

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

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 72186 / May 19, 2014**

**INVESTMENT COMPANY ACT OF 1940**  
**Release No. 31049 / May 19, 2014**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-15874**

**In the Matter of**

**Michael H. Johnson**

**Respondent.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS,  
PURSUANT TO SECTIONS 15(b) AND 21C  
OF THE SECURITIES EXCHANGE ACT OF  
1934, AND SECTION 9(b) OF THE  
INVESTMENT COMPANY ACT OF 1940,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A CEASE-  
AND-DESIST ORDER**

**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”), and Section 9(b) of the Investment Company Act of 1940 (“Investment Company Act”) against Michael H. Johnson (“Johnson” or “Respondent”).

**II.**

In anticipation of the institution of these proceedings, Respondent has 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 him and the subject matter of these proceedings, which are admitted, Respondent consents 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, and Section 9(b) of the Investment Company Act of 1940, 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 Respondent's Offer, the Commission finds<sup>1</sup> that:

#### **Summary**

This proceeding arises out securities lending practices at Penson Financial Services, Inc. ("Penson") that resulted in systematic violations of Rule 204 of Regulation SHO. From October 2008 through November 2011, Johnson and his subordinates in the Securities Lending Department implemented procedures that they knew, or were reckless in not knowing, did not comply with Rule 204 of Regulation SHO. In so doing, Johnson willfully aided and abetted and caused Penson's violations, and failed reasonably to supervise his subordinates with a view to preventing and detecting their misconduct.

#### **Respondent**

1. Johnson, of Dallas, Texas, was the Senior Vice President of Penson Worldwide, Inc.'s ("PWI") Securities Lending Department from at least October 2008 until June 2012. In that position, Johnson oversaw securities lending activities at Penson. Johnson was associated with Penson between 2004 and 2012. Johnson is not currently associated with any registered broker-dealer. Johnson held Series 7, 24, 27, and 63 licenses.

#### **Other Relevant Entity**

2. Penson was a registered broker-dealer incorporated in North Carolina with a principal place of business in Dallas, Texas. From at least 2010 to 2012, Penson was the second-largest clearing firm in the United States as measured by the number of correspondent broker-dealers for which it cleared. Penson was a wholly-owned subsidiary of SAI Holdings, Inc., which in turn was a wholly-owned subsidiary of PWI. Penson filed a Form BDW, which became effective in October 2012, and then declared bankruptcy in January 2013. A bankruptcy plan implementing Penson's liquidation was approved in July 2013.

#### **Background**

3. In September 2008, the Commission implemented Rule 204T of Regulation SHO, which required, among other things, clearing firms to close out Continuous Net Settlement ("CNS") failures to deliver in all sales of equity securities that they cleared. In July 2009, the Commission made those requirements permanent in adopting Rule 204 of Regulation SHO. The Commission adopted Rule 204 of Regulation SHO to address, among other things, abusive "naked" short selling and failures to deliver.<sup>2</sup>

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

<sup>2</sup> Rule 204T and Rule 204 will be collectively referred to as Rule 204.

4. Rule 204(a) requires participants of a registered clearing agency (generally, clearing firms) to deliver equity securities to a registered clearing agency when delivery is due, i.e., by settlement date, or close out fails to deliver resulting from long or short sales within certain timeframes. Settlement date is generally three days after the trade date (“T+3”). For short sales, if the clearing firm has a failure-to-deliver position at the clearing agency, it must close out the CNS failure-to-deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours (i.e., market open) on the settlement day following the settlement date (“T+4”). For long sales, if the clearing firm has a failure-to-deliver position at the clearing agency, it must close out the CNS failure-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 day following the settlement date (“T+6”).

5. If Penson failed to close out a CNS failure to deliver within the timeframes required by Rule 204(a), it was required to follow the “pre-borrow” requirements of Rule 204(b). Rule 204(b) provides that if a CNS failure to deliver position is not closed out pursuant to Rule 204(a), Penson may not accept a short sale order in the equity security from another person, or effect a short sale in the equity security for its own account, without first borrowing the security, or entering into a bona fide arrangement to borrow the security, until Penson closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled. The requirements of Rule 204(b) are also referred to as the “penalty box.”

### **Penson Violates Rule 204 of Regulation SHO**

6. At all relevant times, Penson was a clearing firm and a member of the National Securities Clearing Corporation (“NSCC”), a clearing agency registered with the Commission that clears and settles the majority of United States transactions in equities. From October 2008 through November 2011, Penson systematically failed to close out CNS failures to deliver resulting from certain long sales by market open T+6. The relevant long sales originated with securities held in customer margin accounts. Under the Commission’s customer protection rule, Penson was permitted, subject to certain conditions and limitations, to re-hypothecate margin securities to third parties. Penson re-hypothecated margin securities according to the terms of the Master Securities Lending Agreement (“MSLA”) developed by the Securities Industry and Financial Markets Association (“SIFMA”). Penson’s Securities Lending Department generated revenue and helped to finance Penson’s operations by loaning out shares held in customer margin accounts.<sup>3</sup>

7. When a margin customer sold the hypothecated securities that were out on loan, Penson issued account-level recalls to the borrowers on T+3, i.e., three business days after execution of the margin customer’s sale order. If the borrowers did not return the shares by the close of business T+3 and Penson did not otherwise have enough shares of the relevant security to meet its CNS delivery obligations, Penson incurred a CNS failure to deliver in the relevant security. When the open stock loan continued to cause a CNS failure to deliver as of market open

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<sup>3</sup> The circumstances in which margin customers sold securities that were on loan will be referred to as “long sales of loaned securities.”

T+6, it was Penson's procedure not to purchase or borrow shares by market open sufficient to close out its failure to deliver position. Instead, Penson systematically violated Rule 204(a) by allowing its CNS failure to deliver position to persist beyond market open T+6.

8. Penson also violated Rule 204(b) of Regulation SHO by not pre-borrowing prior to effecting further short sales in the security until it had purchased shares sufficient to close out the CNS fail to deliver and the purchase cleared and settled.

9. When closing out CNS fails to deliver resulting from short sales, Penson frequently located sources that could provide borrowable securities, or made arrangements to borrow, instead of actually borrowing (or purchasing) securities sufficient to close out the CNS fail position.

**Penson's Securities Lending Department Adopts Procedures for Long Sales of Loaned Securities that Violate Rule 204(a)**

10. At all relevant times, Johnson was the senior officer in the Securities Lending Department. The Securities Lending Department was included on the organizational charts of PWI, the parent company, rather than within Penson, which was then a registered broker-dealer. However, the policies and procedures of Penson treated the Securities Lending Department as part of the broker-dealer and the employees of the Securities Lending Department as associated persons of the broker-dealer. Securities Lending Department personnel had direct access to Penson's account with NSCC and conducted all securities lending activity on behalf of Penson. The Securities Lending Department had primary responsibility at Penson for effecting Rule 204(a) close-outs of Penson's CNS failures to deliver resulting from long sales of loaned securities.

11. Johnson had primary authority and responsibility within the Securities Lending Department for its operational practices and for the Department's Written Supervisory Policies and Procedures ("WSPs"), which were incorporated into Penson's WSPs.

12. In September 2008, the Securities Lending Department initially attempted to comply with Rule 204 for long sales of loaned securities by recalling loans at the account level on T+3 and buying in borrowing counterparties at market open T+6. However, under the MSLA applicable to the loans, the borrowing counterparties had three full business days from the T+3, account-level recall – i.e., until close of business T+6 – to return the shares. Because the MSLA provided for three full business days for the borrowing counterparties to return the shares, those counterparties often pushed back against Penson's attempted market open T+6 buy ins.

13. In response to this push back, Johnson and the Securities Lending Department supervisors met to discuss Penson's compliance with Rule 204. Johnson and the Securities Lending Department supervisors agreed that, due to their view of industry practices, they would not close out Penson's CNS failures to deliver resulting from long sales of loaned securities by market open of T+6. They further agreed that, in certain circumstances, they would allow the CNS failures to deliver to persist beyond close-of-business T+6.

14. Johnson knew the procedures the Securities Lending Department implemented as a result of these discussions did not comply with Rule 204.

15. Johnson and other Securities Lending Department supervisors discussed the non-compliant procedures with Penson's senior compliance officers. Johnson and the Securities Lending Department supervisors explained that, based on their view of securities lending industry practices, they were not complying with Rule 204. Johnson and Penson's senior compliance officers agreed that Penson would continue implementing the non-compliant procedures.

16. The non-compliant Rule 204 procedures were in effect at Penson from at least October 2008 through November 2011.

**Penson's Securities Lending Department Adopts Procedures for Long Sales of Loaned Securities That Violate Rule 204(b)**

17. Rule 204(b) required Penson to "penalty box" all securities for which it had a Rule 204(a) violation. However, Penson's Securities Lending Department implemented procedures under which it did not "penalty box" securities for CNS failures to deliver that persisted beyond market open T+6. Instead, it only took certain, incomplete steps to "penalty box" securities when it allowed failures to deliver to persist beyond close-of-business T+6. This caused Penson to violate Rule 204(b) from October 2008 through November 2011.

18. Penson's Securities Lending Department caused Penson to violate Rule 204(b)'s penalty box requirements in the following ways:

- When Rule 204(a) violations relating to long sales of loaned securities occurred, the Securities Lending Department typically did not purchase securities as required by Rule 204(b). Instead, it simply waited for the shares recalled at the account level to return during the business day on T+6 and placed no pre-borrow restrictions on short sales if the shares were returned during that day.
- If the recalled shares were not returned on T+6, the Securities Lending Department sometimes purchased shares by effecting a buy-in at close of business T+6 against the borrowing counterparty. After effecting this buy in, the Securities Lending Department immediately cleared the relevant security for short selling without pre-borrow requirements instead of waiting for the purchase to clear and settle.
- The Securities Lending Department only placed pre-borrow restrictions on securities if it deferred, at the borrowing counterparty's request, a buy-in at close of business T+6. However, the Securities Lending Department did not then purchase shares as required by Rule 204(b). Instead, it again waited for the recalled shares to be returned, and then allowed short selling without pre-borrows in the securities once the shares were returned.

19. Johnson knew or was reckless in not knowing that these procedures did not comply with Rule 204(b).

**Penson’s Securities Lending Department Implements Procedures for Short Sales That Violate Rule 204(a)**

20. Rule 204(a) required Penson to close out CNS failures to deliver resulting from short sales by borrowing or purchasing securities by market open T+4. Merely obtaining a “locate” or arranging to borrow shares was not sufficient to meet the close-out requirement of Rule 204(a).

21. Penson’s Securities Lending Department implemented Rule 204(a) procedures for close-outs of CNS failures to deliver resulting from short sales under which Securities Lending personnel contacted other broker-dealers prior to market open T+4 to determine whether they had shares available for lending. The Securities Lending personnel deemed the close-out completed, and instructed Penson’s Buy Ins Department personnel to take no further close-out action, if the other broker-dealers stated they had shares available. This may have resulted in Penson obtaining a “locate,” but did not constitute borrowing of shares.

22. In other cases, Securities Lending personnel “booked” the “locates” in Penson’s electronic lending platform prior to market open – a more definitive, but not final, stage in the borrow process. But the personnel did not confirm whether the potential lender booked a reciprocal transaction or actually delivered securities by market open. In so doing, Penson did not borrow the shares.

23. In many cases, these “locates” and/or arranged borrows ultimately “dropped,” i.e., were never completed, because the potential lender never delivered the shares. This caused failures to deliver to persist beyond T+4.

24. Johnson knew or should have known these procedures amounted to arranged borrows and/or “locates” for Rule 204(a) close-out purposes, and that, as a result, Johnson aided and abetted and caused Penson to violate Rule 204(a) from October 2008 through November 2011.

**Johnson’s Supervisory Responsibilities**

25. Johnson was the direct supervisor of two Vice Presidents in the Securities Lending Department, both of whom were associated with Penson. The two Vice Presidents aided and abetted Penson’s Rules 204(a) violations by implementing procedures they knew or were reckless in not knowing would result in violations of Rule 204(a) in connection with long sales of loaned securities.

26. Johnson failed reasonably to supervise his subordinates with the view to preventing and detecting their violations. Instead, Johnson fostered and encouraged their misconduct by participating in it with them.

**Violations**

27. As a result of the conduct described above, Johnson willfully aided and abetted and caused Penson’s violations of Rules 204(a) and 204(b) of Regulation SHO, which require registered participants of clearing agencies to close out CNS failures to deliver resulting from long

sales by market open T+6, to close out CNS failures to deliver resulting from short sales by market open T+4, and impose pre-borrowing restrictions on securities for which the close-out requirements are violated.

28. As a result of the conduct described above, Johnson failed reasonably to supervise the two Vice Presidents of Securities Lending within the meaning of Section 15(b)(4)(E) of the Exchange Act with a view to detect and prevent them from willfully aiding and abetting Penson's violations of Rule 204(a).

#### IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Sections 15(b) and 21C of the Exchange Act and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Johnson cease and desist from committing or causing any violations and any future violations of Rule 204 of Regulation SHO.

B. Pursuant to Section 15(b)(6) of the Exchange Act and Section 9(b) of the Investment Company Act, Respondent be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization with the right to apply for reentry after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

C. Any reapplication for association by the Respondent 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 the Respondent, 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.

D. Respondent shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of \$125,000.00 to the United States Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in one of the following ways:

(1) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or

(2) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center  
Accounts Receivable Branch  
HQ Bldg., Room 181, AMZ-341  
6500 South MacArthur Boulevard  
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying Johnson as a Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Julie K. Lutz, Regional Director, Denver Regional Office, Securities and Exchange Commission, 1801 California Street, Suite 1500, Denver, Colorado 80202.

E. Such civil money penalty may be distributed pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended ("Fair Fund distribution"). Regardless of whether any such Fair Fund distribution is made, amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the United States Treasury or to a Fair Fund, as the Commission directs. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

By the Commission.

Lynn M. Powalski  
Deputy Secretary