

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 60441 / August 5, 2009**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-13570**

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<b>In the Matter of</b>	:	
	:	<b>ORDER INSTITUTING</b>
	:	<b>ADMINISTRATIVE AND CEASE-AND-</b>
<b>Hazan Capital Management, LLC</b>	:	<b>DESIST PROCEEDINGS PURSUANT</b>
<b>and Steven M. Hazan,</b>	:	<b>TO SECTIONS 15(b) AND 21C OF THE</b>
	:	<b>SECURITIES EXCHANGE ACT OF</b>
<b>Respondents.</b>	:	<b>1934, MAKING FINDINGS, AND</b>
	:	<b>IMPOSING REMEDIAL SANCTIONS</b>
	:	<b>AND A CEASE-AND-DESIST ORDER</b>
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**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act against Respondent Hazan Capital Management, LLC (“HCM”) and Respondent Steven M. Hazan (“Hazan”) (collectively, “Respondents”).

**II.**

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

### III.

On the basis of this Order and Respondents' Offer, the Commission finds<sup>1</sup> that:

#### Summary

1. These proceedings arise out of Respondent HCM's violations of Regulation SHO ("Reg SHO"). Subject to certain exceptions, Reg SHO requires market participants seeking to effect a short sale to borrow, arrange to borrow, or have reasonable grounds to believe that a security can be borrowed prior to effecting the short sale. This is known as the "locate requirement." Market makers, who ensure liquidity in the market, are excepted from the locate requirement if they are engaged in bona fide market making activities. At the time, Reg SHO also required fail-to-deliver positions<sup>2</sup> in certain securities that persisted for thirteen consecutive settlement days to be immediately closed out.<sup>3</sup> In contrast to the locate requirement, market makers are not excepted from Reg SHO's close-out requirement.

2. In this case, HCM improperly relied on the market maker exception from Reg SHO's locate requirement and engaged in certain transactions that violated the locate and close out requirements. The first type of transaction – known in the industry as a "reverse conversion" or "reversal" – involves selling a put option and buying a call option – a combination that creates what is known as a "synthetic" long position – while selling short the underlying stock. The counterparty on the components of the reverse conversion – which is engaging in a "conversion" – benefits from the transaction because it is able to acquire a long stock position that is perfectly hedged by the synthetic short options position. That party can then loan out the shares of stock and receive fees from the borrowers. Those fees can be quite significant when the stock is a

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<sup>1</sup> The findings herein are made pursuant to Respondents' Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

<sup>2</sup> Fails to deliver occur when a seller fails to deliver securities to the buyer when delivery is due. Generally, investors complete or settle their security transactions within three settlement days. This settlement cycle is known as T+3 (or "trade date plus three days"). T+3 means that when a trade occurs, the participants to the trade deliver and pay for the security at a clearing agency three days after the trade is executed so the brokerage firm can exchange those funds for the securities on that third settlement day. The three-day settlement period applies to most securities transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next settlement day following the trade (or T+1).

<sup>3</sup> A "close out" of a fail position involves the purchase of shares of like kind and quantity in the amount of the fail-to-deliver position.

threshold security, because threshold securities are hard to borrow and therefore command large fees in the stock loan market. Consequently, prime brokers created the demand for the reverse conversion to create inventory for stock loans on hard to borrow securities, and options market makers like HCM fed this demand.

3. The second type of transaction – referred to herein as a “reset” – is a transaction in which a market participant who has a “fail-to-deliver” position in a threshold security buys shares of that security while simultaneously selling short-term, deep in-the-money<sup>4</sup> call options to – or buying short-term, deep in-the-money put options from – the counterparty to the share purchase. The purchase of shares creates the illusion that the market participant has satisfied the close out obligation of Reg SHO. However, the shares that are apparently purchased in the reset transactions are never actually delivered to the purchaser because on the day after executing the reset, the option is either exercised (if a call) or assigned (if a put), transferring the shares back to the party that apparently sold them the previous day. This paired transaction allows the market participant with the fail-to-deliver position to effectively borrow the stock for a day, in order to appear to have satisfied the close out requirement of Rule 203(b)(3).

4. By avoiding the cost of borrowing shares and engaging in these reverse conversion and reset transactions, HCM was able to earn a profit while subject to minimal risk. Because HCM improperly failed to borrow or arrange to borrow securities to make delivery when delivery was due, the short sales were “naked” short sales<sup>5</sup> that violated Reg SHO.

5. Specifically, from January 2005 through October 2007, Respondent HCM – a putative options market maker – willfully violated Rule 203(b)(1) of Reg SHO by improperly claiming the market maker exception to avoid locating shares before effecting short sale transactions in Reg SHO threshold securities. HCM 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 HCM to circumvent its close out obligations in Reg SHO threshold securities.<sup>6</sup> HCM also assisted other options market makers who were executing their own sham

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<sup>4</sup> An “in-the-money” option is an option that entitles its holder to either buy securities below the current market price for that security (in the case of a call option), or to sell securities above the market price (in the case of a put option). An option that is “deep in-the-money” has a strike price that is far below (in the case of a call option) or far above (in the case of a put) the market price for the given security.

<sup>5</sup> In a “naked” short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver the securities to the buyer when delivery is due.

<sup>6</sup> A “threshold security” is a security for which there is an aggregate fail-to-deliver position exceeding the size criteria set forth in Rule 203(c)(6) of Regulation SHO for a period of five consecutive settlement days.

reset transactions by acting as a counterparty to the sham transactions and in doing so violated the locate requirement. Respondent Hazan, the principal trader at HCM and its majority owner, willfully aided and abetted and caused HCM's violations of Rules 203(b)(1) and 203(b)(3) of Reg SHO.

### **Respondents**

6. **Hazan Capital Management, LLC**, a New York limited liability company, is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. HCM was a Regular Member Organization of the AMEX<sup>7</sup> until terminating its membership effective December 24, 2007. From June 2006 until on or about October 20, 2007, HCM was an Options Trading Permit Holder and market maker on the ARCA.

7. **Steven Moses Hazan**, age 31, is a resident of New York, New York. At all relevant times, Hazan was the majority owner and managing member of HCM and controlled its trading activity. During the relevant period, Hazan was registered as Regular Member and a registered options trader on the AMEX, and was also an Options Trading Permit Holder and market maker with the ARCA. Hazan's membership on the AMEX was terminated effective August 3, 2006; his membership on the ARCA was terminated on or about October 20, 2007.

### **Facts**

#### **HCM Failed to Locate Shares Prior to Effecting Short Sales**

8. From January 2005 through October 2007,<sup>8</sup> HCM engaged in reverse conversions with purchasers of Reg SHO threshold securities.

9. In these reverse conversions, Hazan, on behalf of HCM, sold short shares of Reg SHO threshold securities while simultaneously creating a synthetic long position in those same securities by purchasing call options from, and selling put options to, the same counterparty to whom HCM was selling short the shares of the threshold securities. These call and put options had the same strike price and expiration date, and were options to buy (or sell) the same threshold securities that HCM sold short in the reverse conversion transactions. HCM purchased enough call options and put options so that the number of shares underlying the options equaled

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<sup>7</sup> On October 1, 2008, the AMEX was acquired by NYSE Euronext and renamed NYSE Alternext US, LLC. On March 6, 2009, NYSE Alternext US, LLC was renamed NYSE Amex, LLC.

<sup>8</sup> The trading at issue took place on the AMEX during the period January 3, 2005 through July 31, 2006, and on the ARCA during the period June 2006 through October 20, 2007.

the number of shares it sold short. Through this set of transactions, HCM eliminated its market risk because the short position was used to hedge the synthetic long position that had been created by purchasing call options and selling put options.

10. The reverse conversion transactions in Reg SHO securities were profitable for HCM because the prices of the three separate components of the transactions – the short sale, the sale of the put options, and the purchase of the call options – were interdependent, and were set at levels that created an agreed-upon net profit per share for HCM. That per-share net profit was the effective price of the conversion, a price that HCM’s counterparties were willing to pay in order to obtain shares of hard-to-borrow Reg SHO threshold securities for the length of time between the original execution of the conversion and the expiration of the option components of the conversion.

11. In executing these reverse conversions, HCM claimed the market maker exception in Rule 203(b)(1) of Reg SHO and did not locate, arrange to borrow, or borrow shares of the security in question prior to effecting the short sale. This failure to locate, arrange to borrow, or borrow shares was improper, however, because HCM was not engaged in bona fide market making activity in connection with effecting the short sale transactions.

#### **HCM Failed to Close Out Fail-to-Deliver Positions in Reg SHO Threshold Securities**

12. HCM’s short sales resulted in a fail-to-deliver position in the threshold security on the books and records of its clearing firm – i.e. HCM had not delivered the shares it sold short to its clearing firm so that the clearing firm could settle the trade.

13. During the relevant time, Rule 203(b)(3) of Reg SHO required clearing firms immediately to close out any fail-to-deliver position in a threshold security that persists for thirteen consecutive settlement days by purchasing securities of a like kind and quantity. Specifically, at the relevant time, Rule 203(b)(3) required a participant of a clearing agency registered with the Commission to take immediate action to close out a fail-to-deliver position in a threshold security in the Continuous Net Settlement system that has persisted for thirteen consecutive settlement days. However, pursuant to Rule 203(b)(3)(vi) of Reg SHO, a clearing firm is permitted reasonably to allocate a fail-to-deliver position to a broker or dealer whose short sale resulted in the position. Once the clearing firm has allocated the fail-to-deliver position to another broker or dealer, the obligation for complying with the close out requirement shifts to that broker or dealer.

14. On numerous occasions from January 2005 through October 2007, HCM’s clearing firm notified HCM that the clearing firm had allocated to HCM the obligation to close out fail-to-deliver positions in threshold securities. These notifications informed HCM that if it did not purchase shares sufficient to satisfy its fail-to-deliver position, the clearing firm would purchase (or “buy-in”) those shares for HCM’s account.

15. HCM did not want its fail-to-deliver position – which resulted from the short sale portion of the reverse conversion – to be closed out by the clearing firm because this would result in the clearing firm making large purchases of Reg SHO threshold securities, at HCM’s expense, at a price determined by the market. Additionally, the close out would have exposed Respondent HCM to market risk on its reverse conversion transaction because it would have eliminated the short position that had been used to hedge HCM’s synthetic long position created by the options component of the reverse conversion.

16. To avoid a forced close out, Hazan, on behalf of HCM, entered into a series of sham reset transactions that circumvented HCM’s obligation under Reg SHO to close out its fail-to-deliver position. These complex sham transactions gave the appearance that HCM was closing out its fail-to-deliver position by purchasing securities of like kind and quantity.

17. Specifically, on numerous occasions, Hazan, on behalf of HCM, effected short-term in-the-money option transactions in conjunction with stock purchases to circumvent the Reg SHO close out requirements. HCM “purchased” stock in the Reg SHO threshold security from another market maker and simultaneously sold a short-term call option to (or purchased a short-term put option from) the same market maker. These combined stock and option transactions were either “married puts” (the purchase of stock in conjunction with the purchase of a put option on the same security) or “buy-writes” (the purchase of stock in conjunction with the sale (or “writing”) of call options on the same security).

18. Although married puts and buy-writes can be created using standard options, the option component of HCM’s reset transactions were usually established using “FLEX” options. FLEX options are exchange traded options for which the parties can customize certain terms of the options, including the strike price, expiration date, and exercise type (*i.e.*, American or European). HCM used these FLEX options because it did not intend to actually purchase the shares required to satisfy its close out obligation. Rather, it simply wanted to appear to have satisfied that obligation through a purported purchase of shares. Thus, HCM structured the reset transactions so that the options component of the transaction would expire very soon after the purported “purchase” of shares had been reflected in HCM’s account at its clearing firm. Indeed, most of the FLEX options were customized to expire one day after they were purchased.<sup>9</sup>

19. By entering into these reset transactions, HCM created the false impression that it had satisfied its Reg SHO close out obligation. HCM, however, knew that the following day, or shortly thereafter, the option would expire in-the-money, causing the market maker that had purchased that call option to assign an exercise notice to HCM for HCM to sell the stock. (In the

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<sup>9</sup> The options exchanges prohibited the trading of FLEX options on certain days right before and right after the standard expiration date of any given month (*i.e.*, the third Saturday after the first Friday of the month). Thus, for reset transactions executed on those days, HCM used standard options to create the married puts and buy-writes.

case of a put option, HCM itself would exercise the right to sell the stock back to its counterparty.)

20. Moreover, HCM never actually received the stock it “purchased” from the other market maker because that market maker was selling short the stock without actually having any shares to sell.<sup>10</sup> Accordingly, HCM never received any shares and so never in fact closed out the “fail-to-deliver” position – as required by Reg SHO – that was initially established during the reverse conversion transaction. HCM knew, or should have known, that the combination of the purchase of shares and the sale of the FLEX option would result in maintenance of the “fail-to-deliver” position.

21. HCM’s clearing firm, however, reset HCM’s Reg SHO close out obligation to day one – thus giving HCM another thirteen settlement days in which to close out the short position – based on HCM’s purported “purchase” of shares and exercise of the option.

22. After receiving subsequent close out notices from its clearing firm, HCM continued to engage in these and other types of transactions until the initial options positions (call options purchase/put options sale) expired or were assigned, thus closing out the short position and eliminating the synthetic long position that the short position had hedged. By engaging in this course of conduct, Hazan, on behalf of HCM, impermissibly maintained fail-to-deliver positions in numerous Reg SHO threshold securities longer than thirteen settlement days. Indeed, on numerous occasions, HCM’s repeated use of reset transactions allowed it to maintain a large fail-to-deliver position in a threshold security for several months.

23. During the relevant period, HCM engaged in a large volume of reverse conversions and reset transactions in numerous threshold securities. As a result of HCM’s repeated violation of Reg SHO’s locate and close out requirements, it received ill-gotten gains of at least \$3 million.

24. In addition, on numerous occasions, HCM assisted other putative market makers in evading their close out obligations by acting as the counterparty to reset transactions. Specifically, HCM sold short shares of Reg SHO threshold securities so that other market makers could “purchase” the securities to close out their own fail-to-deliver positions, and simultaneously bought deep in-the-money call options, the combination of which allowed the other market makers to circumvent their own Reg SHO close out obligations. HCM did not borrow, arrange to borrow, or locate the shares of these threshold securities prior to entering into the short sale component of these reset transactions.

## **VIOLATIONS**

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<sup>10</sup> These market makers were themselves improperly relying on Reg SHO’s locate exception related to bona fide market making activity because they were not engaged in bona fide market making activity in connection with these short sales.

### **HCM Willfully Violated Rule 203(b)(1) of Reg SHO and Hazan Willfully Aided and Abetted and Caused HCM's Violation**

25. Pursuant to the locate requirement of Rule 203(b)(1) of Reg SHO, a broker or dealer may not effect a short sale in an equity security unless it has “(i) [b]orrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) [r]easonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) [d]ocumented compliance with [these requirements].”

26. Rule 203(b)(2)(iii) contains an exception to this locate requirement for short sales effected “by a market maker in connection with bona-fide market making activities in the security for which this exception is claimed.”

27. At the time Hazan, on behalf of HCM, placed orders to sell short certain Reg SHO threshold securities as part of the reverse conversion transactions and reset transactions described above, he failed to borrow, arrange to borrow, or locate the securities, claiming the market maker exception to the locate requirement. The market maker exception was not available to HCM, however, because it was not engaging in bona-fide market making activities in these securities.

28. As a result of this conduct, HCM willfully violated, and Hazan willfully aided and abetted and caused HCM's violations, of Rule 203(b)(1) of Reg SHO.

### **HCM Willfully Violated Rule 203(b)(3) of Reg SHO and Hazan Willfully Aided and Abetted and Caused HCM's Violation**

29. At the relevant time, Rule 203(b)(3) imposed an obligation on clearing firms immediately to close out any fail-to-deliver positions in a threshold security that lasts for thirteen consecutive settlement days<sup>11</sup> by purchasing securities of like kind and quantity. Pursuant to Rule 203(b)(3)(vi), however, a clearing firm is permitted reasonably to allocate a fail-to-deliver position to a broker or dealer whose short sale resulted in the position. Once the clearing firm has allocated the fail-to-deliver position to another broker or dealer, the obligation to comply with the mandatory close out requirement shifts to that broker or dealer.

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<sup>11</sup> In October 2008, the Commission adopted Rule 204T (which was made permanent as Rule 204 on July 27, 2009). Under Rule 204, clearing firms must close out fails-to-deliver on all securities (not just threshold securities) and must do so earlier than under Rule 203(b)(3). Clearing firms must now close out fails-to-deliver by either borrowing or purchasing sufficient shares before the beginning of trading hours on the first settlement day after the settlement date. Fails relating to long sales or bona fide market making activity have two additional settlement days before they must be closed out.

30. Once the fail-to-deliver position is allocated to the broker or dealer, that broker or dealer, in order to satisfy the close out requirement of Rule 203(b)(3) of Reg SHO, must purchase securities of like kind and quantity. Borrowing securities, or otherwise entering into an arrangement that merely creates the appearance of a purchase, does not satisfy Reg SHO's close out requirement.

31. In addition, Rule 203 of Reg SHO specifically prohibits firms from satisfying their close out obligations through sham transactions that merely give the appearance of closing out a fail-to-deliver position. Specifically, Rule 203(b)(3)(vii) provides that a clearing firm – or a broker or dealer to which the clearing firm allocated a fail-to-deliver position – will be deemed not to have satisfied the close out obligation if it knows, or has reasonable grounds to believe, that the close out purchase will result in a fail-to-deliver.

32. By selling (or purchasing) deep in-the-money FLEX call (or put) options while simultaneously purporting to “purchase” stock, Respondent HCM engaged in sham transactions that gave the appearance that it was closing out its fail-to-deliver position when, in fact, Respondent HCM knew, or should have known, that these transactions would result in a fail-to-deliver position.

33. As a result of this conduct, HCM willfully violated, and Hazan willfully aided and abetted and caused HCM's violations of, Rule 203(b)(3) of Reg SHO.

#### **Undertakings**

34. Respondent Hazan and Respondent HCM have undertaken to pay, jointly and severally, a fine in the amount of \$500,000 to NYSE Amex, LLC pursuant to the terms of the decision by the NYSE Amex, LLC Hearing Board accepting the Stipulation of Facts and Consent to Penalty entered into by Respondents and NYSE Amex, LLC on February 19, 2009.

35. Respondent Hazan and Respondent HCM have undertaken to pay, jointly and severally, a fine in the amount of \$500,000 to NYSE Arca, Inc. pursuant to the terms of the decision by the NYSE Arca, Inc. Hearing Board accepting the Stipulation of Facts and Consent to Penalty entered into by Respondents and NYSE Arca, Inc. on February 19, 2009.

In determining whether to accept Respondents' Offer, the Commission has considered these undertakings.

#### **IV.**

In view of the foregoing, the Commission deems it appropriate and in the public interest to impose the sanctions agreed to in Respondents' Offer.

Accordingly, pursuant to Section 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

1. Respondent HCM shall cease and desist from committing or causing, and Respondent Hazan shall cease and desist from causing, any violations and any future violations of Exchange Act Rules 203(b)(1) and 203(b)(3);
2. Respondent Hazan be, and hereby is barred from association with any broker, or dealer, with the right to reapply for association after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission.
3. Any reapplication for association by Respondent Hazan will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent Hazan, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order;
4. Respondent HCM is censured;
5. Respondent Hazan and Respondent HCM shall pay, jointly and severally, disgorgement in the amount of \$3,000,000. This order to pay disgorgement shall be deemed satisfied by the orders of NYSE Amex, LLC directing Respondent Hazan and Respondent HCM to pay disgorgement in the amount of \$1,500,000, and NYSE Arca, Inc. directing Respondent Hazan and Respondent HCM to pay disgorgement in the amount of \$1,500,000, in related actions brought by those self-regulatory organizations, NYSE Amex Disciplinary Proceedings against Steven M. Hazan and Hazan Capital Management, LLC and NYSE Arca Disciplinary Proceedings against Steven M. Hazan and Hazan Capital Management, LLC.

By the Commission.

Elizabeth M. Murphy  
Secretary