

NEW YORK STOCK EXCHANGE LLC

NYSE HEARING BOARD DECISION 06-113

June 28, 2006

DAIWA SECURITIES AMERICA INC.
MEMBER ORGANIZATION

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Violated Rule 200(f) of Regulation SHO by utilizing independent trading unit aggregation to determine its net position when it did not have written plan of organization; violated Rule 200(g) of Regulation SHO by failing to mark certain sell orders as “long,” “short,” or “short exempt;” violated Rule 203(b)(1) of Regulation SHO by effecting short sales for its own account without having borrowed securities, or entered into bona-fide arrangements to borrow securities, or having reasonable grounds to believe that securities could be obtained for delivery when due and without having documented that it had borrowed security, or entered into bona-fide arrangements to borrow security, or had reasonable grounds to believe that securities could be obtained for delivery when due; violated NYSE Rule 342 by (a) failing to provide for appropriate procedures of supervision and control, and establish separate system of follow-up and review to determine that delegated authority and responsibility for compliance with Regulation SHO was being properly exercised, (b) failing to have adequate controls regarding manner in which it effected short sales for certain of its own accounts to prevent such trades from occurring without having (i) borrowed securities, or entered into bona-fide arrangements to borrow securities, or having reasonable grounds to believe that securities can be obtained for delivery when due, and (ii) documented that it had borrowed security, or entered into bona-fide arrangements to borrow security, or had reasonable grounds to believe that securities could be obtained for delivery when due; violated Section 17(a) of Securities Exchange Act of 1934 and Rules 17a-3 and 17a-4 thereunder, and NYSE Rule 440 by not properly marking sell orders as “long,” “short,” or “short exempt” – Consent to censure and \$400,000 fine.

Appearances:

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

For Respondent
Ben A. Indek, 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 Daiwa Securities America Inc. (“Respondent,” “DSA,” 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 200(f) of Regulation SHO in that it utilized independent trading unit aggregation to determine its net position when it did not have a written plan of organization.
- II. Violated Rule 200(g) of Regulation SHO in that it failed to mark certain sell orders as "long," "short," or "short exempt."
- III. Violated Rule 203(b)(1) of Regulation SHO in that on multiple occasions it effected short sales for its own account without having:
 - a. borrowed the securities, or entered into bona-fide arrangements to borrow the securities, or having reasonable grounds to believe that securities could be obtained for delivery when due; and
 - b. documented that it had borrowed the security, or entered into bona-fide arrangements to borrow the security, or had reasonable grounds to believe that securities could be obtained for delivery when due.
- IV. Violated NYSE Rule 342 in that it:
 - a. failed to provide for appropriate procedures of supervision and control, and establish a separate system of follow-up and review to determine that the delegated authority and responsibility for compliance with Regulation SHO was being properly exercised.
 - b. failed to have adequate controls regarding the manner in which it effected short sales for certain of its own accounts to prevent such trades from occurring without having:
 - (i) borrowed the securities, or entered into bona-fide arrangements to borrow the securities, or having reasonable grounds to believe that securities can be obtained for delivery when due; and
 - (ii) documented that it had borrowed the security, or entered into bona-fide arrangements to borrow the security, or had reasonable grounds to believe that securities could be obtained for delivery when due.

- V. Section 17(a) of the Exchange Act and Rules 17a-3 and 17a-4 thereunder, and NYSE Rule 440 in that it did not properly mark sell orders as "long," "short," or "short exempt."

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. DSA, located in New York, is a wholly owned subsidiary of Daiwa America Corporation, whose ultimate parent is Daiwa Securities Group Inc. DSA is a registered broker-dealer and has been a member firm of the NYSE since 1982. Its business includes securities and futures brokerage for institutional customers, proprietary trading and investment banking.
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 the relevant provisions was January 3, 2005.
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 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.

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

* Hearing Officer Note: The facts, allegations, and conclusions contained in paragraphs 1 to 25 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.

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 relevant 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.

Summary of Violative Conduct

8. As set forth below, DSA failed to comply with the requirements of Regulation SHO in certain respects during the period January 3, 2005 through April 15, 2005 (“relevant period”). One of the Firm’s proprietary trading desks effected numerous short sales without obtaining locates and the Firm did not prevent it from doing so. In addition, another Firm proprietary trading desk failed to document compliance with the locate requirement with respect to short sale orders. Also, the Firm failed to mark certain proprietary orders as long, short or short exempt. Further, the Firm utilized independent trading unit aggregation to determine its net position prior to effecting a sell order without having a written plan of organization identifying each trading aggregation unit as required. Finally, the Firm failed to reasonably supervise in that it did not have adequate policies and procedures to provide for compliance with certain aspects of Regulation SHO.

DSA Failed to Obtain and Document Locates for Short Sales

9. Rule 203(b)(1) of Regulation SHO states:

A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity

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.”

security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) Documented compliance with this paragraph (b)(1).

10. The broker-dealer may locate the securities (also referred to as obtaining a locate) in a number of ways, including but not limited to obtaining a representation from the selling customer that it has located the securities, and locating the securities through the broker-dealer's stock loan department. The broker-dealer executing the short sale must document that the securities have been located.

Failure to Obtain Locates

11. During the period January 3, 2005 through April 15, 2005, the Firm's Quantitative Trading Group within the Firm's Equities Division ("Quantitative Trading") effected proprietary equity program trades.
12. Prior to and during this period, before effecting any short sales, Quantitative Trading was required to obtain locates by contacting the Firm's Structured Transactions Group, which acted as the Firm's stock loan desk.
13. Quantitative Trading regularly effected numerous short sales on each trade date during the period June 2004 through December 2004, and was required to but did not obtain locates for short sales during this period.²
14. During the period, January 3, 2005 through April 15, 2005, Quantitative Trading effected approximately 103,000 short sales for which locates were not obtained.³ During this period, Quantitative Trading performed and documented locates prior to short sales on only three trade dates in January 2005. At least five of the short sales effected by Quantitative Trading during this period were in threshold securities and resulted in "fails to deliver."

Failure to Document Compliance with the Locate Requirement

15. The Structured Transactions Group was responsible for obtaining and documenting locates for all short sales which it effected. The Firm was unable to produce any evidence that locates had been obtained for any short sales effected

² Prior to December 2004, NYSE Rule 440C required that member organizations locate the security for delivery prior to effecting a short sale.

³ The Firm's analysis of the approximately 103,000 short sales effected by Quantitative Trading for which locates were not obtained indicates that approximately: 87,000 of the trades were for 100 shares or less; and 16,000 were for a greater amount.

by the Structured Transactions Group throughout the review period of January 10, 2005 through March 1, 2005.

DSA Failed to Mark Paper Sell Order Tickets as Long, Short or Short Exempt

16. Rule 200(g) of Regulation SHO requires that a broker or dealer must mark all sell orders of any equity security as "long," "short," or "short exempt." The accurate marking of sell orders is essential for locate, stock borrow, and execution purposes.
17. The Firm used electronic entry and paper order tickets to effect Firm orders during the relevant period. A review of 20 electronic orders and 10 paper order tickets for Firm sell orders effected during the relevant period, revealed that the Firm failed to mark the 10 paper sell tickets long, short or short exempt.

DSA Utilized Independent Trading Unit Aggregation Without Having the Required Written Plan

18. Rule 200(f) of Regulation SHO states in pertinent part, "In order to determine its net position, a broker or dealer shall aggregate all of its positions in a security unless it qualifies for independent trading unit aggregation, in which case each independent trading unit shall aggregate all of its positions in a security to determine its net position. Independent trading unit aggregation is available only if: (1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity...."
19. During the relevant period, DSA did not have a written plan of organization that specified each aggregation unit's trading objective(s), and supported its independent identity. As such, DSA was required to determine its net position by aggregating its Firm-wide proprietary positions in a security.
20. During the relevant period, the Firm improperly calculated its net position for purposes of determining whether it was long or short in connection with proprietary sales by trading unit rather than Firm-wide.

DSA Was Not in Compliance with NYSE Rule 342

21. 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.
22. DSA failed to adequately supervise its proprietary trading activities, as described above, to prevent and detect repeated failure to obtain locates prior to effecting short sales.

23. DSA failed to adequately supervise its proprietary trading, as described above, to prevent and detect repeated failure to document compliance with the locate requirement.
24. The Firm failed to have adequate policies and procedures regarding the following aspects of Regulation SHO: obtaining locates prior to effecting short sales; documenting locates; the close out of fails in threshold securities; and fails to deliver resulting from long sales.

Corrective Measures Taken

25. In determining to resolve this matter on the basis set forth herein, Enforcement took into consideration certain actions by DSA, including: (i) immediately investigating Quantitative Trading's short sale activity, and sharing the findings of its review with MFR and Enforcement; (ii) ceasing trading by Quantitative Trading until an adequate locate system could be implemented; (iii) implementing an electronic system in the Structured Trading Group to maintain the required locate documentation for short sales; (iv) instituting additional reviews of order tickets to confirm they are properly marked; and (v) educating members of its Equities Division in particular with regard to the requirements of Regulation SHO. Finally, Enforcement took into account the fact that prior to 2006 Daiwa had never been the subject of a formal NYSE disciplinary proceeding.

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 \$400,000 fine.

For the Hearing Board

Peggy Kuo - Chief Hearing Officer