

NEW YORK STOCK EXCHANGE LLC

NYSE HEARING BOARD DECISION 06-111

June 28, 2006

CITIGROUP GLOBAL MARKETS, INC.
MEMBER ORGANIZATION

* * *

Violated Rule 203(b)(3) of Regulation SHO by failing to accurately account for its fails to deliver in threshold securities at registered clearing agencies by failing to aggregate its fails which occurred under separate clearing numbers; violated NYSE Rule 342 by failing to provide for appropriate procedures of supervision and control, and establish a separate system of follow-up and review to determine that it accurately accounted for its fails to deliver in threshold securities at registered clearing agencies and that it and its customers were in compliance with Rule 105 of Regulation M – Consent to censure and \$250,000 fine.

Appearances:

For the Division of Enforcement
Susan Light, Esq.
Steven F. Korostoff, Esq.
Jeanne R. Elmadany, Esq.

For Respondent
James J. Tyne, Esq.

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A Hearing Officer on behalf of the New York Stock Exchange LLC (“NYSE”) considered a Stipulation of Facts and Consent to Penalty entered into between NYSE Regulation, Inc.’s Division of Enforcement (“Enforcement”) and Citigroup Global Markets, Inc. (“Respondent,” “Citigroup” or the “Firm”), an NYSE member organization. Without admitting or denying guilt, Respondent consented to a finding by the Hearing Officer that it:

- I. Violated Rule 203(b)(3) of Regulation SHO in that it failed to accurately account for its fails to deliver in threshold securities at registered clearing agencies by failing to aggregate its fails which occurred under separate clearing numbers.
- II. Violated NYSE Rule 342 by failing to provide for appropriate procedures of supervision and control, and establish a separate system of follow-up and review to determine that:

- a. it accurately accounted for its fails to deliver in threshold securities at registered clearing agencies;
- b. it and its customers were in compliance with Rule 105 of Regulation M, which prohibits a short seller from covering short sales with offering securities purchased from an underwriter or broker or dealer participating in the offering, if the short sale occurred during the restricted period defined by Rule 105, typically the five-day period prior to pricing.

For the sole purpose of settling this disciplinary proceeding, Enforcement and Respondent stipulate to certain facts, the substance of which follows: *

Background and Jurisdiction

1. Citigroup is a wholly owned subsidiary of Citigroup Financial Products, Inc. and indirectly a wholly owned subsidiary of Citigroup, Inc. which is traded on the New York Stock Exchange LLC. Citigroup provides investment banking, asset management, brokerage, securities trading, advisory and other financial services to customers, and engages in proprietary trading for its own accounts. Citigroup is a member of all principal exchanges, is registered as a block positioner, and is also a Primary Dealer.
2. Effective September 7, 2004, the U.S. Securities and Exchange Commission (“SEC”) adopted Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”), and the commencement date for compliance with its provisions was January 3, 2005. At the same time, the SEC also adopted amendments that remove the shelf offering exception, and issued interpretive guidance concerning Regulation M.
3. In the second quarter of 2005, after Regulation SHO had been in effect for approximately four months, the NYSE’s Division of Member Firm Regulation (“MFR”) performed a special examination of the operational and supervisory standards, and written policies and procedures established and maintained by the Firm with respect to Regulation SHO. MFR issued a report of that examination, MFR’s 2005 Special Regulation SHO Examination Report (the “Report”), that included exceptions reflecting that the Firm failed to have and/or failed to adequately implement supervisory policies and procedures with regard to Regulation SHO and Regulation M, and was not in compliance with certain provisions of Regulation SHO. The Report was referred to Enforcement.
4. By letter dated November 1, 2005, Enforcement advised the Firm that it was investigating, among other things, possible violations of NYSE Rules, Regulation SHO and/or other federal securities laws contained in MFR’s Report.

* Hearing Officer Note: The facts, allegations, and conclusions contained in paragraphs 1 to 17 are taken from the executed Stipulation of Facts and Consent to Penalty between Enforcement and Respondent. No changes have been made to the stipulated paragraphs by the Hearing Officer.

Overview

5. Regulation SHO was designed to, among other things, establish uniform locate and delivery requirements in order to address problems associated with failures to deliver,¹ including potentially abusive “naked” short selling (“naked” short selling generally refers to selling short without having borrowed the securities to make delivery), and create uniform marking requirements for sales of all equity securities.
6. Regulation SHO has three primary purposes: to create uniform order marking requirements for sales of all equity securities; to reduce the number of potential failures to deliver by means of the “locate” requirement; and to limit the time in which a broker can permit failures to deliver to persist in securities in which a substantial number of fails have occurred (“threshold securities”) by means of a buy-in requirement.
7. The commencement date for compliance with the provisions of Regulation SHO was January 3, 2005. Among other things, Regulation SHO defines ownership of securities, specifies requirements for the aggregation of long and short positions, and requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt." Regulation SHO also requires short sellers in all equity securities to locate securities and/or pre-borrow before selling, and also imposes more stringent delivery requirements on broker-dealers for threshold securities.
8. Rule 105 of Regulation M prohibits a short seller from covering short sales with offering securities purchased from an underwriter or broker or dealer participating in the offering, if the short sale occurred during the Rule 105 restricted period, typically the five-day period prior to pricing. The reason for the prohibition is that the pre-pricing short sales that are covered with offering shares artificially distort the market price for the security, preventing the market from functioning as an independent pricing mechanism and eroding the integrity of the offering price.

Summary of Violative Conduct

9. As set forth below, Citigroup failed to comply with the requirements of Regulation SHO in certain respects during the period January 3, 2005 through July 13, 2005 (the “relevant period”). The Firm inaccurately accounted for fails in threshold securities by not combining its fails under its two clearing numbers. In addition, the Firm failed to supervise by not having adequate policies and procedures for compliance with Regulation SHO in that it did not have procedures for resolution of fails in threshold securities that extended beyond 10 days rather

¹ When a seller does not deliver the securities sold to the buyer by settlement date as required it is referred to as a “failure to deliver”, “fail to deliver” or fail. The resulting open position is referred to as a “fail position” or “fail.”

than 13 days as required. Further, the Firm did not adequately supervise with regard to Regulation M by not having policies and procedures which prohibited a short seller from covering short sales with offering securities purchased from an underwriter or broker or dealer participating in an offering, if the short sale occurred during the restricted period.

Citigroup Failed to Properly Calculate its Fails in Threshold Securities

10. Rules 203(b)(3) and 203(b)(3)(iii) of Regulation SHO state:

(3) if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for 13 consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity....

(3)(iii) if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for 13 consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.

11. During the relevant period, Citigroup maintained two clearing platforms at The Depository Trust Company (“DTC”) and tracked its fails in threshold securities separately for these two clearing platforms.
12. Despite the number of clearing platforms it may have at a registered clearing agency, for the purpose of calculating its fails under Regulation SHO, each broker-dealer is still a single participant in the registered clearing agency, and therefore must combine its positions to calculate its fails in threshold securities. Therefore, Citigroup was required to combine its fails on its two clearing platforms to determine its obligations with regard to fails in threshold securities, in order to ensure fails were closed out as required and to prevent prohibited short sales from occurring.

Citigroup Was Not in Compliance with NYSE Rule 342

13. NYSE Rule 342 requires that a member firm reasonably supervise and control its business activities; provide for appropriate procedures of supervision and control;

and establish a separate system of follow-up and review to determine that delegated authority and responsibility is being properly exercised.

14. Reg SHO requires a broker-dealer to age its fails in threshold securities for the purpose of timely effecting buy-ins.²
15. Citigroup was responsible for performing the functions of identifying fails to deliver in threshold securities, tracking the age of those fails to deliver, and ultimately resolving those fails to deliver by closing them out.
16. Citigroup's procedures of supervision and control with respect to fails to deliver in threshold securities were designed to address such fails within 10 days. The Firm's procedures were inadequate in that they did not address action to be taken with respect to fails to deliver in threshold securities after 10 days, up to and beyond 13 days, as required.
17. During the relevant period, Citigroup's policies and procedures of supervision and control were inadequate in that they did not prohibit the Firm or its customers from covering short sales, executed during the restricted period defined by Rule 105 prior to the pricing of a secondary offering, with shares obtained from an underwriter or broker or dealer participating in the offering, to prohibit violations of Regulation M.

DECISION

The Hearing Officer, in accepting the Stipulation of Facts and Consent to Penalty, found Respondent guilty as set forth above.

PENALTY

In view of the above findings, the Hearing Officer imposed the penalty consented to by Respondent of a censure and a \$250,000 fine.

For the Hearing Board

Peggy Kuo - Chief Hearing Officer

² In a securities transaction wherein securities are not delivered on time, the broker-dealer on the sell-side is forced to close or "buy-in" the resulting fail position by obtaining shares from other sources.