11/2009	7	256,400	SS
Satyam Computer Services Ltd. (SAY)	6/11/2009	11	451,000	B
Goldman Sachs Group Inc. (GS)	6/16/2009	3	85,600	SS
SAY	6/17/2009	6	318,000	B
PDS	6/17/2009	7	229,000	S

NYSE contacted LSC regarding the above order cancellations on June 23, 2009.²²⁸ LSC responded to NYSE's inquiry, informing NYSE that two of its Dimension customers entered the orders.²²⁹ LSC also indicated that "this trading behavior is practiced by the vast majority of market participants today."²³⁰

On August 12, 2009, more order entries and cancellations were observed in GS, the same stock that NYSE had identified for LSC on June 23, 2009.²³¹ Specifically, the pre-market activity in GS was as follows:

²²⁵ Cary R. Kahn, Exchange Act Rel. No. 50046, 2004 SEC LEXIS 1530, at *3 (July 20, 2004).

²²⁶ Hearing Tr. (Scrofani) at 669-72.

²²⁷ JX-57, JX-59, JX-61; CX-110.

²²⁸ JX-55.

²²⁹ JX-56.

²³⁰ *Id.*

²³¹ JX-57, JX-58.

Symbol	Trade Date	Entry Time	Side	Order Quantity	Cancel Time
GS	8/12/2009	9:19:53	SShort MKT	10,100	9:20:55
GS	8/12/2009	9:20:06	SShort MKT	10,000	9:29:09
GS	8/12/2009	9:20:55	SShort MKT	15,100	9:21:16
GS	8/12/2009	9:21:16	SShort MKT	25,100	9:21:51
GS	8/12/2009	9:21:51	SShort MKT	32,100	9:23:04
GS	8/12/2009	9:23:04	SShort MKT	37,100	9:23:59
GS	8/12/2009	9:23:59	SShort MKT	44,100	9:24:22
GS	8/12/2009	9:24:22	SShort MKT	48,100	9:25:06
GS	8/12/2009	9:25:06	SShort MKT	75,100	9:26:15
GS	8/12/2009	9:26:15	SShort MKT	82,100	9:27:22
GS	8/12/2009	9:27:12	SShort MKT	31,100	9:27:34
GS	8/12/2009	9:27:22	SShort MKT	86,100	9:28:29
GS	8/12/2009	9:28:29	SShort MKT	96,100	9:29:03
GS	8/12/2009	9:29:03	SShort MKT	100,000	9:29:48
GS	8/12/2009	9:29:09	SShort MKT	20,000	9:29:48

All 15 short sale orders, totaling 712,200 shares, occurred prior to the opening of the market. The last two cancels, totaling 120,000 shares, occurred just 12 seconds before the market opened.

On August 12, the GS stock opened with a volume of 49,400 and a price \$0.98 higher than the previous day's closing price.²³² The amount of cancels was significantly higher than the opening stock volume. The total amount of pre-open cancels in GS was 14 times the opening volume; and the last two cancels, occurring 12 seconds before the market opened, were two and a half times the opening volume.

²³² CX-83; Hearing Tr. (Scrofani) at 727.

On August 19, 2009, the NYSE sent a second letter to LSC about the GS pre-open trading activity.²³³ LSC informed the NYSE that its customer's traders had entered these GS orders and cancels.²³⁴ Lek stated that he had reached out to the customer because he was "unaware of their reasons for entering and quickly cancelling orders before the opening."²³⁵

On September 22, 2009, the NYSE sent a third letter inquiring about additional order entries and cancellations on September 2, 2009, in the following stocks: AIB, COP, and GS.²³⁶ LSC told the NYSE that the same Dimension customer entered the trades.²³⁷ On September 25, 2009, LSC told the NYSE that it had reached out to the customer to determine "the purpose behind the cancels and how we can monitor such behavior, if necessary."²³⁸

On September, 28, 2009, additional order entries and cancellations, most of which were pre-open, occurred in the PSAPRI and GS stocks.²³⁹

On October 7, 2009, the NYSE sent a comprehensive request letter to LSC requesting information about the orders and cancels that had occurred from June through September 2009.²⁴⁰ The NYSE also asked whether LSC's surveillance systems and reports, or any reviews conducted pursuant to LSC's supervisory procedures, identified any of the orders that the NYSE had flagged for LSC.²⁴¹ On October 19, 2009, LSC informed the NYSE that, in late August and early September 2009, its trading desk noticed several large pre-market cancels and immediately

²³³ JX-57.

²³⁴ JX-58.

²³⁵ *Id.*

²³⁶ JX-59.

²³⁷ JX-60.

²³⁸ *Id.*

²³⁹ JX-61, at 5-6.

²⁴⁰ JX-61.

²⁴¹ *Id.* at 1.

contacted Dimension, the introducing broker.²⁴² Dimension informed LSC's Compliance Department that "the orders were not appropriate and that they had instructed the responsible individuals to immediately cease such trading behavior."²⁴³ LSC notified the NYSE that it had developed an exception report to identify all large pre-market cancels.²⁴⁴

LSC developed its surveillance report to detect pre-market cancellations greater than 10,000 shares;²⁴⁵ however, it did not always function as intended. For example, on April 13, 2010, the pre-market cancellation report did not capture a 16,800 share buy order of CTT that was cancelled pre-open.²⁴⁶ There was no evidence that LSC investigated or flagged this cancellation.²⁴⁷ In addition, LSC did not always contact the customer to investigate the cancellations identified on its surveillance report to determine if such trading activity was appropriate. For example, on March 10, 2010, a Dimension trader cancelled an order to buy 15,100 shares of Mahanagar Telephone Nigam Ltd.²⁴⁸ The order and cancellation appeared on LSC's pre-market cancellation report.²⁴⁹ Although LSC acknowledged that it cannot determine the purpose of the cancellations or the intention of the trader without contacting its customer,²⁵⁰ LSC did not follow up with the customer.²⁵¹ Specifically, LSC's pre-market cancellation log stated, "Reviewed all the cancels and they were okay - no need to follow up."²⁵²

²⁴² JX-62, at 3.

²⁴³ *Id.*

²⁴⁴ *Id.* at 4.

²⁴⁵ Hearing Tr. (Lek) at 1990-91.

²⁴⁶ Compare JX-66, at 3 with JX-70, at 5; Hearing Tr. (Skeketee) at 872-73.

²⁴⁷ Hearing Tr. (Skeketee) at 873.

²⁴⁸ JX-66, at 3; JX-70, at 6; Hearing Tr. (Skeketee) at 870-71.

²⁴⁹ JX-70, at 6.

²⁵⁰ JX-60, JX-62, at 3-4.

²⁵¹ Hearing Tr. (Skeketee) at 871-72.

²⁵² JX-68, at 5.

(b) Wash Trading

“Wash trading” is a term for effecting a trade with no change in beneficial ownership. NYSE Rule 476(a)(8) prohibits entering buy and sell orders that would have no change in beneficial ownership; a violation of the Rule does not require manipulative intent.

During the relevant time period, LSC’s WSPs relating to wash trading stated the following:

Transactions between two accounts with no market risk and where there is no beneficial change in ownership may be considered a “wash sale.” ... There should be no pre-arrangement or guarantee of execution price for both sides of the transaction where there is no change in beneficial ownership. All such transactions should be executed at the risk of the market.²⁵³

Although Lek testified that “our compliance system is based on reading the rule book,”²⁵⁴ and both NYSE Rule 476(a)(8) and LSC’s WSPs prohibited wash trading, LSC did not have a supervisory system to monitor such prohibited trading.²⁵⁵ On August 14, 2009, LSC implemented an electronic surveillance report to detect such potentially violative activity.²⁵⁶

(c) Marking The Close

Marking the close is the practice of executing transactions in a stock at or near the end of the trading day in order to affect the stock’s closing price.²⁵⁷ Such activity sends false signals to the market about the value of the security.²⁵⁸

²⁵³ JX-108, at 203.

²⁵⁴ Hearing Tr. (Lek) at 2279.

²⁵⁵ Hearing Tr. (Lek) at 938-40.

²⁵⁶ *Id.*; JX-40, at 3.

²⁵⁷ Answer ¶ 97.

²⁵⁸ Hearing Tr. (Lek) at 969, 1018.

LSC's WSPs prohibited the entry of orders for the purpose of affecting the price of a stock on the close.²⁵⁹ The WSPs stated that "patterns of orders that are potentially manipulative (i.e., orders at the close) are to be reviewed by the supervisor for corrective action."²⁶⁰ To detect such potentially manipulative trading activity, LSC relied on a rapid succession order report, the parameters of which required the entry of 25,000 orders within one minute from one customer in one security.²⁶¹ However, marking the close can occur by effecting a small number of transactions near the end of the day.²⁶² Accordingly, LSC's rapid succession order report was not a reasonable method to detect potential marking the close transactions. LSC did not develop a surveillance system to detect potential marking the close transactions by its electronic trading customers until March 2010.²⁶³

III. CONCLUSIONS OF LAW

The Hearing Panel finds LSC liable for all the violations alleged in the Charging Memorandum.

A. LSC Violated NYSE Rules And Policies Relating To Odd-Lot Orders

Market Regulation alleges that LSC violated: (i) NYSE Rules 476(a)(6) and 401 by introducing for execution on the NYSE a pattern of odd-lot orders that were prohibited by the NYSE's odd-lot rules and policies; and (ii) NYSE Rule 405(1) by failing to learn essential facts

²⁵⁹ JX-68, at 289-90; JX-108, at 203 ("Orders entered at the opening or close of the market for purposes of influencing the price of a security are prohibited.").

²⁶⁰ JX-68, at 249; JX-108, at 166.

²⁶¹ JX-40, at 2; Hearing Tr. (Lek) at 969-71, 1015-16, 1021-22.

²⁶² Hearing Tr. (Lek) at 1017 ("Marking the close happens ... with a very small transaction that often results in no change of beneficial ownership....").

²⁶³ Hearing Tr. (Lek) at 1018, 2280.

relative to certain of its customers and its customers' orders that it introduced for execution on the NYSE.²⁶⁴

The applicable NYSE's odd-lot rules and policies date back to 1994. On January 21, 1994, the NYSE submitted a proposed rule change to the SEC that identified additional types of odd-lot limit order trading that the NYSE believed were not consistent with traditional odd-lot investment activity and, therefore, should not be permitted through the odd-lot limit order service. Included among these was "any pattern of day trading."²⁶⁵ The SEC noted that "[u]pon approval of this proposed rule change, the [NYSE] intends to advise its members and member organizations, *through an Information Memo*, that these types of trading practices may not be effectuated by means of the odd-lot limit order service."²⁶⁶ On February 24, 1994, the SEC approved the NYSE's proposed rule change.²⁶⁷ In approving the odd-lot trading practices as a rule, the SEC stated that "it is reasonable for the NYSE to preclude use of its odd-lot limit order system for index arbitrage, program trading, and day trading." "Ensuring the odd-lot limit order system is only utilized for the types of orders it was intended to accommodate will help ensure the continued economic liability [sic] of the system which should ultimately benefit all investors."²⁶⁸ Thereafter, on April 18, 1994, the NYSE issued IM 94-14, *Odd-Lot Trading Practices*, which notified its members that using the odd-lot limit order service for odd-lot trading in a pattern of day trading was prohibited. IM 94-14 warned its members that they would be subject to regulatory action for engaging in such trading activity.

²⁶⁴ See Charging Memorandum, Charges I, II, and III.

²⁶⁵ CX-5.

²⁶⁶ *Id.* at 2 (emphasis added).

²⁶⁷ *Id.* at 1.

²⁶⁸ *Id.* at 3.

From April 1 to May 18, 2007, LSC introduced odd-lot orders in a pattern of day trading for execution on the NYSE. All of the orders were from Prestige and Pacific Coast, and the majority of the orders were limit orders. Such trading activity violated the prohibition described in IM 94-14, which had the effect of a rule as a result of the SEC's approval of the NYSE's proposed rule change.²⁶⁹

NYSE Rule 476(a)(6) requires members to observe high standards of commercial honor and just and equitable principles of trade, and NYSE Rule 401 requires member firms to adhere to principles of good business practice.²⁷⁰ The Hearing Panel finds that LSC violated NYSE Rules 476(a)(6) and 401 by introducing for execution on the NYSE a pattern of odd-lot orders that were prohibited by IM 94-14. The SEC approved NYSE's proposed rule change prohibiting odd-lot limit orders in a pattern of day trading. Even assuming that IM 94-14 did not have the effect of a NYSE Rule, the Hearing Panel finds that LSC acted unethically in failing to abide by specific regulatory memoranda that prohibited such trading activity and warned of regulatory action if members engaged in such trading activity.

NYSE Rule 405(1) requires members to use due diligence to learn the essential facts relative to every customer and "every order ... *accepted or carried by such organization.*"²⁷¹ The Hearing Panel also finds that LSC violated NYSE Rule 405(1) by failing to learn essential facts relative to the odd-lot limit orders from Prestige and Pacific Coast that it introduced for execution on the NYSE.

²⁶⁹ See *infra* footnotes 273-276 and accompanying text.

²⁷⁰ In 2009, NYSE Rules 476(a)(6) and 401(a) were replaced with new NYSE Rule 2010. NYSE IM 09-24, *Harmonization of Certain NYSE and NYSE AMEX Equities Rules with FINRA Rules, Including Rules 342.30, 350, 392, 401, 405A, 421, 435, 440F, 4409 and 476* (June 2, 2009).

²⁷¹ NYSE Rule 405(1) (emphasis added).

1. LSC's Arguments

LSC does not deny that odd-lot orders in a pattern of day trading occurred.²⁷² Rather, in defense of the odd-lot trading allegations, LSC argues that it is not liable for three reasons. First, no NYSE rule prohibiting odd-lot day trading existed. Second, it had no notice that such trading activity was prohibited. Third, LSC argues that because there was not a specific rule prohibiting odd-lot day trading, it is necessary for Market Regulation to prove that LSC acted in bad faith or unethically in order to establish a violation of NYSE Rules 476(a)(6) and 401.

(a) LSC's Argument That There Was No NYSE Rule Prohibiting Odd-Lot Day Trading

LSC asserts that the NYSE had no rule prohibiting the use of its odd-lot trading service as a professional day-trading vehicle. The Panel rejects LSC's assertion. The NYSE submitted to the SEC a proposed rule change, as well as two amendments, describing the prohibited odd-lot day-trading activity. The SEC approved the proposed rule on February 24, 1994.²⁷³ When approving the proposed rule change, the SEC announced that the NYSE would be advising its members of the prohibited trading practices through an Information Memo.²⁷⁴ On April 18, 1994, the NYSE issued IM 94-14, *Odd-Lot Trading Practices*, advising members that odd-lot limit orders executed in a pattern of day trading were prohibited and warning members that such trading activity would result in regulatory action.²⁷⁵ Thereafter, on March 19, 2004, in IM 04-14, *Odd-Lot Order Handling And Prohibited Trading Practices – Exchange Rules 124 and 411(B); “Know Your Customer” Requirements – Exchange Rule 405*, which reminded its members and

²⁷² Hearing Tr. (LSC's counsel) at 277 (representing that LSC does not dispute that the odd-lot trades occurred).

²⁷³ CX-5, at 1. The NYSE submitted the proposed rule change to the SEC pursuant to 15 U.S.C. § 78s(b)(1), and the SEC approved the rule change pursuant to its rule-making authority under that statute.

²⁷⁴ CX-5, at 2.

²⁷⁵ CX-3.

member organizations that IM 94-14, and the prohibitions contained therein, had been filed with the SEC and had the effect of a rule. Specifically, the NYSE stated

[t]he odd-lot requirements in this memo, as set forth in prior Information Memos, have been filed with the Securities and Exchange Commission as a policy, practice or interpretation and are deemed to be a rule change pursuant to Securities Exchange Act Regulation 240.19b-4 (SR-NYSE-92-13).²⁷⁶

Accordingly, LSC should have been aware of the SEC's approval of the NYSE's proposed rule change regarding prohibited odd-lot day trading.

(b) LSC's Argument That There Was No Notice Prohibiting Odd-Lot Day Trading

LSC argues that it did not have notice that the odd-lot day-trading activity was prohibited.²⁷⁷ The Hearing Panel disagrees. As discussed above, NYSE members, such as LSC, received notice of the prohibited trading activity from the SEC on February 24, 1994, and from the NYSE on April 18, 1994. Thereafter, on March 19, 2004, IM 04-14 reinforced the prohibition of “[o]ther types of trading activity in odd-lot orders that is not consistent with traditional odd-lot investment activity, including ... any pattern of activity that would suggest day trading....”²⁷⁸

LSC also had adequate notice that the NYSE would discipline members for engaging in the prohibited odd-lot day-trading practices. The SEC Release approving the proposed rule and subsequent Information Memos warned members of the possibility of regulatory action. The Release stated that “the Exchange intends to initiate appropriate regulatory action if it finds that member organizations have permitted such trading practices, either for proprietary accounts or

²⁷⁶ CX-4, at 1, n.1.

²⁷⁷ LSC's Post-Hrg Br. at 78-79.

²⁷⁸ CX-4.

for the accounts of its customers.”²⁷⁹ IM 94-14 stated “[s]hould such trading activity occur involving the odd-lot limit order service, the Exchange intends to take regulatory action.”²⁸⁰ Then, after reminding members of the prohibited odd-lot trading practices, IM 04-14 clearly stated that “[t]hese abusive odd-lot practices ... may also constitute a failure to adhere to principles of good business practice (Exchange Rule 401), ... [and] conduct inconsistent with just and equitable principles of trade (Exchange Rule 476(a)(6)).”²⁸¹

The NYSE Hearing Board has enforced the odd-lot prohibitions through formal actions against its member firms. For example, in a 2006 case, the NYSE Hearing Board accepted a stipulation and consent finding that a firm violated NYSE Rules 476(a)(6) and 401 by introducing for execution on the NYSE, through the firm’s connection to SuperDOT, odd-lot orders that were inconsistent with the NYSE’s odd-lot policies.²⁸² Specifically, the firm, among other things, allowed a non-member customer to enter odd-lot orders, the majority of which were limit orders, in a pattern of day trading.²⁸³ In the decision, the Hearing Board cited IM 94-14 and noted that it “*was filed with, and approved as an NYSE rule by, the Securities and Exchange Commission.*”²⁸⁴

²⁷⁹ CX-5, at 3.

²⁸⁰ CX-3, at 2.

²⁸¹ CX-4, at 2.

²⁸² See *Bear Stearns & Co., Inc.*, NYSE Decision 06-NYSE-122, 2006 NYSE Disc. Action LEXIS 138, at *4 (Hearing Board June 28, 2006); see also *Pioneer Capital Corp.*, NYSE Decision 06-NYSE-160, 2006 NYSE Disc. Action LEXIS 187, at *9 (Hearing Board Sept. 7, 2006) (stating “[t]he Securities and Exchange Commission approved the policies and procedures set forth in Information Memo 94-14 giving it the full force and effect of a NYSE rule.”) (citing Exchange Act Rel. No. 34-33678 (Feb. 24, 1994)).

²⁸³ *Bear Stearns*, 2006 NYSE Disc. Action LEXIS 138, at *7-8.

²⁸⁴ *Id.* at *7, n.1 (citing Exchange Act Rel. No. 34-33678 (Feb. 24, 1994)) (emphasis added).

(c) LSC's Argument That It Did Not Demonstrate Bad Faith Or Unethical Conduct

LSC argues that it is necessary for Market Regulation to prove that it demonstrated bad faith or unethical behavior because LSC contends there is no NYSE rule prohibiting odd-lot day trading.²⁸⁵ LSC asserts that Market Regulation failed to establish either because the evidence merely shows that LSC was not aware of IM 94-14.²⁸⁶

As stated above, the Hearing Panel finds that the SEC approved the NYSE's proposed rule prohibiting odd-lot limit orders in a pattern of day trading. However, even assuming, as LSC contends, that there was not a rule prohibiting odd-lot day trading, the Panel concludes that LSC's violation of the NYSE's clearly stated prohibition of odd-lot limit orders in a pattern of day trading constitutes unethical conduct, in violation of NYSE Rules 476(a)(6) and 401. While LSC claimed to be unaware of the prohibition of trading odd-lot limit orders in a pattern of day trading, the SEC has repeatedly emphasized that "[p]articipants in the securities industry must take responsibility for compliance with regulatory requirements and cannot be excused for lack of knowledge, understanding, or appreciation of these requirements."²⁸⁷ Rules 476(a)(6) and 401 impose a broad ethical standard of conduct.²⁸⁸ The rules depend on fair dealing and marketplace practices.²⁸⁹ LSC had an ethical duty to comply with the trading prohibition announced by both the SEC and the NYSE.

²⁸⁵ See LSC's Post-Hrg Br. at 24-25.

²⁸⁶ Lek testified that he never read the SEC Release, IM 94-14, and IM 04-14. Hearing Tr. (Lek) at 927-28, 2227-28, 2238.

²⁸⁷ *Thomas C. Kocherhans*, 52 S.E.C. 528, 531 (1995) (citing *Kirk A. Knapp*, 51 S.E.C. 115, 134 (1992)).

²⁸⁸ NYSE Rule 476(a)(6) "focuses on the securities professional's conduct rather than on a subjective inquiry into the professional's intent or state of mind. Accordingly, a violation of the rule need not be premised on a motive or scierter finding." *Thomas W. Heath, III*, Exchange Act Rel. No. 59223, 2009 SEC LEXIS 14, at *15 (Jan. 9, 2009) (citations omitted).

²⁸⁹ *Cf. Dep't of Enforcement v. Conway*, No. E102003025201, 2010 FINRA Discip. LEXIS 27, at *29 (N.A.C. Oct. 26, 2010) (citing *Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12-15 (N.A.C. June 2, 2000)).

2. Conclusion

The Hearing Panel finds that LSC violated NYSE Rules 476(a)(6) and 401 by introducing for execution on the NYSE a pattern of odd-lot orders that were prohibited by IM 94-14. The Panel also finds that LSC violated NYSE Rule 405(1) by failing to learn essential facts relative to the odd-lot limit orders in a pattern of day trading that it introduced for execution on the NYSE.

B. LSC Violated The September 18th Order

Market Regulation alleges that LSC willfully violated Section 12(k)(4) of the Exchange Act by introducing short sale transactions for execution in contravention of the September 18th Order. Market Regulation also alleges that such activity violated NYSE Rule 401.²⁹⁰

Section 12(k)(4) of the Exchange Act states, in relevant part, that “[n]o member of a national securities exchange, broker, or dealer shall . . . effect any transaction in, or induce the purchase or sale of, any security in contravention of an order of the Commission under [Section 12(k)] unless such order has been stayed, modified or set aside [by a reviewing court] as provided in [Section 12(k)(5)] or ceased to be effective upon direction of the President as provided in [Section 12(k)(3)].” The SEC issued the September 18th Order pursuant to its authority under Section 12(k)(4) of the Exchange Act.²⁹¹ The September 18th Order, which was in effect from September 19 through October 8, 2008, prohibited the short selling of the publicly traded common stock of the Included Financial Firms.

From September 19 to October 8, 2008, LSC effected approximately 6,468 short sale transactions (related to approximately 2,822 orders) on behalf of its customers in the common

²⁹⁰ See Charging Memorandum, Charges IV and V.

²⁹¹ CX-129.

stock of certain Included Financial Firms in contravention of the September 18th Order.²⁹² These short sales occurred because LSC intentionally exempted certain customers from its ROX screening program, which LSC had designed to block the banned securities, and failed to extend the expiration date in ROX to comport with the extension of the September 18th Order.

The Hearing Panel finds that LSC violated Section 12(k)(4) of the Exchange Act and NYSE Rule 401. LSC violated Section 12(k)(4) of the Exchange Act by introducing for execution on the NYSE approximately 6,468 short sale transactions in the common stock of Included Financial Firms in contravention of the September 18th Order. The Panel finds that LSC's violation of the Section 12(k)(4) of the Exchange Act was willful. A finding of willfulness does not require intent to violate the law, but merely intent to do the act that constitutes a violation of the law.²⁹³ A failure to act may be willful even though it was inadvertent.²⁹⁴ Applying these principles, the Hearing Panel concludes that LSC acted willfully in failing to prevent short sales in the common stock of the Included Financial Firms during the time period that the September 18th Order was in effect. LSC violated NYSE Rule 401 by failing to adhere to the principles of good business practice in that it introduced the short sale transactions in violation of the September 18th Order.

1. LSC's Arguments

LSC presented two arguments in defense of the allegations relating to the September 18th Order. The Hearing Panel rejects LSC's arguments for the reasons stated below.

²⁹² CX-26(a)-(m), CX-125; JX-13. Approximately 1,309 of the 6,468 short sale transactions occurred between October 3 and October 8, 2008. CX-26(k)-(m).

²⁹³ *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976).

²⁹⁴ *Stonegate Sec.*, 55 S.E.C. 346, 351, n.9 (2001) (citing *Hammon Capital Mgmt. Corp.*, 48 S.E.C. 264, 265 (1985)); *Jesse Rosenblum*, 47 S.E.C. 1065, 1067 & n.9 (1984); *Oppenheimer & Co.*, 47 S.E.C. 286, 287-88 (1980) (citing *Haight & Co., Inc.*, 44 S.E.C. 481, 507 (1971), *aff'd without opinion* (D.C. Cir. 1971)).

(a) LSC's Argument That Its Customers Agreed To Perform Their Own Stock Locate

LSC argues it should not be liable for the short sales relating to the Dimension entities it exempted because Dimension had previously agreed to perform its own stock locate and was responsible for complying with the September 18th Order.²⁹⁵ However, the September 18th Order contains no exemption for entities who have performed a "locate" pursuant to Rule 203(b)(1) of Regulation SHO. More importantly, Section 12(k)(4) of the Exchange Act requires each "member of a national securities exchange, broker, or dealer" to abide by the September 18th Order. Accordingly, LSC had an independent obligation to ensure that it complied with the September 18th Order. There was no rational basis for LSC to exempt the Dimension accounts from its systemic controls. In doing so, LSC executed short sales in violation of the September 18th Order.

(b) LSC's Argument That Its Customers Were Market Makers

LSC asserted that certain of its customers were market makers and therefore exempted from the requirements of the September 18th Order.²⁹⁶ Specifically, LSC stated that Optiver US, Diamond Carter Trading, and Group One were market makers.²⁹⁷ While the SEC amended the September 18th Order to include a market-making exemption, LSC did not satisfy its burden to

²⁹⁵ Hearing Tr. (Lek) at 2239-41. LSC has provided different reasons for its lack of culpability. During the investigation, LSC claimed that Dimension Securities, Dimension Brokerage, and Dimension Trading International were exempt from the September 18th Order because they were broker-dealers exempt from the locate requirement of Rule 203(b) of Regulation SHO. JX-13.

²⁹⁶ LSC's Post-Hrg Br. at 44.

²⁹⁷ *Id.*; JX-17, at 2; JX-23, at 2; Hearing Tr. (Lek) 2055-57, 2084, 2316-17.

support its entitlement to this exemption.²⁹⁸ Pursuant to the September 18th Order, the SEC exempted the following entities from the short sale ban:

[r]egistered market makers, block positioners, or other market makers obligated to quote in the over-the-counter market, in each case that are selling short a publicly traded security of an Included Financial Firm *as part of bona fide market making in such security*.²⁹⁹

Lek testified that he knew these entities and had observed them making markets on the various options exchanges.³⁰⁰ However, there was no evidence that the above entities were *registered* as market makers.

In addition, firms make markets in *particular* securities, not entire categories of securities. The Exchange Act defines a market maker as one who “with respect to *a security*, holds himself out (by entering quotations in an interdealer communications system or otherwise) as being willing to buy and sell *such security* for his own account on a regular or continuous basis.”³⁰¹ Accordingly, LSC must demonstrate its customers’ market-maker status on a security-by-security basis. There was no evidence that any of the short sales at issue were part of bona fide market making in such security, or in an option or other derivative related to the security. Accordingly, there is insufficient evidence to establish that LSC properly exempted Optiver US, Diamond Carter Trading, and Group One from its systemic controls.

²⁹⁸ See *Rosen ex rel. Egghead.com, Inc. v. Brookhaven Capital Mgmt., Co.*, 194 F. Supp. 2d. 224, 228 (S.D.N.Y. 2002) (“Courts have also specifically held in the securities context that defendants have the burden to plead and prove statutory exemptions.”); *James E. Ryan*, 47 S.E.C. 759, 760; 1982 SEC LEXIS 1960 at *3 (1982) (in order to qualify for the market maker exemption set forth in Exchange Act Rule 144, respondent had the burden of proving that he was a market maker as that term is defined in Section 3(a)(38) of the Exchange Act); *Dep’t of Enforcement v. Legacy Trading Co., LLC*, No. 2005000879302, 2010 FINRA Discip. LEXIS 20 at *28 (N.A.C. Oct. 8, 2010) (finding that respondents had failed to demonstrate that short sales effected were made in connection with bona fide market making transactions, so as to be eligible for the market maker exemption and exempt from the locate requirement of Rule 203(b)(1) of Regulation SHO and NASD Rule 3370(b)(2)).

²⁹⁹ CX-129, at 3 (emphasis added).

³⁰⁰ Hearing Tr. (Lek) at 2055-57.

³⁰¹ 15 U.S.C. § 78c(a)(38) (emphasis added).

2. Conclusion

The Hearing Panel finds that LSC willfully violated Section 12(k)(4) of the Exchange Act by introducing for execution on the NYSE approximately 6,468 short sale transactions in the common stock of Included Financial Firms in contravention of the September 18th Order. LSC also violated NYSE Rule 401 by failing to adhere to the principles of good business practice by introducing the short sale transactions in violation of the September 18th Order.

C. LSC Violated The Requirements Of Regulation SHO

Market Regulation alleges that LSC willfully violated Rules 204T(a), 204(a), 204T(b), 204T(c), and 204(c) of Regulation SHO, by (i) failing to timely close out Fails in certain equity securities, (ii) accepting certain customer short sale orders in equity securities for which it had an open Fail while LSC and the customer were in the “penalty box”, and (iii) failing to timely notify its customers that it had an open Fail that had not been closed out.³⁰² The Hearing Panel concludes that LSC violated the above Regulation SHO rules and addresses each violation below.³⁰³

1. LSC Failed To Timely Close Out Fail-To-Deliver Positions In Violation Of Rules 204T(a) And 204(a) Of Regulation SHO

LSC failed to timely close out Fails in both long and short sale transactions in violation of Rules 204T(a) and 204(a) of Regulation SHO. Rule 204(a) requires a participant, such as LSC, to deliver securities by settlement date for long or short sale transactions in any equity security; or, when the participant has a Fail in that equity security, the participant shall, by no later than the

³⁰² See Charging Memorandum, Charges VI, VII, VIII, and IX. Charge IX does not include a reference to Rule 204(c) or the term “willful”; however, LSC was on notice of this alleged violation. Paragraph 79 apprised LSC of a willful violation of Rules 204T(c) and 204(c).

³⁰³ In reaching its conclusion regarding LSC’s liability for the Regulation SHO violations, the Hearing Panel considered the SEC No-Action Letter, dated September 6, 2013, as well as the supplemental briefing submitted by the parties on this issue. Here, the transactions at issue occurred during 2008 and 2009, approximately four years before the SEC issued the No-Action Letter. The Hearing Panel declined to apply the No-Action Letter retroactively.

beginning of regular trading hours on the settlement day following the settlement date (T+4), immediately close out the Fail by borrowing or purchasing securities of like kind and quantity. Rule 204(a) is identical to its predecessor, Rule 204T(a). Under certain circumstances, Rule 204 provides for additional time to close out Fails. For example, Rule 204(a)(1), like Rule 204T(a)(1), provides that, if a participant had a Fail and it can demonstrate on its books and records that such Fail resulted from a long sale, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date (T+6), close out the Fail. Under Rule 204(a)(1), the Fail can be closed out by either borrowing or purchasing securities. This differs from Rule 204T(a)(1), which only permitted a Fail to be closed out by purchasing.

LSC's violative Fails relating to its long and short sale transactions are discussed below.

(a) Long Sales

LSC violated Rule 204T(a) by failing to timely close out Fails from long sales in the following securities: HTM, GW, NG, and AZ. Applying the willfulness standard described above, the Hearing Panel finds that LSC's violations were willful.³⁰⁴ Each security is discussed below.

HTM

LSC's net Fail in HTM was between 6,200 and 150,000 shares from October 31 through November 17, 2008.³⁰⁵ LSC did not timely close out its Fail from a customer's October 29, 2008 sale. The customer did not deliver 6,200 shares on November 3, the settlement date. Applying Rule 204T(a)(1), LSC was required to close out the Fail by the beginning of regular trading

³⁰⁴ See *supra* footnotes 293 and 294 accompanying text.

³⁰⁵ CX-132.

hours on November 6, 2008 (T+6). LSC did not do so. Instead, it waited for the customer to deliver the shares on November 7, 2008.

LSC also failed to timely close out its Fail in HTM resulting from its customer's sales on October 30, 2008, totaling 106,400 shares, and on October 31, 2008, in the amount of 37,400 shares. The customer did not deliver the shares on the respective settlement dates of November 4 and 5. Applying Rule 204T(a)(1), LSC should have closed out the Fail relating to (1) the October 30 sales by the beginning of regular trading hours on November 7, and (2) the October 31 sales by the beginning of regular trading hours on November 10. LSC did not do so. Instead, its Fail remained open until the customer delivered the shares on November 18, 2008.

GW

LSC had a Fail in GW of between 199,900 and 200,000 shares from December 5 through December 9, 2008.³⁰⁶ The Fail stemmed from a December 2 customer sale. The customer did not deliver the 200,000 shares on the December 5 settlement date.³⁰⁷ Applying Rule 204T(a)(1), LSC should have closed out the Fail before trading began on December 10, 2008. LSC did not do so. Instead, it waited for the customer to deliver the shares, which occurred during the trading day on December 10, 2008.³⁰⁸

NG

LSC had an outstanding Fail in NG of between 5,300 and 8,000 shares from January 13 through January 22, 2009.³⁰⁹ A portion of the Fail related to a customer sale on January 12, 2009. The customer sold long 253,800 NG shares, but delivered only 245,800 shares on the January 15

³⁰⁶ CX-28, CX-132.

³⁰⁷ CX-28, CX-132.

³⁰⁸ CX-29; Hearing Tr. (Louis) at 1617.

³⁰⁹ CX-30, CX-132.

settlement date.³¹⁰ This contributed to the NG Fail reflected on CNS.³¹¹ Applying Rule 204T(a)(1), LSC should have closed out the Fail by the beginning of regular trading hours on January 21, 2009. LSC did not do so. Instead, it closed out its NG Fail on January 23, 2009, when the customer delivered the remaining 8,000 NG shares.³¹²

AZ

LSC had outstanding Fails in AZ for two time periods during May and June 2009. The first AZ Fail period related to a customer long sale on April 17, 2009, for 35,600 shares. The customer did not deliver any shares on the April 22 settlement date. On April 28, the customer delivered 18,830 shares, stemming from an April 23 purchase.³¹³ LSC's Fail in AZ on May 1 was 16,770 shares, the difference between the customer's long sale of 35,600 shares and its purchase of 18,830 shares.³¹⁴ Applying Rule 204T(a)(1), LSC should have closed out the Fail by the beginning of regular trading hours on April 27, 2009; however, it maintained a Fail until at least May 13.³¹⁵ On May 15, 2009, LSC closed out its Fail when it received 90,000 AZ shares.³¹⁶

The second AZ Fail related to a May 26, 2009, customer long sale for 28,300 shares.³¹⁷ The customer failed to make delivery to LSC on May 29, the settlement date, which caused LSC to have a Fail of 28,830 shares.³¹⁸ Applying Rule 204T(a)(1), LSC should have closed out the

³¹⁰ CX-31.

³¹¹ CX-30, at 3; CX-132.

³¹² CX-30, CX-31, CX-132.

³¹³ RX-137, at 6.

³¹⁴ CX-35; RX-137, at 2, 5; Hearing Tr. (Louis) at 1596.

³¹⁵ CX-35, CX-132; RX-137.

³¹⁶ CX-36.

³¹⁷ RX-137, at 2, 5.

³¹⁸ CX-37, CX-132; RX-137.

Fail by the beginning of regular trading hours on June 3, 2009; however, an AZ Fail remained open until June 9 when LSC closed out its Fail when it received 28,900 AZ shares.³¹⁹

(b) Short Sales

LSC violated Rules 204T(a) and 204(a) by failing to timely close out Fails from short sales relating to the following securities: LEN, FRD, VWO, YAVY, SPG, MRGE, SSW, CVO, MSJ, and MBI.³²⁰ The Hearing Panel also finds that LSC's violations were willful.³²¹ Each security is discussed below.

LEN

LSC had an outstanding net LEN Fail on February 26 and February 27, 2009.³²² The Fail resulted in part from the failure of three customers to fully deliver their 10,000 LEN shares from short sales they effected. On February 26, 2009, the settlement date, only one customer had delivered 1,000 shares, which caused LSC to have a net Fail of 9,000 shares.³²³ Applying Rule 204T(a), LSC was required to close out its Fail by no later than the beginning of regular trading hours on February 27, the settlement day following the settlement date (T+4). LSC did not do so. A Fail remained open at LSC until March 2, when it received 20,000 LEN shares.³²⁴

FRD

LSC had an outstanding Fail in FRD of between 1,305 and 5,740 shares from February 27 through March 17, 2009.³²⁵ LSC's Fail was due in part from one customer's failure to fully

³¹⁹ CX-37, CX-38, CX-132; RX-137.

³²⁰ Temporary Rule 204T(a) applied to short sales through July 31, 2009; and Rule 204(a), the final rule, applied to short sales after July 31, 2009.

³²¹ See *supra* footnotes 293 and 294 and accompanying text.

³²² CX-132.

³²³ CX-50, CX-51, CX-132.

³²⁴ CX-50, CX-51, CX-132.

³²⁵ CX-44, CX-132.

deliver its shares from a February 24 short sale. The customer sold short 8,105 shares, but as of the February 27 settlement date, the customer had not delivered 3,205 shares to LSC.³²⁶

Applying Rule 204T(a), LSC was required to close out its Fail by the beginning of March 2; however, LSC's Fail remained open until March 17, 2009.³²⁷

VWO

LSC had an outstanding Fail in VWO of between 10,480 and 10,580 shares from May 7 through May 11, 2009.³²⁸ The Fail stemmed from a May 4 customer short sale of 10,580 shares.³²⁹ The customer did not deliver any shares on the May 7 settlement date, causing LSC to have a 10,580-share Fail.³³⁰ Applying Rule 204T(a), LSC was required to close out its Fail by the beginning of May 8; however, LSC's Fail remained open until May 12.³³¹

YAVY

LSC had an outstanding Fail in YAVY of between 1,000 and 1,200 shares from May 6 through May 29, 2009.³³² The Fail was related to a customer's failure to deliver 1,000 shares when it sold short on May 1.³³³ On May 6, the settlement date, LSC had a Fail of 1,000 shares.³³⁴ Applying Rule 204T(a), LSC was required to close out this Fail by the beginning of May 7;

³²⁶ CX-44, at 1; CX-132.

³²⁷ CX-44, CX-132.

³²⁸ CX-46, CX-132.

³²⁹ CX-47.

³³⁰ CX-46, CX-132.

³³¹ CX-46, CX-47, CX-132.

³³² CX-48, CX-132.

³³³ CX-49.

³³⁴ CX-48, CX-132.

however, the Fail remained open until June 1, when LSC received 1,200 shares as a result of a May 27 purchase.³³⁵

SPG

LSC had an outstanding Fail in SPG of between 850 and 3,577 shares from June 4 through June 12, 2009.³³⁶ One cause for the Fail was a customer's failure to deliver shares. The customer had sold short 2,400 shares on June 3. On June 8, the settlement date, the customer failed to deliver any shares, which caused LSC to have a net Fail of 1,950 shares.³³⁷ Applying Rule 204T(a), LSC was required to close out this Fail by the beginning of June 9, but a Fail remained open until June 15, when LSC received shares from customer purchases on June 8 and 10.³³⁸

MRGE

LSC had an outstanding Fail in MRGE ranging between 10,671 and 25,671 shares from June 4 through June 17, 2009.³³⁹ LSC's net Fail on June 4 was 13,000 shares. On June 1, a customer sold short 13,000 shares, but did not deliver any shares on the June 4 settlement date.³⁴⁰ Applying Rule 204T(a), LSC was required to close out this Fail by the beginning of June 5, but a Fail remained open until June 18 when LSC received 32,000 MRGE shares.³⁴¹

³³⁵ CX-49, CX-132.

³³⁶ CX-55, CX-132; RX-137.

³³⁷ CX-55, at 3; CX-132; RX-137.

³³⁸ CX-55, CX-56, CX-132; RX-137.

³³⁹ CX-52, CX-132; RX-137.

³⁴⁰ CX-52, at 1; CX-132; RX-137, at 2.

³⁴¹ CX-53, CX-132; RX-137.

SSW

LSC had an outstanding Fail in SSW of between 800 and 9,800 shares from July 1 through July 13, 2009.³⁴² On July 1, an LSC customer did not deliver any shares related to its June 26 short sale, which caused LSC to have a Fail of 800 shares.³⁴³ On July 6, the same customer did not deliver any shares related to its June 30 net short sale of 5,000 shares, which caused LSC's Fail to increase to 5,800 shares.³⁴⁴ Applying Rule 204T(a), LSC was required to close out the July 1 Fail by the beginning of July 2, and close out the July 6 Fail by the beginning of July 7. LSC did not timely close out the SSW Fail, and a Fail remained open through July 13, 2009.³⁴⁵

CVO

LSC had outstanding Fails in CVO during three time periods. From June 4 through July 20, 2009, LSC had an outstanding Fail in CVO of between 2,000 and 4,000 shares.³⁴⁶ On June 4, the settlement date for a customer's 2,000 share short sale, the customer did not deliver any shares, causing LSC to have a Fail of 2,000 shares.³⁴⁷ Applying Rule 204T(a), LSC was required to close out the Fail by the beginning of June 5. It did not do so and the Fail remained open until July 21 when LSC received 4,000 shares.³⁴⁸

³⁴² CX-59, CX-132; RX-137.

³⁴³ CX-59, CX-132.

³⁴⁴ CX-59, CX-132.

³⁴⁵ CX-59, CX-132.

³⁴⁶ CX-61, CX-132.

³⁴⁷ CX-61, at 1; CX-132.

³⁴⁸ CX-61, CX-62, CX-132; RX-137, at 20.

From August 18 through August 26, 2009, LSC had a Fail in CVO between 7,000 and 57,000 shares.³⁴⁹ On August 14, LSC's customer sold short 11,000 shares.³⁵⁰ On August 19, the settlement date, the customer did not deliver any shares, causing LSC to have a net Fail of 7,000 shares.³⁵¹ Applying Rule 204(a), LSC was required to close out the Fail by the beginning of August 20. LSC did not timely close out the Fail as required. Rather, a CVO Fail remained open until August 27, when LSC closed out its Fail through the receipt of borrowed shares.³⁵²

From September 3 through at least September 18, 2009, LSC had an outstanding Fail in CVO between 429 and 14,979 shares.³⁵³ On August 31, 2009, LSC's customer sold short 2,300 shares.³⁵⁴ On September 3, the settlement date, the customer did not deliver any shares, which caused LSC to have a net Fail of 2,229 shares.³⁵⁵ Applying Rule 204(a), LSC was required to close out the Fail by the beginning of September 4. LSC did not timely close out the Fail as required. Instead, a Fail remained open until September 22, 2009, when the customer's purchase of 95,000 shares settled.³⁵⁶

MSJ

LSC had an outstanding Fail in MSJ between 4,000 and 13,000 shares from August 5 through August 21, 2009.³⁵⁷ On August 6, the settlement date for the August 3 trades, the

³⁴⁹ CX-63, CX-132.

³⁵⁰ CX-63, at 1; RX-137.

³⁵¹ CX-63, at 1; CX-132.

³⁵² CX-63, CX-64, CX-132; RX-137, at 22.

³⁵³ CX-65, CX-132.

³⁵⁴ CX-66; RX-137.

³⁵⁵ CX-65, at 1; CX-132.

³⁵⁶ CX-66, CX-132.

³⁵⁷ CX-67, CX-132.

customer did not deliver 5,000 shares, which caused LSC to have a Fail of 5,000 shares.³⁵⁸ On August 7, the customer did not deliver 5,000 shares from an August 4 short sale, which caused LSC's Fail to increase to 10,000 shares.³⁵⁹ On August 11, the customer did not deliver 3,000 shares from its net sale on August 6, which again increased LSC's Fail to 13,000 shares.³⁶⁰ Applying Rule 204(a), LSC was required to close out its Fail on August 6 by the beginning of August 7. LSC did not timely close out the Fail as required. Rather, LSC's Fail increased as the same customer continued to fail to deliver its MSJ shares. LSC's Fail remained open until August 24, 2009, when customer purchases on August 19 settled.³⁶¹

MBI

LSC had an outstanding Fail in MBI of between 11,500 and 12,500 shares from August 25 through September 4, 2009.³⁶² On August 22, an LSC customer sold short 50,000 shares and purchased 37,500 shares, resulting in a net sale of 12,500 shares.³⁶³ On August 26, the settlement date, the customer did not deliver the shares, which caused LSC to have a Fail of 12,500 shares.³⁶⁴ Applying Rule 204(a), LSC was required to close out the August 26 Fail by the beginning of August 27. LSC did not close out the Fail as required, and the Fail remained open until September 8, 2009, when LSC received 12,500 borrowed MBI shares.³⁶⁵

³⁵⁸ CX-67, at 1; CX-68, at 1; CX-132; RX-137.

³⁵⁹ CX-67, at 2; CX-132.

³⁶⁰ CX-67, at 3; CX-132.

³⁶¹ CX-68, at 1; CX-132; RX-137.

³⁶² CX-132.

³⁶³ CX-70.

³⁶⁴ CX-69, at 1; CX-70, CX-132.

³⁶⁵ CX-70, CX-132; RX-137, at 34.

(c) LSC's Arguments

LSC presented five arguments in defense of the allegations relating to its failure to timely close out Fails in violation of Rules 204T(a) and 204(a) of Regulation SHO. The Hearing Panel rejects LSC's arguments for the reasons stated below.

(1) LSC's Argument That There Is No Evidence Of Naked Short Selling

In defense of the Regulation SHO violations, LSC argues that the purpose of Rules 204T and 204 was to prevent abusive naked short selling.³⁶⁶ LSC further argues that Market Regulation presented no evidence that the Fails at issue resulted from naked short selling. The Hearing Panel acknowledges that one of the goals of Rules 204T and 204 was to address naked short selling; however, the SEC also stated that another important goal was the reduction of Fails.³⁶⁷ Accordingly, LSC's argument does not relieve it from liability for the violations of Rules 204T and 204 of Regulation SHO.

(2) LSC's Argument That The Securities Were "Easy To Borrow" Securities

LSC asserts that the securities were "easy to borrow" for virtually every security at issue relating to the Regulation SHO violations.³⁶⁸ The Panel rejects this defense. Rules 204T and 204 do not contain an exemption or exception for securities that are deemed "easy to borrow."

(3) LSC's Argument That It Was Entitled To Pre-Fail Credits

LSC asserts that it is not liable for certain Regulation SHO violations because the Fails were closed out with customer purchases. Specifically, LSC argues that the short sales in VWO,

³⁶⁶ LSC's Post-Hrg Br. at 50-51.

³⁶⁷ RX-39, Exchange Act Rel. No. 34-60338, at 1, 2 n.3, 4, 6, 9, 12, 17, 19, 21, 27, 34, 38, 45, 55, 56, 60, 67, 72, 75, 77, 83, 86, 87, 89 n.257, 91, and 95.

³⁶⁸ RX-137, at 2-5.

SPG, and SSW were covered with customer purchases, and thus there was no violation of Rule 204T because the “pre-fail credit” provision in Rule 204T(e) applied.³⁶⁹ For example, LSC argues that it was not required to take any action to close out the 10,580 Fail in VWO that stemmed from its broker-dealer customer’s short sale on May 4, 2009, because the broker-dealer customer purchased 40,780 shares on May 7, which settled on May 12. The Hearing Panel finds that LSC’s assertion of the pre-fail credit does not apply under the facts and circumstances of this case.

Rule 204T(a) requires a participant of a registered clearing agency such as LSC to *deliver* securities to a registered clearing agency by settlement date.³⁷⁰ In lieu of delivering the securities by settlement date, a participant shall, by no later than the beginning of regular trading hours on the day after settlement day (T+4), immediately close out its Fail by borrowing or purchasing securities of like kind and quantity.³⁷¹ The SEC stressed that the close-out requirement requires that the participant take affirmative action to purchase or borrow securities. The “participant also must be able to demonstrate *on its books and records* that on the Close-Out Date *it purchased or borrowed shares in the full quantity of its settlement date fail to deliver position and, therefore, that the participant has a net flat or net long position on its books and records in that equity security on the Close-Out Date.*”³⁷² If a participant does not purchase or borrow shares to close out a Fail, the participant violates the close-out requirement of Rule 204T.³⁷³

³⁶⁹ LSC’s Post-Hrg Br. at 58-66; *see* LSC’s Supp. Br. Regarding No-Action Letter (arguing that, in light of the SEC’s No-Action Letter, customer purchases should be included when calculating the pre-fail credit); *see also supra* footnote 303.

³⁷⁰ RX-29, at 15.

³⁷¹ *Id.*

³⁷² *Id.* at 16 (emphasis added).

³⁷³ *Id.* at 25.

Rule 204T's close-out requirement had broad implications for a participant and its customers.³⁷⁴ For example, Rule 204T(b) places a participant and its broker-dealer customers in the "penalty box" when the participant has a Fail. Both the participant and the broker-dealer customer are prevented from accepting a short sale without first borrowing the security, or entering into a bona fide arrangement to borrow the security.³⁷⁵ That restriction remains in place until the participant closes out the Fail by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.³⁷⁶

To alleviate the widespread implications of Rule 204T on all broker-dealers from which a participant receives trades for clearance and settlement, Rule 204T(d) permits a participant to allocate the portion of its Fail to the broker-dealer for which it clears based on that broker-dealer's short position.³⁷⁷ Then, if that broker-dealer customer does not comply with the close-out requirements of Rule 204T(a), it is subject to the "penalty box" provision of subparagraph (b) and must notify the participant thereof. A broker-dealer can also avoid the requirements of subparagraphs (a) and (b) by complying with the pre-fail credit provisions of Rule 204T(e). Rule 204T(e) provides that:

[e]ven if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with paragraph (a) of this section, or has not allocated a fail to deliver position to a broker or dealer in accordance with paragraph (d) of this section, a broker or dealer shall not be the subject to the requirements of paragraph (a) or (b) of this section if the broker or dealer purchases securities prior to the beginning of regular trading hours on the settlement day after the settlement date for a long or short sale to close out an

³⁷⁴ A participant is required to notify any broker-dealer from which it receives trades for clearance or settlement that (1) it has a Fail that has not been closed out, and (2) when the purchase, made by the participant to close out the Fail, cleared and settled at the registered clearing agency. *Id.* at 92.

³⁷⁵ *Id.* at 25.

³⁷⁶ *Id.* at 91. A broker-dealer customer can remove itself from the requirements of subsection (b) if: (1) it timely certifies to the participant that it has not incurred a fail-to-deliver on settlement date in a security in which the participant has a Fail, or (2) the broker-dealer is in compliance with the pre-fail credit provisions of Rule 204T(e).

³⁷⁷ *Id.* at 17.

open short position, and if,

- (1) The purchase is bona fide;
- (2) The purchase is executed on, or after, the trade date but by no later than the end of regular trading hours on settlement date for the transaction;
- (3) The purchase is of a quantity of securities sufficient to cover the entire amount of the open short; and
- (4) The broker or dealer can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is seeking to demonstrate that it has purchased shares to close out its open short position.

Throughout Rule 204T, the SEC drew a distinction between a participant, such as LSC, and broker-dealers from which a participant receives trades for settlement, such as LSC's broker-dealer customers. Here, LSC erroneously claims credit for the purchases of its broker-dealer customers. However, as reflected above, Rule 204T(e), the pre-fail credit exception, relates to broker-dealers, not participants like LSC. In fact, it refers to a broker-dealer's "open short" position.³⁷⁸ LSC cannot claim the pre-fail credit for its customers' purchases.

There is also no evidence that LSC ever allocated its Fails in any of the securities to any of its broker-dealer customers, which it was permitted to do pursuant to Rule 204T(d).³⁷⁹ Accordingly, LSC was solely responsible for closing out its Fails to CNS. It did not do so in a timely manner.

³⁷⁸ RX-29, at 93; see also *Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors against "Naked" Short Selling Abuses, Rule 204TFAQ*, www.sec.gov/divisions/marketreg/204tfaq.htm.

³⁷⁹ Hearing Tr. (Louis) at 1660, 1728 ("We don't allocate to the customer.").

**(4) LSC's Argument That Certain Securities Were
"Deemed to Own"**

LSC argues that because its customers were "deemed to own" GW, NG, HTM, and AZ, it was entitled to rely on the extended 35-day close out exemption of Rule 204(a)(2).³⁸⁰ Regarding the long sale transactions in GW, NG, and HTM, LSC states that they were "pending" delivery between the settlement date and the delivery date and, therefore, the customer was "deemed to own" the shares.³⁸¹ For the long sale in AZ, LSC states that AZ is a sponsored international arbitrage (a/k/a American Depository Receipt ("ADR") arbitrage).³⁸² LSC stated that in final Rule 204, the SEC permitted the extended close-out period for all securities a customer was "deemed to own" under Rule 200(b)(3) of Regulation SHO. LSC explained that ADR securities are "convertible securities" and thus are "deemed to own." LSC asserted that it was entitled to the extended close-out period. The Hearing Panel rejects LSC's argument.

The long sale transactions at issue all occurred prior to July 31, 2009, when Rule 204T was in effect. Rule 204T did not have a "deemed to own" provision or an exception for securities deemed to be owned from the close-out requirements of Rule 204T(a) of Regulation SHO. The only securities entitled to an extended close-out exception were securities sold pursuant to Exchange Act Rule 144. None of the securities at issue were Rule 144 securities.³⁸³

³⁸⁰ LSC's Post-Hrg Br. at 66-77. In LSC's brief and at the hearing, LSC asserted that it was also entitled to the "deemed to own" exemption for VCP; however, the Hearing Panel did not consider VCP transactions, or two AZ transactions, because they were outside the review period delineated in the Charging Memorandum. In the Charging Memorandum, the review period for violations of Rule 204T(a) of Regulation SHO relating to long sales was October 22, 2008, through July 7, 2009. The Charging Memorandum also alleged a violation of Rule 204(a) on August 14, 2009. Charging Memorandum ¶ 65. When addressing the Regulation SHO Charges relating to long sales, the Panel restricted its review to the evidence presented that pertained to the time periods delineated in the Charging Memorandum. None of the alleged long sale violations related to the transaction date of August 14, 2009. See Market Regulation's Findings at 14-21.

³⁸¹ LSC's Post-Hrg Br. at 72-74.

³⁸² *Id.* at 71.

³⁸³ Rule 204T(a)(2) of Regulation SHO.

(5) LSC's Argument That Rule 204 Did Not Apply To Options

LSC argues that Rule 204 does not apply to assigned options positions. Specifically, LSC asserts that the 12,500 share Fail in MBI was the result of the exercise of a short call option and, therefore, not covered by Rule 204.³⁸⁴ The Hearing Panel rejects LSC's argument.

There is nothing in Rule 204, or the accompanying SEC Release announcing Rule 204, that exempts short sales resulting from the exercise of an option.³⁸⁵ In fact, the SEC has repeatedly stated that certain transactions that involve options can result in a short sale.³⁸⁶ LSC's claim is also contrary to the regulatory guidance available when the SEC enacted Rule 204T. Specifically, in a September 19, 2008 Regulatory Circular providing guidance on Rule 204T, the Chicago Board Options Exchange ("CBOE") advised its members, among other things, that if a short call option was established by a person before the effective date, then any short stock position that results from the assignment of the short call option is not subject to emergency Rule 204T.³⁸⁷

The Regulatory Circular also provided information on how to calculate the delivery date for short sales resulting from the assignment of a short call position or the exercise of a long put.³⁸⁸

³⁸⁴ Hearing Tr. (Louis) at 1458-59.

³⁸⁵ However, in other instances the SEC has exempted options from Rule 201 of Regulation SHO. *Amendments to Regulation SHO*, Exchange Act Rel. No. 61595, at 46 (May 10, 2010). In addition, the September 18th Order specifically exempted sales resulting from options exercises and assignments. There is no similar exemption for Rule 204.

³⁸⁶ See, e.g., *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Exchange Act Rel. No. 58166, at n.3 (July 15, 2008); *Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Exchange Act Rel. No. 58611 (Sept. 21, 2008); and *Amendments to Regulation SHO*, Exchange Act Rel. No. 61595, at n.433 (May 10, 2010); see also SEC No-Action Letter, at 3, n.9 (Sept. 6, 2013) (confirming that Rule 204 applies to "Fails related to sales resulting from options exercises or assignments").

³⁸⁷ CBOE Regulatory Circular, *SEC Issues New Rules Regarding Short Sales (UPDATE) – Guidance on Temporary Rule 204T*, RG08-113 (Sept. 19, 2008). LSC's President, who was specifically tasked with handling Regulation SHO close-out matters, was a member of the CBOE. Hearing Tr. (Louis) at 1448-49.

³⁸⁸ CBOE Regulatory Circular, at 2.

LSC's Fail in MBI between 11,500 and 12,500 shares occurred from August 25 through September 4, 2009.³⁸⁹ There is no evidence that the customer's short call position in MBI was created prior to the enactment of Rule 204T. Accordingly, LSC has not established that it was exempt from Rule 204 for MBI.

(d) Conclusion

The Hearing Panel concludes that LSC willfully violated: (1) Rule 204T(a) by failing to timely close out Fails relating to long and short sales in HTM, GW, NG, AZ, LEN, FRD, VWO, YAVY, SPG, MRGE, SSW, and CVO; and (2) Rule 204(a) by failing to timely close out Fails relating to short sales in CVO, MSJ, and MBI.³⁹⁰

2. LSC Effected Short Sales In Violation Of Rule 204T(b) Of Regulation SHO

LSC effected short sales while in the "penalty box" in violation of Rule 204T(b) of Regulation SHO. Rule 204T(b) states that a participant may not accept a short sale order in an equity security from another person, without first borrowing the security, or entering into a bona fide arrangement to borrow the security, until the participant closes out the Fail by purchasing securities of like kind and quantity and the purchase has cleared and settled. From approximately February 23 to July 7, 2009, LSC effected short sales when it had open Fails from its customers' short sales in the following stocks: FRD, YAVY, MRGE, SSW, and CVO. There was no evidence that LSC actually borrowed shares or entered into a bona fide arrangement to borrow shares prior to effecting the short sales in FRD, YAVY, MRGE, SSW, and CVO.

The Hearing Panel finds that LSC violated Rule 204T(b) by effecting short sales when it had open Fails without first borrowing the security, or entering into a bona fide arrangement to

³⁸⁹ CX-132.

³⁹⁰ The Panel utilized the "willfulness" standard discussed above. See *supra* footnotes 293 and 294 and accompanying text.

borrow the security. Applying the willfulness standard described above, the Hearing Panel finds that LSC's violations were willful.³⁹¹

3. LSC Failed To Notify Its Broker-Dealer Customers That It Had Open Fail-to-Deliver Positions In Violation Of Rule 204T(c)/204(c) Of Regulation SHO

LSC failed to notify its broker-dealer customers that it had open Fails. Rule 204(c), which is unchanged from Rule 204T(c), requires a participant, such as LSC, to notify any broker or dealer for which it clears and settles transactions: (1) that it has a Fail that has not been closed out as required; and (2) when the purchase that it has made to close out the Fail has cleared and settled. Until such purchase has cleared and settled, the participant and any broker-dealer from which it received trades in that security for clearance and settlement are in the "penalty box" and, as a result, cannot effect short sales in that security without first borrowing the security or entering into a bona fide arrangement to borrow the security. There is no evidence that LSC notified its broker-dealer customers that it had any open Fails. Rather, the evidence reveals that LSC continued to effect short sales for its customers when it was in the "penalty box."

The Hearing Panel finds that LSC violated Rules 204T(c) and 204(c) by failing to notify its broker-dealer customers: (1) that it had Fails that had not been closed out as required; and (2) when any purchases it made to close out the Fails cleared and settled. Applying the willfulness standard described above, the Hearing Panel finds that LSC's violations were willful.³⁹²

D. LSC Violated NYSE Rule 70.40 By Conducting BlueLine Trading Without Prior Approval

Market Regulation alleges that LSC violated NYSE Rules 70.40 and 2010. NYSE Rule 70.40 requires firms to (1) obtain prior approval from NYSE Regulation before engaging in

³⁹¹ See *supra* footnotes 293 and 294 and accompanying text.

³⁹² See *supra* footnotes 293 and 294 and accompanying text.

BlueLine trading, and (2) adopt and implement comprehensive written procedures and guidelines, approved by NYSE Regulation before implementation, governing the conduct and supervision of its BlueLine business.³⁹³ LSC admits that from June 2007 to October 2009, it engaged in BlueLine trading without approval from NYSE Regulation.³⁹⁴ In July 2009, LSC notified NYSE that it was “in the process of developing specific written supervisory procedures.”³⁹⁵ Accordingly, the Hearing Panel finds that LSC violated NYSE Rule 70.40.

NYSE Rule 2010 requires a member, in the conduct of its business, to “observe high standards of commercial honor and just and equitable principles of trade.” On July 17, 2009, NYSE Regulation sent LSC the C & D Letter, instructing it to immediately cease all unapproved BlueLine trading.³⁹⁶ LSC represented to the NYSE that “all such activity has ceased . . . as of the afternoon of July 17.”³⁹⁷ Then, in subsequent letters to FINRA, dated September 23 and October 9, 2009, LSC again represented that it had instructed its Floor brokers to stop routing all orders to away markets.³⁹⁸ Despite LSC’s representations, LSC continued to engage in BlueLine trading until October 19, 2009.³⁹⁹ The Hearing Panel finds that LSC’s conduct violates NYSE Rule 2010.

1. LSC’s Arguments

While LSC acknowledges that it had not applied for BlueLine trading approval from the enactment of Rule 70.40 on June 14, 2007, until September 21, 2009,⁴⁰⁰ it denies liability for the

³⁹³ See Charging Memorandum, Charges X and XI.

³⁹⁴ Hearing Tr. (Lek) at 1925.

³⁹⁵ JX-75, at 2.

³⁹⁶ JX-73; Hearing Tr. (DeGregorio) at 469-70.

³⁹⁷ Charging Memorandum ¶ 107; Answer ¶ 107; JX-75, at 2.

³⁹⁸ Charging Memorandum ¶ 108; Answer ¶ 108; JX-83, JX-92.

³⁹⁹ Answer ¶ 105; Hearing Tr. (Giberson) at 641-52; JX-83, JX-93, JX-96.

⁴⁰⁰ Hearing Tr. (Lek) at 1925.

BlueLine trading violations for three reasons.⁴⁰¹ First, LSC argues that compliance with Rule 70.40 would require LSC to violate its best execution requirements. Second, LSC argues that the purpose of Rule 70.40 is to expand access to NYSE member-only firms. Third, LSC argues that applying Rule 70.40 to LSC constitutes an illegal, anticompetitive restraint on trade. The Hearing Panel rejects LSC's arguments for the reasons discussed below.

(a) LSC's Argument That Compliance Would Cause It To Violate Its Best Execution Requirements

LSC argues that it was required to route orders to away markets to meet its best execution requirements.⁴⁰² However, the SEC considered this issue when it enacted the amendment to Rule 70. Specifically, the SEC noted that NYSE Rule 70.40 was implemented to address "changes in the way in which trading occurs on the Exchange ... due to, among other things, Regulation National Market System ("Regulation NMS")...."⁴⁰³ Nothing in the approval of Rule 70.40 allowed firms to bypass the approval process in order to meet their best execution requirements.

(b) LSC's Argument That The Rule Was Limited To Only NYSE Member Firms

LSC also asserts that the scope of NYSE Rule 70.40 was limited to firms that were members only of the NYSE, and was not applicable to firms that were already NASD

⁴⁰¹ LSC also asserts that the BlueLine trading allegation violates its due process rights because it never had notice that its conduct would constitute a violation. LSC's Post-Hrg Br. at 78-79. The Hearing Panel rejects LSC's due process argument. Rule 70.40 and the applicable Information Memo were clear and the Rule was properly approved pursuant to the SEC's rule-making authority. Further, LSC never asserted that it was unaware of Rule 70.40; rather, Lek determined that Rule 70.40 did not apply to LSC and LSC continued conducting its BlueLine trading business. Hearing Tr. (Lek) at 2261.

⁴⁰² Hearing Tr. (Lek) at 1911.

⁴⁰³ RX-12, *Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Rule[] ... 70 ("Bids and Offers")*, Exchange Act Rel. No. 34-55908, 2007 SEC LEXIS 1314, at *3 (June 14, 2007).

members.⁴⁰⁴ However, NYSE Rule 70.40 does not distinguish between firms that are NYSE member-only firms and firms that are members of other exchanges. Furthermore, IM 07-77 states that if an NYSE member organization is already approved as an NASD member, it meets the requirements to conduct all trading activity business from its booth premises that it could conduct from an upstairs office, “*subject to the requirements described in this information memo.*”⁴⁰⁵ The requirements in IM 07-77 included the adoption and implementation of a “stand-alone section of the firm’s written policies and procedures” governing the conduct and supervision of business handled in the booth. Pursuant to both NYSE Rule 70.40(7) and IM 07-77, these written procedures “must be approved by [NYSE Regulation] before implementation.” Despite the requirement to have NYSE Regulation approve written supervisory procedures for BlueLine business, LSC failed to seek such approval for more than two years.

(c) LSC’s Argument That The Rule Is Anti-Competitive, Illegal, And Unenforceable

LSC argues that NYSE Rule 70.40 is illegal because it requires a firm to get approval from NYSE Regulation before it can route orders away from the Floor, which it argues is a “condition precedent” prohibited under Securities Exchange Act Rule 19c-1.⁴⁰⁶ For this reason, LSC asks the Hearing Panel to invalidate Rule 70.40; however, the Panel does not have authority to do so.

Congress tasked the SEC with oversight of the NYSE as a national securities association registered under Section 15A(a) of the Exchange Act.⁴⁰⁷ The Exchange Act expressly requires

⁴⁰⁴ Hearing Tr. (Lek) at 1911-12, 1925. In LSC’s Pre-Hearing Brief, it argued that Rule 70.40 allowed for “grandfathering” activity and therefore was not binding upon LSC; however, in its Answer, LSC correctly noted that Rule 70.40 did not allow for “grandfathering.” Compare LSC’s Pre-Hearing Br. at 17-18 with Answer ¶ 100.

⁴⁰⁵ JX-98, at 4-5, NYSE IM 07-77 (emphasis added); Hearing Tr. (DeGregorio) at 471-73.

⁴⁰⁶ Hearing Tr. (Lek) at 1914-15, 1928-31; LSC’s Pre-Hrg Br. at 19.

⁴⁰⁷ 15 U.S.C. § 78o-3(a).

that a self-regulatory organization file with the SEC any proposed rule change, and that “[n]o proposed rule change shall take effect unless approved by the Commission....”⁴⁰⁸ Here, the SEC approved NYSE Rule 70.40 on June 14, 2007.⁴⁰⁹ The SEC determined that Rule 70.40 did not impose any burden upon competition. Specifically, the SEC noted that the Rule is consistent with the objective “to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments and to perfect the mechanism of a free and open market and a national market system.”⁴¹⁰

Under the doctrine of “primary jurisdiction,” and as explicitly provided for by the statutory scheme enacted by Congress under the Exchange Act, if LSC was aggrieved by NYSE Rule 70.40, it was required to present its claims to the SEC and the federal circuit courts of appeals, not to this Hearing Panel. Specifically, the Exchange Act states:

A person aggrieved by a final order of the Commission entered pursuant to this title ... may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.⁴¹¹

The exercise of this right of review is predicated upon the aggrieved party’s first presenting its grievance to the SEC itself.⁴¹² LSC never petitioned the SEC to modify Rule 70.40.⁴¹³

⁴⁰⁸ See Exchange Act Section 19(b), 15 U.S.C. § 78s(b); see also *DL Capital Group, LLC v. Nasdaq Stock Mkt., Inc.*, 409 F.3d 93, 95 n.1 (2d Cir. 2005) (“Pursuant to 15 U.S.C. § 78s(b), the SEC must approve all NASD rules, practices, policies and interpretations before they are implemented.”).

⁴⁰⁹ RX-12; CX-5.

⁴¹⁰ RX-12, at 10. The Release further states that “the Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.” See also RX-135, at 21.

⁴¹¹ Section 25(a)(1), 15 U.S.C. § 78y(a)(1).

⁴¹² See Exchange Act, Section 25(c)(1) (“No objection to an order or rule of the Commission, for which review is sought under this section, may be considered by the court unless it was urged before the Commission or there was reasonable ground for failure to do so.”), 15 U.S.C. § 78y(c)(1).

⁴¹³ Hearing Tr. (Lek) at 2298.

2. Conclusion

The Hearing Panel finds that LSC violated NYSE Rule 70.40 by engaging in BlueLine trading, conducting “upstairs” operations in its booth premises on the NYSE Floor, without: (1) obtaining the required approval from NYSE Regulation to conduct such business; (2) adopting and implementing comprehensive written procedures and guidelines governing the conduct and supervision of such business; and (3) obtaining the required approval of its written procedures and guidelines from NYSE Regulation. The Panel also finds that LSC violated NYSE Rule 2010 by continuing to conduct, after being instructed by NYSE Regulation’s Division of Market Surveillance to immediately cease and desist such activity, an “upstairs” operation from its booth premises on the Floor of the NYSE without having received regulatory approval.

E. LSC Violated NYSE Rule 123C By Failing To Comply With The Requirements For The Cancellation Of Market-On-Close And Limit-On-Close Orders

Market Regulation alleges that LSC violated NYSE Rule 123C by failing to comply with requirements governing the cancellation of MOC and LOC orders.⁴¹⁴ NYSE Rule 123C stated that MOC and LOC orders could be cancelled or reduced in size between 3:40 p.m. and 3:50 p.m. only to correct a legitimate error.⁴¹⁵ From March 9 through April 22, 2009, LSC cancelled approximately 899 MOC and LOC orders after 3:40 p.m.⁴¹⁶ The cancellations were not done to correct a legitimate error; rather, they occurred because LSC misread, or failed to read, the applicable Product Updates and Information Memo. Accordingly, the Hearing Panel finds that, from March 9 through April 22, 2009, LSC violated NYSE Rule 123C by improperly cancelling 899 MOC and LOC orders after 3:40 p.m.

⁴¹⁴ See Charging Memorandum, Charge XII.

⁴¹⁵ NYSE Rule 123C.

⁴¹⁶ CX-115; Hearing Tr. (Roussel) at 399.

F. LSC Violated NYSE Rule 342 By Failing To Establish, Maintain, And Enforce Reasonable Supervisory Systems And Procedures

Market Regulation alleges that LSC violated NYSE Rule 342 by failing to reasonably supervise and implement adequate controls, including a separate system of follow-up and review, designed to achieve compliance with NYSE Rules and policies, pertaining to the above violations, as well as “spoofing” activity, wash trading, and marking the close.⁴¹⁷ NYSE Rule 342 requires that members provide reasonable supervision and “appropriate supervisory control” over their employees and the members’ activities, including “delegat[ing] to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, . . . provid[ing] for appropriate procedures of supervision and control . . . [and] establish[ing] a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.” Reasonable supervision is a standard that “is determined based on the particular circumstances of each case.”⁴¹⁸ LSC failed to have a reasonable supervisory system in the following areas: (1) odd-lot orders; (2) the September 18th Order; (3) Regulation SHO; (4) BlueLine trading; (5) MOC and LOC orders; and (6) electronic order flow.

Odd-Lot Orders

LSC’s supervisory systems and procedures for its odd-lot orders were not reasonable. Although the prohibition of trading odd-lot limit orders in a pattern of day trading had been in effect since 1994, LSC did not have a surveillance report to capture such trading activity until October 2010.⁴¹⁹ Lek asserted that he was not aware of the applicable Information Memos and

⁴¹⁷ See Charging Memorandum, Charge XIII.

⁴¹⁸ *Dep’t of Enforcement v. Midas Securities, LLC*, No. 2005000075703, 2009 FINRA Discip. LEXIS 23, *43-44 (O.H.O. May 12, 2009) (citing *Christopher J. Benz*, 52 S.E.C. 1280, 1284 (1997)).

⁴¹⁹ Hearing Tr. (Lek) at 1807.

SEC Release discussing the prohibited trading activity.⁴²⁰ However, CCOs are required to have adequate knowledge of the relevant rules, regulations, laws, and standards of conduct relevant to their firm's business lines.⁴²¹ Because a CCO is the primary advisor to the member on its overall compliance scheme and the particularized rules, policies, and procedures that the member adopts, it is essential that the CCO stay abreast of NYSE rules and regulatory guidance.

September 18th Order

LSC's supervisory systems and procedures for its compliance with the September 18th Order were not reasonable. LSC intentionally exempted certain customers from the screening controls it developed to comply with the September 18th Order.⁴²² Further, there was no evidence that LSC monitored its controls. While LSC had the ability to search orders via a query, it never did so to ensure that its controls for the September 18th Order were effective.⁴²³ Instead, the NYSE notified LSC that it had transmitted violative short sale transactions.⁴²⁴

Regulation SHO

LSC's supervision of its long and short sales to ensure compliance with Regulation SHO was not reasonable. LSC took a passive approach to fulfilling its obligations pursuant to Rules 204T and 204. It allowed Fails to continue if it deemed the securities "easy to borrow" or if the Fails were *de minimis*.⁴²⁵ LSC, through its President, failed to take affirmative action to close out its open Fails. Instead, it allowed its Fails to remain open beyond the time periods proscribed in Rules 204T and 204. LSC waited for customer purchases to be delivered to close out its Fails

⁴²⁰ Hearing Tr. (Lek) at 927-28, 2227-28.

⁴²¹ NYSE Info. Memo 2005-101, *Amendments to NYSE 342.30 – Annual Report; Chief Compliance Officer Designation; Chief Executive Officer Certification*, 2005 NYSE Info. Memo LEXIS 101, at *7-8 (Dec. 16, 2005).

⁴²² JX-20, at 5-6, 9; Hearing Tr. (Lek) at 961-62.

⁴²³ Hearing Tr. (Lek) at 2299-2300.

⁴²⁴ Hearing Tr. (Lek) at 2301.

⁴²⁵ RX-137, at 1-5.

even if that meant that the Fail remained open for an extended period of time. LSC also failed to monitor its Fails and notify its customers of its Fails, which resulted in additional short sales during time periods when LSC was in the “penalty box.”

BlueLine Trading

LSC’s supervision of its BlueLine business was not reasonable. After the SEC approved NYSE Rule 70.40 in June 2007, LSC continued to conduct its BlueLine business for more than two years without (1) obtaining the required NYSE approval, or (2) submitting its BlueLine procedures to NYSE for approval.⁴²⁶ In addition, LSC failed to monitor its BlueLine trading to ensure it complied with the C & D Letter. It made inaccurate representations that it had stopped its BlueLine trading because it failed to monitor its Floor brokers’ trading.⁴²⁷

Market-On-Close And Limit-On-Close Orders

LSC’s supervision of its MOC and LOC orders was not reasonable. LSC relied on its Technology Officer, a non-registered person, to implement and monitor its supervisory control systems for MOC and LOC orders during March and April 2009.⁴²⁸ The Technology Officer made changes to LSC’s supervisory control systems for MOC and LOC orders without oversight or supervisory review. Lek acknowledged that it was his responsibility to ensure that LSC had a compliant system to screen MOC and LOC orders;⁴²⁹ however, he did not review the applicable Information Memo until several weeks after LSC turned off its system to detect the MOC and LOC cancels.⁴³⁰ Lek delegated his supervisory responsibility to the Technology Officer. “It is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory

⁴²⁶ Answer ¶ 105; Hearing Tr. (Giberson) at 641-52; JX-83, JX-93, JX-96.

⁴²⁷ Charging Memorandum ¶ 107; Answer ¶ 107; JX-75, at 2; JX-73; Hearing Tr. (DeGregorio) at 469-70.

⁴²⁸ Hearing Tr. (Paone) at 1433, 1444.

⁴²⁹ Hearing Tr. (Lek) at 2277-78.

⁴³⁰ Hearing Tr. (Lek) at 2275.

responsibilities to a subordinate ... and then simply wash his hands of the matter until a problem is brought to his attention.”⁴³¹ Here, no one at LSC became aware of the fact that LSC had erroneously turned off its screening controls until the NYSE brought it to LSC’s attention.

Electronic Order Flow

LSC’s supervisory systems and procedures for its electronic order flow were not reasonable for an extended period of time. Specifically, LSC failed to reasonably supervise and monitor its electronic order flow for spoofing, wash trading, and marking the close.

LSC’s supervisory system and procedures for possible spoofing activity were not reasonable. Until October 2009, it had no surveillance system to monitor for large pre-market cancels, which could be part of a manipulative spoofing scheme.⁴³² The pre-open cancellations were irregular trades that sparked the attention of designated market makers, causing them to contact the NYSE. LSC should have had a supervisory system to enable it to monitor for such irregular trading so that it could investigate and make sure that it was not facilitating potential manipulative trading such as spoofing.⁴³³ In fact, when LSC began investigating the pre-open cancels (in response to the NYSE’s requests for information), it learned from its customer that “the orders were not appropriate and that they had instructed the responsible individuals to

⁴³¹ *Midas Securities LLC*, Exchange Act Rel. No. 66200, 2012 SEC LEXIS 199, at *55-56 (Jan. 20, 2012) (citations omitted) (internal quotations omitted).

⁴³² LSC argues that it was denied due process with respect to the pre-open cancellations allegation. It states that it never had notice that its conduct would constitute a violation because there was no rule or guidance regarding pre-open cancellations. LSC’s Post-Hrg Br. at 14, 79. However, cancellations are an integral part of manipulative spoofing schemes, which have been addressed in case law since at least 2001. The following cases refer to “spoofing”: *Robert J. Monski*, Litigation Rel. No. 16986, 2001 SEC LEXIS 827 (May 3, 2001); *Israel M. Shenker*, Exchange Act Rel. No. 45017, 2001 SEC LEXIS 2321 (Nov. 5, 2001); *Joseph R. Blackwell*, Exchange Act Rel. No. 45018, 2001 SEC LEXIS 2322 (Nov. 5, 2001); *Jason T. Frazee*, Exchange Act Rel. No. 47522, 2003 SEC LEXIS 633 (Mar. 18, 2003); *Leonard Sheehan*, Exchange Act Rel. No. 47521, 2003 SEC LEXIS 633 (Mar. 18, 2003); *Cary R. Kahn*, Exchange Act Rel. No. 50046, 2004 SEC LEXIS 1530 (July 20, 2004); *SEC v. Kundrat and Smolinski*, Litigation Rel. No. 18894, 2004 SEC LEXIS 2160 (Sept. 23, 2004); *Dep’t of Mkt. Regulation v. Yoshikawa*, 2005 NASD Discip. LEXIS 33 (NAC Aug. 31, 2005); *Terrance Yoshikawa*, 2006 SEC LEXIS 948 (Apr. 26, 2006).

⁴³³ *Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, *46 (July 6, 2005) (citation omitted) (finding that “red flags and suggestions of irregularities” demanded “inquiry as well as adequate follow-up and review”).

immediately cease such trading behavior.”⁴³⁴ LSC failed to monitor the effectiveness of its pre-open cancel surveillance. As demonstrated above, LSC’s pre-open cancel surveillance report did not always capture all the applicable trading. And LSC’s employees did not always conduct proper follow-up when reviewing trades that had been flagged.

LSC also failed to have a reasonable supervisory system to monitor for wash sales and marking the close. Wash trading is specifically prohibited by NYSE Rule 476(a)(8). Yet, LSC did not have an electronic surveillance report to detect the potentially violative activity until August 14, 2009.⁴³⁵ While LSC’s WSPs addressed marking the close, LSC relied on a rapid succession order report, which required the entry of 25,000 orders within one minute from one customer in one security, to monitor for such activity.⁴³⁶ Because marking the close can occur by effecting just a small number of transactions near the end of the day, LSC’s rapid succession order report was not a reasonable tool to detect potential marking the close transactions. LSC did not develop a surveillance system to detect potential marking the close transactions by its electronic trading customers until March 2010.⁴³⁷

1. LSC’s Argument

LSC’s primary argument in defense of the supervisory charges is that, pursuant to NYSE Rule 382, it appropriately allocated its supervisory responsibilities to Dimension, its introducing

⁴³⁴ JX-62, at 3.

⁴³⁵ JX-40, at 3; Hearing Tr. (Lek) at 938-40.

⁴³⁶ JX-40, at 2; Hearing Tr. (Lek) at 1021-22.

⁴³⁷ Hearing Tr. (Lek) at 1018, 2280.

broker, in its clearing agreement.⁴³⁸ Rule 382 provides that clearing firms and introducing brokers must allocate responsibilities between themselves in a clearing agreement.⁴³⁹ However, LSC's reliance on its clearing agreement with Dimension Securities pursuant to Rule 382 is misplaced for three reasons.

First, in approving rule changes to NYSE Rules 382 and 405, the SEC noted that “[n]o contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under federal securities laws and applicable SRO rules.”⁴⁴⁰ The NYSE also stated that under NYSE Rule 382 “[e]ach organization will be accountable for actual performance of all functions performed by employees and other associated persons, as well as for overall supervision of functions and activities performed by it pursuant to a carrying agreement.”⁴⁴¹

Second, the purpose of the amendments to NYSE Rules 382 and 405 was to relieve clearing firms from the duty to supervise the *sales practices* of introducing firms as required under Rule 405. Here, in contrast, LSC seeks to avoid liability for charges brought by its regulator, which relate to its failure to supervise its electronic order flow. As an NYSE member

⁴³⁸ LSC's Post-Hrg Br. at 6-11. LSC also argued that there was no evidence that LSC acted unreasonably. *Id.* at 11-13. For the reasons discussed above, the Hearing Panel rejects this argument. LSC also stated that testimony regarding industry practice was necessary in order to determine reasonableness. *Id.* at 11. This argument was raised and rejected when LSC requested expert testimony on industry custom and practice for the supervision charge described in Charge XIII. As explained to LSC in a pre-hearing order, in an NYSE disciplinary proceeding, a Hearing Panel is composed of a professional Hearing Officer and two industry members who have securities industry experience and expertise. In this case, after consultation with the industry panelists, the Hearing Officer determined that LSC's proposed expert testimony regarding industry custom and supervision was inadmissible because it would not be helpful to the adjudicators who also have industry expertise. Order Denying LSC's Mot. to Call Expert Witnesses (Dec. 7, 2012).

⁴³⁹ RX-115, at 1, NYSE Rule 382 (b) (“Each agreement in which accounts are to be carried on a fully disclosed basis shall specifically identify and allocate the respective functions and responsibilities of the introducing and carrying organizations”).

⁴⁴⁰ Exchange Act Rel. No. 34-18497 (SR-NYSE-81-19).

⁴⁴¹ CX-133, NYSE Interpretation 382/03.

transmitting and executing electronic trades on the NYSE, LSC is required to comply with NYSE rules, as well as the federal securities rules and regulations.

Third, LSC was an executing broker for each of the customers at issue, providing them with electronic access to the NYSE through ROX and the SuperDOT. Each customer executed a Lek Securities Customer Agreement, ROX System License and User Agreement, Lek Securities Standard Option Agreement, and Lek Securities Agreement for Prime Broker Clearing Services.⁴⁴² The ROX Agreement stated that each customer is:

... granted a non-exclusive, non-transferable, royalty free license to use the ROX system for the benefit of [its] proprietary and customer trading activities, *to transmit orders to [Lek Securities] as [its] executing broker.*⁴⁴³

IM 89-6, *Customer Transmission of Order to SuperDot Via Member Firm Systems*,⁴⁴⁴ clearly states that “[m]ember Firms who wish to provide their customers with the ability to electronically transmit orders to their order processing system for re-transmission to SuperDot must provide a written statement *acknowledging their responsibility for orders sent to the NYSE.*” Similarly, IM 92-15, *Electronic Transmission of Orders*, states that “[m]ember organizations are expected to have written procedures and controls in place for the monitoring and supervision of electronic orders.”

The SEC also has stressed that firms such as LSC have the duty to maintain adequate systems to surveil order flow:

⁴⁴² JX-47-54; CX-120, CX-121.

⁴⁴³ See, e.g., CX-120d, at 1; JX-48 (emphasis added).

⁴⁴⁴ This Information Memo was cited in *Risk Management Controls for Brokers or Dealers with Market Access*, Exchange Act Rel. No. 34-61379, 2010 SEC LEXIS 359, at *5-6 (Jan. 19, 2010), in which the SEC stated that “whether the broker-dealer is trading for its own account, is trading for customers through more traditionally intermediated brokerage arrangements, or is allowing customers direct market access or sponsored access, *the broker-dealer with market access is legally responsible for all trading activity that occurs under its [market participant identifier].*” (emphasis added).

As gatekeepers to the capital markets, broker-dealers have a responsibility to establish, maintain, and enforce adequate policies and procedures and risk controls *in light of the specific risks associated with the broker-dealer's business*. In particular, broker-dealers that provide access to the markets must ensure that they have policies and procedures and systems of controls in place that are reasonably designed to ensure, among other things, compliance with all regulatory requirements that are applicable *in connection with the access they provide*. These controls must be reasonably designed to identify and prevent, among other things, abusive trading practices.⁴⁴⁵

Remarkably, Lek testified that LSC, as a "\$2 broker" executing transactions on behalf of entities such as Dimension, is not responsible for complying with NYSE rules and regulations for orders it executes on the NYSE. This simply is not the case. As shown above, both the SEC and the NYSE have repeatedly reminded firms, such as LSC, that they are responsible for customer orders sent electronically to the market.

2. Conclusion

The Hearing Panel finds that LSC violated NYSE Rule 342 by failing to reasonably supervise and implement adequate controls, including a separate system of follow-up and review, designed to achieve compliance with NYSE Rules and policies, pertaining to: (1) odd-lot orders; (2) the September 18th Order; (3) compliance with Rules 204T and 204 of Regulation SHO; (4) BlueLine trading; (5) MOC and LOC orders; and (6) its electronic customer order flow to detect potential violations in connection with "spoofing" activity, wash trading, and marking the close.

IV. SANCTIONS

The integrity of the NYSE market is dependent on the adherence of its members to its trading rules. Here, the Panel found LSC liable for each violation in the Charging Memorandum. In determining appropriate remedial sanctions for LSC's violations, the Hearing Panel considered IM 05-77, *Factors Considered by the New York Stock Exchange Division of*

⁴⁴⁵ *Hold Brothers On-Line Investment Services, LLC*, Exchange Act Rel. No. 67924, 2012 SEC LEXIS 3029 at *2-3 (Sept. 25, 2012) (emphasis added).

Enforcement in Determining Sanctions, which include the following factors: nature of the misconduct and degree of scienter; harm caused by the misconduct; extent of the misconduct; prior disciplinary record; acceptance of responsibility; implementation of corrective measures; enrichment or deceptive conduct; neglect or disregard of “red flags”; effectiveness of operational, supervisory, and compliance controls; and respondent’s size and financial resources. The Panel also factored in deterrence because, as the SEC has noted, “to be truly remedial, the sanctions must deter the applicants before us and others who may be tempted to engage in similar violations.”⁴⁴⁶

The Hearing Panel determined that the appropriate remedial sanctions for LSC are a censure and a total fine of \$775,000. The Panel believes that the sanctions imposed here will have a deterrent effect.⁴⁴⁷ The sanctions for the violations are discussed below in the following categories: (1) odd-lot orders; (2) the September 18th Order; (3) Regulation SHO; (4) BlueLine trading; (5) MOC and LOC orders; and (6) supervisory systems and procedures.⁴⁴⁸ Where appropriate, the Panel has batched related Charges.

A. Odd-Lot Orders

Charges I, II, and III concern LSC’s misconduct relating to odd-lot orders. At no time did LSC accept responsibility for its odd-lot violations. Instead, it argued that there was no rule prohibiting such trading. It claimed to be unaware of the applicable regulatory guidance and the

⁴⁴⁶ *Investment Planning*, 51 S.E.C. 592, 599 (1993).

⁴⁴⁷ See *Edward John McCarthy*, 406 F.3d 179, 189 (2d Cir. 2005) (emphasizing the importance of providing a deterrence rationale for our decisions, in the context of a two-year suspension). Cf. *Schild Management Co.*, Exchange Act Rel. No. 53201, 2006 SEC LEXIS 195, *35 (Jan. 31, 2006) (noting in our review of an administrative law judge’s decision that we consider the extent to which the sanction will have a deterrent effect); *Ahmed Mohamed Soliman*, 52 S.E.C. 227, 231 n.12 (1995) (stating in our review of an administrative law judge’s decision that the selection of an appropriate sanction involves consideration of several elements, including deterrence); *Steadman v. SEC*, 603 F.2d 1126, 1142 (5th Cir. 1979) (In ruling on an appeal of our review of an administrative law judge’s decision, the Fifth Circuit stated that “the Commission also may consider the likely deterrent effect its sanctions will have on others in the industry.”), *aff’d on other grounds*, 450 U.S. 91 (1981).

⁴⁴⁸ All supervisory violations are charged in Charge XIII and addressed collectively.

subsequent published decisions.⁴⁴⁹ Contrary to explicit regulatory guidance stating that firms such as LSC are responsible for the orders that they send to the NYSE, LSC tried to distance itself from the violative trades by asserting that its introducing broker was responsible for the trades under the clearing agreement. LSC was the executing broker for Prestige and Pacific Coast. Its odd-lot violations allowed those customers to generate \$150,000 in two months from prohibited trading activity.

Although the odd-lot system has been decommissioned, the Panel views LSC's violation of the odd-lot day-trading prohibitions that had been in effect since 1994 as serious. After careful consideration the Panel finds that the appropriate remedial sanctions for Charges I, II, and III are a censure and a \$50,000 fine.

B. The September 18th Order

Charges IV and V relate to LSC's violations of the September 18th Order. Here, too, LSC minimizes its misconduct and tries to shift blame to its introducing broker via its clearing agreement. The Panel views LSC's misconduct as very serious. During the severe 2008 financial crisis, LSC allowed the transmission of over 6,000 short sales transactions in stocks of Included Financial Firms in direct contravention of the SEC's September 18th Order. The majority of the violations occurred because LSC deliberately excluded certain customers from its screening controls. After careful consideration the Panel finds that the appropriate remedial sanctions for Charges IV and V are a censure and a \$75,000 fine.⁴⁵⁰

⁴⁴⁹ See *supra* footnotes 282 - 284 and accompanying text, citing settled disciplinary actions brought by NYSE's Department of Enforcement and approved by an NYSE Hearing Officer.

⁴⁵⁰ Cf. *Lightspeed Trading, LLC*, Exchange Act Rel. No. 60540, 2009 SEC LEXIS 2858 (Aug. 19, 2009) (respondent sanctioned with a censure, \$75,000 fine, and disgorgement for executing approximately 724 short sales in violation of the September 18th Order).

C. Regulation SHO

Charges VI, VII, VIII, and IX relate to LSC's Regulation SHO violations. LSC refused to accept responsibility for its Regulation SHO violations, which occurred over an extended period of time. For approximately one year, October 2008 through September 2009, LSC failed to comply with the Regulation SHO close-out requirements. At all times, LSC was fully aware of its Fails as it received daily notification reports from CNS. Instead of curing its Fails, LSC allowed the Fails to continue until the shares from customer purchases arrived. LSC's failure to properly close out its Fails and notify its broker-dealer customers placed it in the "penalty box." LSC violated an additional provision of Regulation SHO by executing short sales while in the "penalty box." These Regulation SHO violations did not occur as a result of inaction by a lower level employee that went undetected by upper level management; rather, LSC's President was directly responsible for the Regulation SHO violations. After careful consideration, the Panel finds that the appropriate remedial sanctions for Charges VI, VII, VIII, and IX are a censure and a \$50,000 fine.⁴⁵¹

D. BlueLine Trading

Charges X and XI relate to LSC's BlueLine trading violations. Unlike the odd-lot violations, LSC does not disclaim knowledge of NYSE Rule 70.40. Rather, despite the plain language of the rule, LSC concluded that it did not apply. For more than two years, LSC ignored the rule, conducting its BlueLine trading business without approval. Further, it did not heed the NYSE's request for it to stop its unapproved BlueLine trading. Instead, LSC flouted the C & D Letter and continued to conduct its BlueLine business for approximately three more months. The

⁴⁵¹ In determining the appropriate remedial sanctions, the Hearing Panel considered the SEC's No-Action Letter.

Hearing Panel finds LSC's misconduct was egregious and imposes a censure and a \$100,000 fine.

E. Market-On-Close And Limit-On-Close Orders

Charge XII relates to LSC's failure to comply with requirements governing the cancellation of MOC and LOC orders. Here, violations occurred because LSC's Technology Officer made a mistake and misread, or failed to fully read, the applicable Product Updates. Given the facts and circumstance of this misconduct, the Hearing Panel determined that the appropriate sanction is a censure.

F. Supervisory Systems And Procedures

LSC did not accept responsibility for any of its supervisory violations. It argued that it did not have a duty to supervise because it had allocated that responsibility to its introducing broker in the clearing agreement. The Hearing Panel disagrees and finds that LSC abdicated its supervisory responsibility.

The Hearing Panel found LSC's supervisory systems and procedures to be deficient in various areas during a period of approximately three years. During April and May 2007, LSC had no supervisory system or procedures to capture odd-lot limit orders in a pattern of day trading, even though the prohibition had been in place since 1994.

Regarding the September 18th Order, LSC's supervisory system was not reasonable because it deliberately excluded certain customers. Further, because LSC did not test or monitor its controls to comply with the September 18th Order, it was unaware of the short sales that had bypassed its system, and that it had failed to change the expiration date in its controls to comport with the extended September 18th Order.

Regarding Regulation SHO, as noted above, LSC received daily reports of its stock positions from CNS. LSC ignored these “red flags” on a daily basis and allowed its Fails to continue. LSC’s President condoned this practice, which LSC continued from approximately October 2008 through September 2009.

LSC’s BlueLine trading violations were particularly troubling to the Panel because LSC ignored NYSE Rule 70.40 for more than two years, and ignored the C & D Letter from the NYSE for almost three months. Further, a member of its Compliance Department made representations to the NYSE and FINRA that the prohibited trading had stopped when it had not. Clearly, LSC’s supervision of its BlueLine trading activity was ineffective because it was either unaware that its BlueLine trading was ongoing or was unable to stop its Floor brokers from continuing to trade.

Regarding the MOC and LOC orders, LSC failed to keep abreast of the regulatory changes. LSC, through Lek, allowed an unregistered person, LSC’s Technology Officer, to make changes to LSC’s supervisory controls without any oversight. In fact, Lek acknowledged that he did not read the applicable regulatory guidance for approximately three weeks after the changes went into effect.

Throughout this entire time, LSC had no supervisory system in place to detect and prevent violations of NYSE rules and the federal securities law against potential manipulations such as spoofing, wash sales, and marking the close. As demonstrated above, the industry has been aware of these types of potentially manipulative activities for many years. It is critical that firms who provide direct market access to their customers, such as LSC, effectively monitor their order flow, as they provide the gateway for these potentially violative orders to reach the market.

LSC had the financial means to create the needed surveillance reports,⁴⁵² but failed to do so for an extended period of time.

Considering the foregoing, the Hearing Panel found LSC's supervisory violations to be egregious. The Panel finds that the appropriate remedial sanctions for Charge XIII are a censure and a \$500,000 fine.

V. ORDER

Based on careful consideration of all the evidence, LSC is censured and fined a total of \$775,000. The violations and the corresponding sanctions are delineated below.⁴⁵³

For violating NYSE Rules 476(a)(6) and 401, as described in Charges I and II, by introducing for execution on the NYSE odd-lot orders in a pattern of day trading that were prohibited by the NYSE's odd-lot rules and policies; and for violating NYSE Rule 405(1), as described in Charge III, by failing to learn the essential facts relative to certain of its customers and its customers' orders that it introduced for execution on the NYSE, LSC is censured and fined \$50,000.

For willfully violating Section 12(k)(4) of the Exchange Act, as described in Charge IV, and violating NYSE Rule 401, as described in Charge V, by introducing for execution on the NYSE short sale transactions in the common stock of financial services companies in contravention of the SEC's September 18, 2008 Emergency Order, LSC is censured and fined \$75,000.

For willfully violating Rules 204T(a), 204(a), 204T(b), 204T(c) and 204(c) of Regulation SHO, as described in Charges VI through IX, by (i) failing to timely close out fail-to-deliver

⁴⁵² LSC has a net capital of approximately \$10 million. Hearing Tr. (Lek) at 1768.

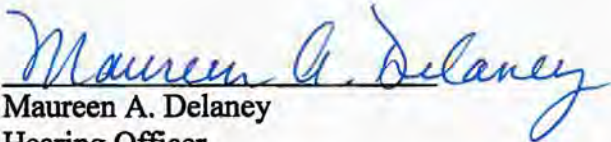
⁴⁵³ The Hearing Panel considered all of the parties' arguments. They are rejected or sustained to the extent that they are inconsistent with the views expressed herein.

positions in certain equity securities; (ii) accepting certain customer short sale orders in equity securities for which it had open fail-to-deliver positions while LSC and the customer were in the “penalty box”; and (iii) failing to timely notify its customers that it had open fail-to-deliver positions that had not been closed out, LSC is censured and fined \$50,000.

For violating (i) NYSE Rule 70.40, as described in Charge X, by conducting “upstairs” operations in its booth premises on the NYSE Floor without prior approval from NYSE Regulation to conduct such business, and without adopting written procedures that were approved by NYSE Regulation; and (ii) NYSE Rule 2010, as described in Charge XI, by continuing to conduct, after being instructed by the NYSE to immediately cease and desist such activity, an “upstairs” operation from its booth premises on the NYSE Floor without having received regulatory approval, LSC is censured and fined \$100,000.

For violating NYSE Rule 123C, as described in Charge XII, by failing to comply with the requirements governing the cancellation of MOC and LOC, LSC is censured.

For violating NYSE Rule 342, as described in Charge XIII, by failing to reasonably supervise and implement adequate controls, including a separate system of follow-up and review, designed to achieve compliance with NYSE Rules and policies, pertaining to the above violations, as well as “spoofing” activity, wash trading, and marking the close, LSC is censured and fined \$500,000.


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