NATIONAL EXAM PROGRAM
RISK ALERT

This Risk Alert encourages awareness of options trading activity that could be used to avoid complying with the close-out requirements under Reg SHO. Such activities may include, for example, trading in short-dated FLEX options, very short-dated listed options, and/or deep in-the-money listed options.

The alert spotlights certain effective practices that some firms use to identify risks and detect trading activities that could be used to circumvent the Reg SHO close-out requirements, including trading that continually "resets" a clearing firm's or broker-dealer's Reg SHO close-out requirements

By the Office of Compliance Inspections and Examinations[1]

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Strengthening Practices for Preventing and Detecting Illegal Options Trading Used to Reset Reg SHO Close-out Obligations

This Risk Alert highlights trading strategies that have been observed by which some broker-dealers and clearing firms appear to circumvent certain requirements of Regulation SHO ("Reg SHO").[2] This alert describes these activities, summarizes certain key enforcement actions involving such activities, and notes effective practices that the staff has observed at some firms to identify risks and detect trading activities that could be used to circumvent certain Reg SHO requirements.

On occasion, hard to borrow securities can be subject to a pricing disparity relative to options trading on the same security. Typically, this may be seen in "synthetic" positions (combinations of call and put options that generally would be expected to mirror the value of the underlying security) trading at a lower price than the underlying security. This creates a potential profit opportunity for short sellers of the underlying equity security in combination with call and put options if these short sellers can avoid the high cost typically associated with obtaining for delivery the hard to borrow security that was sold short.

This Risk Alert highlights observed trading strategies that could be designed to circumvent certain requirements of Reg SHO. Among other things, Reg SHO requires fail to deliver positions resulting from short sale transactions to be closed out by a specified date either by borrowing or by purchasing securities of like kind and quantity (the "close-out requirement.").

1 The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations, in coordination with other SEC staff, including in the Division of Trading and Markets and the Division of Economic and Risk Analysis. The Commission has expressed no view on its contents. This document was prepared by the SEC staff and is not legal advice.

2 Reg SHO became effective on September 7, 2004 and compliance was required as of January 3, 2005. (Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) ("Initial Adopting Rel.")).

In order to address potentially manipulative or abusive "naked" short selling, Reg SHO also requires that broker-dealers borrow securities sold short or have reasonable grounds to believe that such securities can be borrowed prior to effecting a short sale for their own account or accepting a short sale order from another person (the "locate requirement").

The trading strategies discussed in this Risk Alert could be used to give the impression that purchases by the short seller have satisfied the close-out requirement of the clearing firm or the broker-dealer to whom a fail to deliver position was allocated. We have observed, however, that in reality the purchased shares in question are often times not delivered because of subsequent options trading used to re-establish or otherwise extend the broker-dealer's fail position without any demonstrable legitimate economic purpose, such that the clearing firm or broker-dealer allocated a fail to deliver position does not satisfy the close-out requirement.[3]

This alert describes these trading activities in detail, summarizes certain key enforcement actions involving these activities, and notes effective practices that the staff has observed at some firms to identify risks and detect trading activities that could be used to circumvent these Reg SHO requirements.

I. Background

A. Reg SHO Close-out Requirement. Rule 204 of Reg SHO provides that a participant of a registered clearing agency (a "clearing firm") that has a fail-to-deliver position at a registered clearing agency in any equity security for a short sale transaction in that equity security, shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date (referred to as T+4), immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity.[4] If the clearing firm can demonstrate on its books and records that such fail to deliver position resulted from a long sale, or if the fail to deliver position is attributable to bona-fide market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the clearing firm must close-out the fail to deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date (referred to as T+6).[5]

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3 *See* Exchange Act Release No. 60388 (July 27, 2009), 74 F.R. 38266, 38272 n. 82 (July 31, 2009) ("Permanent Rule 204 Adopting Rel."), 17 CFR § 242.204(a).

4 17 CFR § 242.204(a). Rule 203(b)(3) of Reg SHO also provides that if a clearing firm has a fail to deliver position at a registered clearing agency in a "threshold security" for 13 consecutive settlement days, it must immediately thereafter close out the fail-to-deliver position by purchasing securities of a like kind and quality. 17 CFR § 242.203(b)(3). A threshold security is, generally, a security with large and persistent fails to deliver, as defined by Rule 203(c)(6). 17 CFR § 242.203(c)(6).

5 17 CFR § 242.204(a)(1) and (3). Additionally, if a clearing firm has a fail to deliver position at a registered clearing agency in any equity security resulting from a sale of a security that a person is deemed to own pursuant to § 242.200 and that such person intends to deliver as soon as all restrictions on delivery have been removed, the clearing firm shall, by no later than the beginning of regular trading hours on the thirty fifth consecutive calendar day following the trade date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity. 17 CFR § 242.204(a)(2).

A clearing firm may allocate close-out requirements for fail to deliver positions to another registered broker or dealer for which it clears trades or from which it receives trades for settlement, based on such broker's or dealer's short position, under Rule 204(d).[6] If a clearing firm allocates a fail to deliver position to a broker-dealer in accordance with Rule 204(d), the close-out requirements of Rule 204 apply to that broker-dealer, and not to the clearing firm.

Where a clearing firm subject to the close-out requirement, or a broker-dealer allocated a fail to deliver position, purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the clearing firm's fail position, and for which the clearing firm, or broker-dealer allocated a fail to deliver position, is unable to demonstrate a legitimate economic purpose, the clearing firm, or broker-dealer allocated a fail to deliver position, will not be deemed to have satisfied the close-out requirement.[7] In addition, under Rule 204(f), a clearing firm, or a broker-dealer allocated a fail to deliver position, shall not be deemed to have fulfilled the close-out requirements of Rule 204 where the clearing firm, or broker-dealer allocated a fail to deliver position, enters into an arrangement with another person to purchase or borrow securities as required by Rule 204, and the clearing firm, or broker-dealer allocated a fail to deliver position, knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow.[8]

B. <u>Reg SHO Locate Requirement</u>. Rule 203(b)(1) of Reg SHO requires broker-dealers, prior to accepting a short sale order in an equity security from another person, or effecting a short sale in an equity security for their own account, to borrow the security, enter into a bona-fide arrangement to borrow the security, or have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.[9] This requirement is referred to as the "locate" requirement.

Rule 203(b)(2) provides certain exceptions from the above-described locate requirement, including an exception for short sales effected by market makers in connection with bona-fide

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6 17 CFR § 242.204(d).

7 Permanent Rule 204 Adopting Rel., *supra* note 3, at 38272 n. 82.

8 17 CFR § 242.204(f); *see also* Permanent Rule 204 Adopting Rel*., supra* note 3 at 38278 (stating that "Regulation SHO prohibits a participant of a registered clearing agency, or a broker-dealer for which it clears transactions, from engaging in 'sham close outs' by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a fail to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another fail to deliver position."); Exchange Act Release No. 58773 (Oct. 14, 2008) 73 FR 61706, 61714- 61715, n.78 (Oct. 17, 2008)("Temporary Rule 204T Adopting Rel."). Similarly, a clearing firm, or broker-dealer allocated a fail to deliver position, shall not be deemed to have fulfilled the requirements of Rule 203(b)(3) where the clearing firm, or broker-dealer allocated a fail to deliver position, enters into an arrangement with another person to purchase securities as required by Rule 203(b)(3) and the clearing firm, or broker-dealer allocated a fail to deliver position, knows or has reason to know that the other person will not deliver securities in settlement of the purchase. 17 CFR § 242.203(b)(3)(vii); *see also* Initial Adopting Rel., *supra* note 2, at 48018.

9 17 CFR § 242.203(b)(1).

market making activities in the security for which the exception is claimed.[10] Rule 203(c)(1)[11] adopts the definition of the term "market maker" used in Section 3(a)(38) of the Securities Exchange Act of 1934 (the "Exchange Act").[12]

For purposes of qualifying for the exception to Reg SHO's locate requirement, a market maker must also be a market maker in the security being sold, and must be engaged in bona-fide market making in that security at the time of the short sale.[13] The Commission has stated that a market maker engaged in bona-fide market making is a broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market.[14]

For purposes of this alert, it is important to note that broker-dealers may claim to rely on this market maker exception in connection with sham transactions effected to skirt the Reg SHO close-out requirements because the trading at issue may involve short sales in hard to borrow securities. It may not be possible to locate shares in extremely hard to borrow securities, or the cost to borrow such securities may make such transactions unprofitable, by negating the potential profit opportunity that may otherwise be available from the price differential between the put and call options.

C. <u>Rule 10b-21</u>. Rule 10b-21 provides that it constitutes a "manipulative or deceptive device or contrivance" as used in Section 10(b) of the Exchange Act for any person to submit an order to sell an equity security, if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.[15] Rule 10b-21 covers those situations where a seller deceives a broker-dealer, participant of a registered clearing agency, or a purchaser about its intention to deliver securities by settlement date, and the seller fails to deliver securities by settlement date. For purposes of Rule 10b-21, broker-dealers (including market makers) acting for their own accounts are considered sellers.[16] In addition, broker-dealers could be liable for aiding and abetting a customer's fraud under Rule 10b-21.[17]

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10 17 CFR § 242.203(b)(2)(iii).

11 17 CFR § 242.203(c)(1).

12 15 U.S.C. § 78c(a)(38).

13 Temporary Rule 204T Adopting Rel., *supr*a note 7, at 61698.

14 *Id*. at 61698; *see also* Initial Adopting Release, *supra* note 2, at 48015 (providing examples of the types of activities that would indicate that a market maker is *not* engaged in bona fide market making activities).

15 17 CFR § 240.10b-21.

16 *See* Temporary Rule 204T Adopting Rel., *supra* note 7, at 61671.

17 *See id*. at 61673.

D. Key Trading Terms and Concepts. A "buy-write" trade is a simultaneous sale of calls and purchase of the equivalent amount of shares in the underlying stock. Buy-writes associated with the activity at issue typically employ deep in-the-money calls. [18]

A "married put" is the simultaneous purchase of a put and a purchase of the equivalent amount of shares in the underlying stock. When associated with the activity at issue, the married puts typically employ deep in-the-money puts.

"FLEX" options are exchange-traded options that have non-standard, customizable contract terms. The main features of FLEX options compared to standard traded options are the abilities to specify the strike price and the expiration date.

Options are priced in the market place so that the price of the underlying security is the same as the "synthetic"[19] price of its options. This relationship between the price of a security and its options is known as "Put/Call Parity."[20] For example, a "synthetic" long position, which consists of a long call and short put of the same strike and expiration date (also known as a "long combination" position), is typically the equivalent of a 100 share long position in an equity security.[21] When the "synthetic" position is priced correctly with respect to the actual shares, no potential profit opportunities exist in the market. In other words, being long the "synthetic" position (e.g., the long combination) and being short the actual shares normally results in a riskless, fully hedged, and profitless position. This position is commonly known in the industry as a "Reversal."[22]

Where there are differences in the value of "synthetic" positions and the actual shares that they represent, a potential profit opportunity exists. Such opportunities are extremely rare in options trading, are generally corrected very quickly and may not result in net profit after fees and commissions. Such rare, short lived opportunities are typically only accessible by, and profitable to, professional options traders such as floor traders and market makers who may pay lower fees and commissions. Electronic quoting engines of professional option traders ensure that such potential profit opportunities would be quickly priced away and Put/Call Parity would be reinstated.

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18 Deep in-the-money calls are options with a strike price well below the underlying stock price.

19 For an equity option with the standard delivery terms, a synthetic long position of 100 shares of the underlying security is long 1 call and short 1 put of the same strike and expiration month. This can be seen from the Put/Call Parity equation illustrated in footnote 20.

20 The formula for Put/Call Parity is: $C(S,t) - P(S,t) = S(t) - K*e^{-r(T-t)}$

Where, $S(t)$ = Current stock price
$P(S,t)$ = Put price given stock price at time t
$C(S,t)$ = Call price given stock price at time t
K = Strike price of Put and Call
r = Risk free rate
t = Current date
T = Expiration date of Put and Call

21 The most typical deliverable quantity of an exercised or assigned option is 100 shares of the underlying security.

22 A long "synthetic" position coupled with short stock is known as a Reversal. A short "synthetic" position vs. long stock is known as a Conversion. The trade is often referred to as the Reverse Conversion.

Periodically, securities become hard to borrow, and, where there are large and persistent fails to deliver in the security, end up on the threshold security list.[23] These situations give rise to pricing differentials in the options of these securities, and the Put/Call Parity equation may appear out of balance, which is, in part, a reflection of higher borrowing rates on these securities. When shares become hard to borrow, the "synthetic" position typically trades at prices that are less than the actual shares. This reflects the risk that shares cannot be borrowed and will have to be bought, in compliance with the Reg SHO close out requirements. In the extreme, these price differences can be quite large, creating potential profit opportunities in certain option trading strategies for those who are able to short the underlying equity securities without paying the high cost typically associated with obtaining for delivery the hard to borrow securities that were sold short.

II. Option Activity Related to Hard to Borrow and/or Threshold Securities

One strategy that could be designed to take advantage of the potential profit opportunities created by a stock becoming hard-to-borrow (thereby putting the Put/Call Parity into imbalance) is to initiate a Reversal. The activity is most often done by broker-dealers who claim to rely on the exception to the locate requirement for options market makers found in Rule 203(b)(2)(iii).[24] The options market-makers claim that they can enter into the short stock position without first locating the shares to borrow because it is part of "bona fide" market making activity. Although an options market maker engaged in bona fide market making activity may claim an exception to the locate requirement, to comply with Reg SHO, the options market maker must still deliver shares in settlement of the short sale, or if a fail to deliver position results at the clearing firm, the fail to deliver must be closed-out in accordance with Rule 204 of Reg SHO. It may be a violation of Regulation SHO, however, where the options market maker does not deliver shares, and instead engages in a second, subsequent transaction in order to give the appearance of satisfying the clearing firm's obligation to purchase or borrow the security to close out the resulting settlement fail pursuant to Rule 204 close-out requirements ("reset transaction"). In addition, where a clearing firm subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the clearing firm's fail position, and for which the clearing firm is unable to demonstrate a legitimate economic purpose, the clearing firm will not be deemed to have satisfied the close-out requirement.[25]

23 *See supra* note 4.

24 While the bona fide market making exception to the locate requirement makes it more likely that market makers, or purported market makers, would engage in the trading described, the same analysis with respect to sham close-outs would apply to similar arrangements between any market participants. For example, a recent case found that a clearing firm violated Reg SHO by allowing its customers to use buy-writes to appear to satisfy their obligations and the clearing firm's Rule 204 close-out obligation. According to the opinion, the customer used deep-in-the-money calls as part of the buy writes, and these calls were generally exercised the same day they were sold and assigned to the customer and shares were not delivered. In that matter, the clearing firm was found to have willfully violated its close-out obligations under Rule 204 and to have caused and willfully aided and abetted Rule 10b-5 and Rule 10b-21 violations by its customer. In the Matter of optionsXpress, et al., Admin. Proc. File No. 3-14848 (June 7, 2013), available at http://www.sec.gov/alj/aljdec/2013/id490bpm.pdf ("optionsXpress case").

25 Permanent Rule 204 Adopting Rel., *supra* note 3, at 38272 n.82.

Moreover, if the clearing firm or broker-dealer that was allocated the fail to deliver position enters into an arrangement with another person to purchase securities as required by Rule 204, and the clearing firm, or broker-dealer that was allocated a fail to deliver position, knows or has reason to know that the other person will not deliver securities in settlement of the purchase, then the transaction is a sham close-out, in violation of Rule 204(f).

<u>The Initial Transaction</u>
Example:

- Stock XYZ trading \$51.00
- May 50 Puts on XYZ trading \$3.00
- May 50 Calls on XYZ trading \$3.00

Trader A: Sells 10,000 shares XYZ @ \$51.00
Buys 100 May 50 Calls @ \$3.00
Sells 100 May 50 Puts @ \$3.00

In this example, the "synthetic" position is trading for \$50, which is simply Call Price - Put Price + Strike Price. The actual shares are trading for \$51, so that Trader A has effectively sold shares for \$1 more than it paid for them, in a simultaneous transaction. Each time the trade is made, Trader A is earning a \$100 profit[26], assuming that (a) Trader A is not being charged a fee to borrow shares to deliver on the short sale and (b) the clearing firm does not effect a buy-in against the trader to close-out a fail to deliver position.[27] In this case, the trade was made 100 times, so that the profit would be \$10,000. The sole reason for the disparity between the actual shares and the "synthetic" position is the fact that the shares of XYZ are hard to borrow.

<u>The Second Transaction to "Reset the Clock"</u>

Assuming that XYZ is a hard to borrow security, and that Trader A, or its broker-dealer, is unable (or unwilling[28]) to borrow shares to make delivery on the short sale of actual shares, the short sale may result in a fail to deliver position at Trader A's clearing firm. Rather than paying the borrowing fee on the shares to make delivery, or unwinding the position by purchasing the shares in the market, Trader A might next enter into a trade that gives the appearance of satisfying the broker-dealer's close-out requirement, but in reality allows Trader A to maintain its short position without ever delivering on the short sale. Most often, this is done through the use of a buy-write trade, but may also be done as a married put and may incorporate the use of

26 The vast majority of options trade with the exercise ratio of 1 option = 100 shares, so that an option premium of \$1 equals \$100.

27 It is unlikely that a broker-dealer would either be able to borrow shares or buy in the position without incurring or passing on the costs due to the high borrowing fees and large capital commitment associated with the trading.

28 There may be extremely large borrowing costs associated with hard-to-borrow stock and such borrowing costs can negate the mispricing of the options that gave rise to the potential profit opportunity in the first place.

short term FLEX options.[29] These trades are commonly referred to as "reset transactions," in that they have the effect of resetting the time that the broker-dealer must purchase or borrow the stock to close-out a fail. The transactions could be designed solely to give the appearance of delivering the shares, when in reality the trader has no intention of meeting his delivery obligations. The buy-writes may be (but are not always) prearranged trades between market-makers or parties claiming to be market makers. The price in these transactions is determined so that the short seller pays a small price to the other market-maker for the trade, resulting in no economic benefit to the short seller for the reset transaction other than to give the appearance of meeting his delivery obligations. Such transactions were alleged by the Commission to be sham transactions in recent enforcement cases.[30] Such transactions between traders or any market participants have also been found to constitute a violation of a clearing firm's responsibility to close out a failure to deliver.[31]

Trader A may enter a buy-write transaction, consisting of selling deep-in-the-money calls and buying shares of stock against the call sale. By doing so, Trader A appears to have purchased shares to meet the broker-dealer's close-out obligation for the fail to deliver that resulted from the reverse conversion. In practice, however, the circumstances suggest that Trader A has no intention of delivering shares, and is instead re-establishing or extending a fail position.

These circumstances vary. For example, Trader A may be engaging in buy-writes with a known counterparty, such as another market maker (Trader B) that Trader A pays to take the other side of its reset transactions. In this circumstance, Trader A and Trader B agree on a price at which the buy-write will be transacted. The trade is consummated as a spread, with the stock and option portions executed at the same time. Trader A sells calls to Trader B, and Trader A buys shares from Trader B. The size of the trade is dictated by how many shares Trader A is required to deliver to appear to have closed out the settlement fail arising from his short position and avoid a buy-in or large borrowing fees. Trader A knows or has reason to know that the counterparty to the buy-write will not deliver securities in settlement of the transaction. Rather,

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29 To circumvent Reg SHO, traders may set up a one-day FLEX trade, in conjunction with the purchase of the underlying stock to acquire long stock. When the option expires the following day, the trader effectively sells the underlying stock, reestablishing the short position, but the trader may claim, or be credited by its broker-dealer or clearing firm with, having satisfied the close-out requirement of Reg SHO. Traders will pay a very small premium to another trader to do this trade.

30 In the Matter of Gary S. Bell, Exchange Act Rel. 34-65941 (Dec. 13, 2011), *available at* http://sec.gov/litigation/admin/2011/34-65941.pdf. ("Bell case"): "Bell and GAS also willfully violated Rule 203(b)(3) of Reg. SHO by engaging in a series of sham reset transactions that employed short-term, paired stock and option positions, which enabled both Bell and GAS to circumvent their close out obligations in Reg. SHO threshold securities." *See also* In the Matter of Jeffrey Wolfson, et al., Exchange Act Release No. 67450 (July 17, 2012) available at http://www.sec.gov/litigation/admin/2012/34-67450.pdf ("Robert Wolfson case"); In the Matter of Jeffrey Wolfson, et al., Exchange Act Rel. No. 67451 (July 17, 2012) available at ("Jeffrey Wolfson case") In the Matter of Hazan Capital Management, LLC and Steven M. Hazan, Exchange Act Rel. No. 60441 (Aug. 5, 2009) *available at* http://www.sec.gov/litigation/admin/2009/34-60441.pdf ("Hazan case"); In the Matter of Rhino Trading, LLC, Fat Squirrel Trading Group, LLC, Damon Rein, and Steven Peter, Exchange Act Rel. 60941 (Nov. 4, 2009), *available at* http://www.sec.gov/litigation/admin/2009/34-60941.pdf.

31 *See* In the Matter of optionsXpress, Inc., supra note 24.

on the same day of the buy-write, Trader B will, in almost every case, exercise the deep in-the-money options it bought from Trader A in order to eliminate the short position created by selling shares to Trader A in the buy-write transaction, negating Trader A's purchase of those shares. The two counterparties trade deep in-the-money calls with little to no open interest, so that Trader A knows that when Trader B exercises its calls, Trader A will be the one assigned[32] on the exercised calls. As a result of the assignment on the exercised calls, Trader A has another delivery obligation. Trader A, or its broker-dealer, remains unable (or unwilling) to borrow shares to make delivery, and the reset transaction may result in a fail to deliver position at Trader A's clearing firm. The result may be a persistent fail to deliver position in the security at issue.

Trader A may also be engaging in buy-writes with unknown counterparties, but structured in a way that Trader A knows or has reason to know that the calls will be consistently exercised and assigned to Trader A. In particular, Trader A's buy-writes involve deep in-the-money calls on hard to borrow securities with little to no open interest. The end result is very likely the same: Trader A, or its broker-dealer, remains unable (or unwilling) to borrow shares to make delivery on the assignment of the exercised calls, and the repeated reset transactions result in a persistent fail to deliver position at Trader A's clearing firm in the security at issue.

To the broker-dealer or clearing firm, it may appear that Trader A's purchase, in the buy-write, has allowed the broker-dealer to satisfy its close-out requirement. Trader A continues to execute a buy-write reset transaction whenever necessary, and by the time of expiration of its original Reversal, it may have given up some of the profits in the form of premiums paid for the buy-writes, but it has maintained its short position without paying the higher cost to borrow or purchase shares to make delivery on the short sale. In each buy-write transaction, Trader A is aware that the deep in-the-money options are almost certain to be exercised (barring a sudden huge price drop), and it fully expects to be assigned on its short options, thus eliminating its long shares.

III. The Law and Related Cases

In 2003, the Commission issued interpretive guidance in which it stated that "it is important to disabuse traders of any notion" that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements.[33] The Commission

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32 When an option is exercised, a market participant that is short that option will be assigned. The assignment is done on a random basis by The Options Clearing Corporation. For a participant that is assigned on a short call, the short option position is replaced with a position of short 100 shares of the underlying equity and must deliver those shares by T+3. For a participant that is assigned on a short put, the position is replaced with a position of long 100 shares of the underlying equity. Each assignment is transacted at the strike price of the respective options.

33 Exchange Act Release No. 48795 (Nov. 17, 2003), 68 Fed. Reg. 65820, 65822 (Nov. 21, 2003). The release was issued as a means of providing all market participants with guidance regarding the use of married put transactions when determining their net positions under former Rule 3b-3 under the Exchange Act. In addition to discussing Rule 3b-3, the release discusses the operation of former Rule 10a-1 and Rule 105 of Regulation M under the Exchange Act. Although the release was issued prior to the adoption of Reg SHO, the guidance provided in the release noted the proposed adoption of Reg SHO, and explained that "[t]he interpretive guidance we are issuing today on calculating a 'net long' position applies regardless of whether the Commission adopts Regulation SHO." *Id.* at n. 8.

further stated that "[t]he Commission has previously indicated that where transactions involve no market risk and serve no purpose other than rendering a person an owner of a security in order to accomplish indirectly what was prohibited directly, the activity may violate the federal securities laws."[34]

The Commission has brought a number of enforcement actions against several entities and individuals regarding options trading and alleged violations of the locate and close-out requirements of Reg SHO.[35] In two settled cases, the Commission found that the respondents engaged in a series of reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations Reg SHO, and also that the respondents improperly claimed that they were entitled to the market maker exception to the locate requirement.[36] In another settled case, the Commission found that the respondent violated the locate and close out requirements of Regulation SHO by engaging in reverse conversions and sham reset transactions.[37] Likewise, in a recent decision, the Commission alleged that a similar series of reset transactions did not satisfy the close-out requirements of Rule 204.[38] Another set of settled cases involved improper reliance on an exception to the locate requirement in the absence of *bona fide* market making activity and cited violations of the close-out requirements of Reg SHO.[39]

In addition to the actions brought by the Commission, in July 2007, the American Stock Exchange fined several entities and individuals for violating the close-out requirement under Reg SHO based on trading activity similar to that described in this alert.[40] In these cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation. Following the release of these cases, the Chicago Board Options Exchange ("CBOE") sent a regulatory circular to its members "strongly cautioning" its members that transactions "pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed

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[34] *Id*. at n. 19.

[35] *See, e.g.,* Hazan case, supra note 30; In the Matter of TJM Proprietary Trading, LLC, et al., Exchange Act Release No. 60440 (Aug. 5, 2009) available at http://www.sec.gov/litigation/admin/2009/34-60440.pdf ("TJM case"); Bell case, *supra* note 30; optionsXpress case, supra note 24; Robert Wolfson case, *supra* note 30; Jeffrey Wolfson case, *supra* note 30. In some of these cases, the Commission alleged violations of the close-out requirements of Rule 203(b)(3), rather than Rule 204, because the activity in question occurred prior to the adoption of Rule 204. However, the analysis of sham transactions under Rule 203(b)(3) is similar to the analysis under Rule 204. *See supra* note 7.

[36] Hazan case and TJM case, *supra* note 30.

[37] Bell case, *supra* note 30.

[38] optionsXpress case, *supra* note 24.

[39] Robert Wolfson case and Jeffrey Wolfson case, *supra* note 30.

[40] In the Matter of Scott H. Arenstein and SBA Trading, *LLC* (Jul. 20, 2007), *available at* http://www.amex.com/atamex/regulation/discipline/2007/SArensteinSBA_Decision_072007.pdf; In the Matter of Brian A. Arenstein and ALA Trading, LLC (Jul. 20, 2007), *available at* http://www.amex.com/atamex/regulation/discipline/2007/BArensteinALA_Decision_072007.pdf.

improper reset arrangements that do not satisfy the Regulation SHO close-out requirement."[41] The circular goes on to state, "[s]hort sales of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, for example, including, but not limited to, reverse conversions and deep in-the-money long call/short stock, are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase."[42] CBOE then noted that while its examples involved market makers, "the same analysis would apply to similar arrangements between any market participants."[43]

In the context of these cases and issues pertaining to Reg SHO, broker-dealers must maintain adequate written supervisory procedures reasonably designed to achieve compliance with Reg SHO and Rule 10b-21.[44] These include procedures regarding correct marking of short sales and long sales, procedures to perform a locate and document a locate prior to a short sale, and procedures to ensure that fail to deliver positions are closed-out in accordance with Rule 204. As part of these procedures, clearing firms "should consider having in place policies and procedures to help ensure that delivery is being made by settlement date."[45]

In addition, adequate written supervisory procedures reasonably designed to achieve compliance with Rule 10b-21 include procedures to ensure that the broker-dealer, acting for its own account, including as a market maker, or the broker-dealer's customer, do not commit fraud in violation of Rule 10b-21 by deceiving a broker or dealer, a participant of a registered clearing agency, or a purchaser about their intention or ability to deliver the security on or before the settlement date, and failing to deliver the security.

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[41] CBOE Regulatory Circular RG07-87 (Aug. 9, 2007) *available at* https://www.cboe.org/publish/RegCir/RG07-087.pdf. On the same day, the American Stock Exchange issued similar guidance. *See* Amex Reg 2007-35, Applicability of Regulation SHO to Certain market Maker Transactions, (Aug. 9, 2007), available at http://www.amex.com/amextrader/tdrInfo/data/axNotices/2007/reg07035.html.

[42] *Id*.

[43] *Id.* The CBOE itself was recently the subject of a settled enforcement action in which it agreed to pay a $6 million penalty and implement major remedial measures for failing to enforce Reg SHO requirements. In the Matter of Chicago Board Options Exchange, Inc., Securities Exchange Act Rel. No. 69726 (June 11,2013), *available at* http://www.sec.gov/litigation/admin/2013/34-69726.pdf. According to the Commission's press release, this marked the first time that a financial penalty was assessed against an exchange for violations related to its regulatory oversight. "SEC Charges CBOE for Regulatory Failures," *available at* http://www.sec.gov/news/press/2013/2013-107.htm.

[44] NASD Rule 3010(b) requires every broker-dealer member of the Financial Regulatory Authority ("FINRA") to establish, maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, as well as applicable FINRA rules.

[45] Permanent Rule 204 Adopting Rel., *supra* note 3, at 38272.

IV. Staff Observations

The staff has observed that a number of firms have identified certain "red flags" that they look for to identify transactions that should be subject to heightened review by supervisors and/or compliance personnel. Below is a list of some of the activities that the staff has observed some of these firms look for that may indicate an attempt to circumvent certain requirements of Reg SHO. This list is not exclusive, and firms may have other means of monitoring trading to satisfy their supervisory obligations and /or their obligations under Reg SHO.

- Excessive trading or trading exclusively in hard to borrow or Threshold List securities.
- Large short positions in hard to borrow or Threshold List securities.
- Large failure to deliver positions in an account, often in multiple securities.
- Continuous failure to deliver positions at CNS (Continuous Net Settlement System).
- The use of buy-writes and/or married puts, particularly deep in-the-money buy-writes or married puts.[46]
- Use of buy-writes with little to no open interest outside of that trader's activity, resulting in all or nearly all of the call options being assigned.
- Repetitive nature of the use of buy writes.
- Trading in FLEX options in hard to borrow or Threshold List securities, particularly very short term (often with one day expirations) FLEX options.
- Trading exclusively in near term listed options in hard to borrow or Threshold List securities.
- Trading in hard to borrow or Threshold List securities claiming the market maker exception from the locate requirement.[47]
- Multiple large trades that take place with the same trader acting as a contra party in several hard to borrow or Threshold List securities.[48]

Conclusion

This options trading activity poses regulatory and reputational risks for broker-dealers and their correspondent clearing firms. The criteria and techniques listed above could be helpful in protecting a broker-dealer or clearing firm from these risks. If you believe that this activity is occurring with customers at your brokerage or your trading firm, or if you have seen this activity occurring on your exchange, please feel free to contact the Commission Tip line at the address below.

http://www.sec.gov/complaint/info_tipscomplaint.shtml.

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[46] As previously described, this activity can give the appearance of satisfying the Reg SHO close-out obligations, when in reality no delivery of shares is taking place.

[47] The staff has observed that traders may not be engaged in bona fide market-making in these securities, but may instead engage in trading related to speculative selling strategies or investment purposes of the trader, specifically trades to take advantage of the option mispricing.

[48] The staff has observed that traders may assist each other and act as facilitators for one another to avoid having to deliver shares.

This Risk Alert is intended to highlight for firms risks that the staff has identified in the course of examinations regarding certain options trading strategies. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert may reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.