UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15873

In the Matter of

Thomas R. Delaney II and
Charles W. Yancey

Respondents

RESPONDENT CHARLES W. YANCEY'S AMENDED PREHEARING BRIEF

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INTRODUCTION AND SUMMARY OF THE ARGUMENT

This case presents a startling application and extension of long-standing concepts of regulatory supervision by a Chief Executive Officer that, if allowed, will impose an insurmountable burden of due diligence on every regulated CEO in the United States' securities industry. Here, the Division of Enforcement attempts to hold Bill Yancey, the former President and CEO of Penson Financial Services, Inc. ("Penson" or "the Firm"), responsible for failing to supervise two individuals based on purported violations of a highly technical rule, Rule 204(a) of Reg SHO, of which the SEC concedes Mr. Yancey was not made aware, or, as the Division alleges, ***were actively concealed from him***. Rule 204(a) was not intended to apply in this circumstance, and no CEO could meet this standard of diligence without being derelict in his or her day-to-day responsibilities as a steward of the firm.

This case concerns a very narrow category of transactions—long sales of loaned securities. The Division alleges that Penson's Stock Loan department "instituted a policy and practice of intentionally and consistently" violating Rule 204T(a)/Rule 204(a) of Regulation SHO ("Rule 204(a)") with respect to long sales of loaned securities, that Penson's Senior Vice President of Stock Loan, Mike Johnson, and Chief Compliance Officer, Thomas Delaney, aided and abetted these purported violations, and that Respondent Yancey failed to supervise Johnson and Delaney.

There is no basis in law or fact for holding Mr. Yancey liable in this case. The Division's theory of liability in this case is illogical and contradicted by the facts. The Division alleges that Penson's motive for "intentionally" and "consistently" violating Rule 204(a) was to make money. But the evidence will show that Penson was satisfying its Rule 204(a) obligation over

99% of the time and was consistently attempting to comply with the rule. Moreover, the Division grossly overstates the "economic benefit" that Penson allegedly gained from Rule 204(a) violations ***by a factor of 100***.

The Division's claim that Mr. Yancey failed to supervise Michael Johnson fails because Yancey reasonably and appropriately delegated supervision of Johnson to Phil Pendergraft, who, as Penson's co-founder, had decades of experience in the securities industry. Pendergraft had the requisite authority and responsibility to supervise Johnson, and Pendergraft actively supervised Johnson. Pendergraft: evaluated and reviewed Johnson's stock lending activities, reprimanded Johnson, determined Johnson's and other Stock Loan's employees' compensation, approved Johnson's budget, approved Johnson's travel budget, approved Johnson's medical time off and vacation requests, and advised Johnson about his career path. Mr. Yancey diligently monitored Pendergraft's supervision of Johnson and never received any indication that Pendergraft's supervision of Johnson was deficient or unreasonable.

The Division's claim that Mr. Yancey failed to supervise Thomas Delaney fails because Mr. Yancey reasonably supervised Delaney, and none of the "red flags" advanced by the Division would have alerted Mr. Yancey to "systemic" and "intentional" violations of Rule 204(a) for long sales of loaned securities. The Division concedes that Mr. Yancey was not aware of "systematic" and "intentional" Rule 204(a) violations and further alleges that the issues were ***intentionally concealed from him***. Instead, the Division asserts that the results of a Rule 204(a) audit in December 2009 should have alerted Mr. Yancey to "intentional" Rule 204(a) violations, but the Division acknowledges that: (1) the audit did not test "long sales of loaned securities;" and (2) the issues identified in the audit were promptly remediated.

The Division's supervisory allegations against Mr. Yancey also fail because Penson had established procedures, and a system for applying such procedures, to prevent and detect violations, and Mr. Yancey reasonably satisfied his duties and obligations without reasonable cause to believe that the procedures and system were not being followed. Penson's policies and procedures, including written supervisory procedures, were reasonably designed and consistent with Penson's regulatory responsibilities. Moreover, Penson employed a robust testing process with dedicated staff responsible for conducting risk-based testing, as well as a system for tracking and following up on necessary remediation. Mr. Yancey consistently discharged his supervisory duties and obligations through daily, weekly, and monthly meetings with his direct reports.

In sum, to hold Mr. Yancey responsible for failing to supervise Delaney and Johnson would result in an untenable extension of Rule 204(a) that would cause uncertainty and confusion among senior-level managers at broker-dealers as to their supervisory responsibilities and significantly undermine long-standing concepts of regulatory supervision.

BACKGROUND

I. Penson Financial Services, Inc.

Penson was one of the largest independent clearing firms in the United States. Penson was a wholly-owned subsidiary of Penson Worldwide, Inc. ("PWI"). Penson had over 275 active securities clearing correspondents and over 60 futures clearing correspondents. Penson was the second largest clearing and settlement firm in the United States by number of correspondents, which included online, direct access, and traditional brokers, as well as hedge funds, large banks, institutional investors, and financial technology firms located in the United

States, Canada, Europe, and Asia. At its height, Penson had over 600 employees.

Penson cleared a massive volume of trades during the relevant time period.[1] At times, Penson was clearing between one and two million trades per day. Penson's operations were complex; a large percentage of Penson's correspondents were very complicated, high-frequency trading firms.

II. Respondent Bill Yancey

From August 2005 to February 2012, Respondent Charles W. ("Bill") Yancey was the President and CEO of Penson. Prior to joining Penson, Yancey was President of Automated Trading Desk Brokerage Services, LLC ("ATD"). Before joining ATD, he worked at Southwest Securities as an Executive Vice President, responsible for all principal and agency trading operations. Yancey currently serves as the Managing Director of clearing and execution services at First Southwest Company.

Yancey is an accomplished and highly regarded brokerage executive with more than 30 years in the securities industry. The evidence will show that Yancey is honest and a person of integrity with high ethical standards. For 30 years in the securities industry, Yancey maintained an absolutely unblemished U-4. Indeed, individuals who have worked with Yancey for long periods of time will testify about Bill's character for honesty, integrity, and trust.

The record will further confirm that throughout his career Yancey has been a champion of ethics and compliance. At Penson Yancey prioritized compliance and dedicated substantial resources to the Compliance department. In little more than a year, Yancey grew Penson's Compliance department from 8 to 23 employees.

[1] The relevant time period as defined in the Division's Order Instituting Proceedings ("OIP") is October 2008 through November 2011. *See* OIP at ¶ 5.

Throughout his career, Yancey has been elected, selected, and appointed to positions that reflect his industry expertise, accomplishments, leadership, and integrity. Yancey has served as Chairman of the Security Traders Association ("STA"). In 2013 he completed his third-term as a Trustee to the Securities Industry and Financial Markets Association ("SIFMA") Industry Institute at the Wharton School of Business. After completing his service as a Trustee, he was elected as Co-Chair of the Securities Industry Institute ("SII") Society. He also serves on the NASDAQ Stock Market listings panel. Yancey served on the NASDAQ Quality of Markets Committee for four years. He also served on the SIFMA Trading Committee. Yancey has participated in numerous STA, SIFMA, and NASDAQ committees and conferences. Yancey was also voted in as a member of the National Association of Investment Professionals. Yancey has been repeatedly selected as a key person charged with protecting the interests of each of these organization's members.

Yancey is also an ordained Baptist Deacon and serves as Chairman of 6Stones Mission Network, a nonprofit faith based organization committed to building a coalition of businesses, churches, and other entities to provide programs and services that meet the needs of the underprivileged in the greater Dallas/Fort Worth community.

When Yancey left Penson in 2012 he resigned voluntarily. He was not under internal review for violating any securities-related statutes, regulations, rules, or industry standards of conduct. Nor did he voluntarily resign because of allegations of any wrongdoing. After Yancey left Penson, the Firm filed a Form BDW[2] in mid-2012 and declared bankruptcy in January 2013. A bankruptcy plan implementing Penson's liquidation was approved in July 2013. Pursuant to

[2] Notice of withdrawal from registration as a broker-dealer.

the bankruptcy plan, PWI and Penson transferred their assets to Penson Technologies, LLC ("PTL") as successor-in-interest. PTL operates to serve the Penson Liquidation Trust.

III. Rule 204T/204(a)

The rule at issue in this proceeding—Rule 204T/204(a) ("Rule 204(a)")—is explained in depth in the expert report of Marlon Paz, a former SEC regulator who played a central role in the rulemaking process for Rule 204(a).[3] As explained by Mr. Paz, Rule 204(a) is a highly-technical, complex rule. Rule 204(a) requires CNS participants (broker-dealers, such as Penson) to close out fail-to-deliver positions resulting from both short and long sales by borrowing or buying securities in sufficient quantities to close out those fails at the beginning of regular trading hours on T+4 (trade date plus four days) for short sales and T+6 (trade date plus six days) for long sales. With respect to short sales, any fail to deliver by regular settlement date (trade date plus three or "T+3") must be closed out by borrowing or purchasing securities of like kind and quantity no later than the beginning of trading (9:30 a.m. EST) the following day ("T+4").[4] With respect to long sales, any fail to deliver by regular settlement date must be closed out by borrowing or purchasing securities of like kind and quantity no later than the open of trading on T+6

As Mr. Paz explains, the SEC adopted Rule 204(a) primarily to "address abusive 'naked' short selling"—*i.e.*, selling shares short without borrowing shares in time to make delivery

[3] The Expert Report of Marlon Q. Paz ("Paz Report") is attached hereto as Exhibit A.

[4] Investors generally settle their transactions in exchange-traded securities within three settlement days, often referred to a "T+3" or "trade date plus three days." When a trade occurs, the participants to the trade deliver, and pay for, the securities at a clearing agency three settlement days after the trade is executed, which allows the brokerage firm to exchange the funds for the securities on the third settlement day.

within the standard three-day settlement period.[5] In its release announcing Rule 204, the SEC explained its concerns: "We intend that the temporary rule will address potentially abusive 'naked' short selling by requiring that securities be purchased or borrowed to close out any fail to deliver position in an equity security by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred."[6] The SEC further noted that the "rule should provide a powerful disincentive to those who might otherwise engage in potentially abusive 'naked' short selling."[7]

The primary purpose for adopting Rule 204 – to prevent abusive naked short selling – *is not present in this case*. Indeed, there are no allegations that Penson engaged in or facilitated abusive naked short selling. Nor are there any allegations that Penson facilitated fails to deliver as part of a "scheme" to manipulate the price of any security. Rather, the issue in this case involves *long sales* of equity securities. Long sellers are situated differently from short sellers. Unlike short sellers, long sellers own the shares that they are selling and are looking for the best price. Thus, unlike "naked short sellers," long sellers generally have no incentive to depress the price of the security, which is the type of activity that Rule 204 was principally designed to address.

Because of the complexities and ambiguities of Rule 204(a), commentators expressed the view that NSCC participants would not always be able to comply with the rule. In Mr. Paz's

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[5] Paz Report at 9 (citing Exchange Act Release No. 58733 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) ("Rule 204T Adopting Release")); *see also* 2007 Regulation SHO Final Amendments, 72 FR at 45544 (stating that "[a]mong other things, Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date and to target potentially abusive 'naked' short selling in certain equity securities").

[6] Exchange Act Release No. 58733 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008).

[7] *Id.*

opinion, it is precisely for this reason that the SEC created Rule 204(b), the "penalty box" prong of Rule 204, which requires NSCC members and their introducing brokers to refrain from short selling a security that was the subject of a 204(a) violation other than on a pre-borrow basis.[8]

IV. The Division's Claims in this Matter

The Division's allegations in this case are extremely narrow. The Division alleges that "Penson systematically violated Rule 204T(a)/204(a)'s market-open CNS close-out requirement for long sales of loaned securities from October 2008 until November 2011."[9] The Division's allegations involve only long sales of securities that were out on loan—*i.e.*, securities held by customers in margin accounts that Penson had loaned out, or rehypothecated, pursuant to margin account agreements with it customers ("long sales of loaned securities").

As Mr. Paz explains, broker-dealers routinely borrow and re-lend securities held in customer margin accounts, as permitted by Exchange Act Section 15c3-3 and authorized by a customer's margin-account agreement.[10] Among other things, securities lending allows broker-dealers to fund customer margin accounts, make delivery in respect of other customers' short sales, and lend securities to other market participants, all of which has the effect of "improv[ing] market liquidity, reduc[ing] the risk of failed trades, and add[ing] significantly to the incremental return of investors."[11]

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[8] *See* Paz Report at 11.

[9] OIP at ¶ 10.

[10] *See* Paz Report at 12.

[11] *See* ICGN Securities Lending Code of Best Practice, INTERNATIONAL CORPORATE GOVERNANCE NETWORK, (2007), available at https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/sec_lending/2007_securities_lending_code_of_best_practice.pdf.

In this case, the Division alleges:

(1) Penson's Stock Loan Department had "a policy and practice of intentionally and consistently violating Rule 204(a) with respect to a particular type of transaction—long sales of loaned securities;"[12]

(2) Thomas Delaney and Michael Johnson aided and abetted this violation;[13] and

(3) Bill Yancey failed to supervise Thomas Delaney and Michael Johnson.[14]

According to the Division's theory of liability, the motivation for Penson's Stock Loan department to "systematically and intentionally" violate Rule 204(a) was profit. The Division alleges that Penson's Stock Loan department "allowed CNS failures to deliver resulting from long sales of loaned securities to persist beyond market open T+6" because doing so "resulted in direct financial benefit to Stock Loan . . . ."[15] The Division further posits that the Stock Loan department was able to avoid "the costs and market risks associated with buy ins and/or borrows" and "profited by keeping stock out on loan rather than recalling it so that it could be delivered in a timely fashion."[16] The hearing will confirm that the Division's theory of liability is illogical, flawed, and contradicted by the facts.

LEGAL STANDARDS

Section 15(b)(4)(E) of the Securities and Exchange Act ("Exchange Act") authorizes the SEC to impose sanctions on an associated person if that person has failed reasonably to

[12] OIP at ¶ 49; Division's Opposition to Respondent Yancey's Motion for a More Definite Statement, at 3, June 18, 2014 ("Division's Opposition to Motion for More Definite Statement").

[13] *See* OIP at ¶¶ 85-86.

[14] *See* OIP at ¶ 87.

[15] *See* OIP at ¶¶ 22-23.

[16] OIP at ¶ 23.

supervise, with a view to preventing violations of the federal securities statutes, rules, and regulations, another person who commits such a violation, and if such other person is subject to his supervision.[17] There are four essential elements of a failure to supervise claim:

(1) an underlying securities law violation by another person;

(2) association of the registered representative or person who committed the violation;

(3) supervisory jurisdiction over that person; and

(4) failure to reasonably supervise the person committing the violation.[18]

The standard for supervision is whether a person exercises "reasonable supervision under the attendant circumstances."[19] "Negligence is the applicable standard in assessing whether supervision was reasonable under the prevailing circumstances."[20] "Negligence is defined as: '[t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights. The term connotes culpable carelessness.'"[21] "The reasonable person acts sensibly, does things without serious delay, and

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[17] Securities Exchange Act of 1934, §§ 15(b)(6)(A)(i), 15(b)(4)(E).

[18] *See In the Matter of Dean Witter Reynolds, Inc.*, SEC Administrative Proceeding File 3-9686, Initial Decision Release No. 179, 2001 WL 47244 at *38 (Jan. 22, 2001); *In the Matter of Michael Bresner*, SEC Administrative Proceeding File 3-314015, Initial Decision Release No. 517 at 115 (Nov. 8, 2013).

[19] *In the Matter of Eric J. Brown et. al.*, Exchange Act Release No. 34-66469, 2012 WL 625874 at *11 (Feb. 28, 2012); *see also In the Matter of Theodore W. Urban*, SEC Administrative Proceeding File 3-13655, Initial Decision Release No. 402 at 52 (September 8, 2010).

[20] *Urban*, Initial Decision Release No. 402 at 52 (citing *Kevin Upton*, 52 S.E.C. 145, 153 (1995), *rev'd on other grounds*, 75 F.3d 92 (2d Cir. 1996)).

[21] *See Urban*, Initial Decision Release No. 402 at 52 (quoting Black's Law Dictionary 1056 (7th ed. 1999)).

takes proper but not excessive precautions."[22]

The standard for supervision is not perfection. Even if supervision "was not perfect," or a factual analysis indicates that a more thorough investigation might have revealed a supervised employee's misconduct, liability does not exist in the absence of *unreasonable* supervision.[23] "The evolution of the supervision standards is a triumph of common sense that makes oversight of the market more responsible, more accountable, and more practical."[24] As the SEC has made clear, "a firm's President is not automatically at fault when other individuals in the firm engage in misconduct of which he has no reason to be aware."[25]

As noted above, proof of an underlying securities violation by another person is an essential element of a failure to supervise claim.[26] The Division alleges that the Senior Vice President of Securities Lending,[27] Michael Johnson, and Penson's Chief Compliance Officer, Thomas Delaney, "willfully aided and abetted and caused Penson's violations of Exchange Act Rule 204T/204(a)."[28] There are three essential elements to an aiding and abetting claim:

(1) the existence of a securities law violation by the primary party;

(2) awareness or knowledge by the aider and abettor that his role was part of an overall activity that was improper; and

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[22] *Id.* at 52.

[23] *See In the Matter of Arthur James Huff*, Exchange Act Release No. 34-29017, 1991 WL 296561 at *4 (March 28, 1991) (finding that "more thorough investigation by [the supervisor] might have revealed. . . misconduct. However, the statute only requires reasonable supervision under the attendant circumstances").

[24] *In the Matter of Patricia Ann Bellows*, SEC Administrative Proceeding File 3-8951, Initial Decision Release No. 128, 1998 WL 409445, at *9 (July 23, 1998).

[25] *In the Matter of Smartwood Hesse, Inc.*, Exchange Act Release No. 34-31212, SEC Docket 1557, 1992 WL 252184 at *6 (Sept. 22, 1992).

[26] *See Dean Witter Reynolds, Inc.*, 2001 WL 47244 at *38.

[27] The terms "Stock Loan," "Securities Lending," and "Stock Lending" when used in this brief reference Penson's securities lending activities.

[28] OIP at ¶¶ 85-86.

(3) that the aider and abettor knowingly and substantially assisted in the conduct that constituted the primary violation.[29]

With respect to the first element of its aiding and abetting claim, the Division maintains that the underlying violative conduct at issue in this case was "a policy and practice" by Penson's Stock Loan department "of intentionally and consistently violating Rule 204(a) with respect to a particular type of transaction—long sales of loaned securities."[30] Importantly, the Division has further clarified that "this is not a case where the Division alleges isolated violations in a sea of relevant transactions."[31]

Against this backdrop, the Division has the burden to prove each of the following by a preponderance of the evidence:

1. Penson's Stock Loan department had a policy and practice of *intentionally* and *consistently* violating Rule 204(a) with respect to long sales of loaned securities;

2. Thomas Delaney and/or Michael Johnson knew of or were aware of the existence of this policy and practice of intentionally and consistently violating Rule 204(a) with respect to long sales of loaned securities;

3. Delaney and/or Johnson knowingly and substantially assisted the purported policy and practice of intentionally and consistently violating Rule 204(a) with respect to long sales of loaned securities;

4. Johnson and/or Delaney were subject to Yancey's supervision; and

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[29] *See In the Matter of OptionsXpress, Inc.*, SEC Administrative Proceeding File 3-14848, Initial Decision Release No. 490, 2013 WL 2471113, at *79 (June 7, 2013); *see also Woods v. Barnett Bank*, 765 F.2d 1004, 1009 (11th Cir. 1985); *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir. 1980).

[30] *See* Division's Opposition to Respondent Yancey's Motion to Identify Rule 204(a) Violations, at 2, September 17, 2014 ("Division's Opposition to Motion to Identify"); *see also id.* at 5 (". . . this case focuses on a systematic, intentional practice of violating Rule 204(a); *id.* at 4 (" . . . the more important, overarching violation was the intentional practice of consistently violating Rule 204(a)"); Division's Opposition to Motion for More Definite Statement at 3 ("[T]he Division has alleged that Stock Loan instituted a policy and practice of intentionally and consistently violating Rule 204(a) with respect to a particular type of transaction—long sales of loaned securities.").

[31] Division's Opposition to Motion for More Definite Statement at 5, June 18, 2014.

5. Yancey failed reasonably to supervise Johnson and/or Delaney with a view to preventing or detecting the purported policy and practice of intentionally and consistently violating Rule 204(a) with respect to long sales of loaned securities.

Additionally, Section 15(b)(4)(e) of the Exchange Act provides an affirmative defense to Yancey on the failure to supervise claim: no person may be deemed to have failed to reasonably supervise if (1) there have been established procedures, and a system for applying such procedures, to prevent and detect any violation; and (2) the person has *reasonably satisfied* his duties and obligations without reasonable cause to believe that the procedures and system were not being followed.[32]

ARGUMENT AND AUTHORITIES

I. The Evidence Will Not Support the Division's Theory That Penson had a Policy and Practice of Intentionally and Consistently Violating Rule 204(a) With Respect to Long Sales of Loaned Securities.

The Division alleges that "the Rule 204(a) violations at issue" in this case are "a policy and practice" by Penson's Stock Loan department "of intentionally and consistently violating Rule 204(a) with respect to a particular type of transaction—long sales of loaned securities."[33] The record will not support the Division's theory because: (1) The Division's claim is based on unreliable evidence; (2) Penson was complying with Rule 204(a)'s obligations on long sales of loaned securities the overwhelming majority of the time; (3) Penson's Stock Loan department attempted to comply with Rule 204(a); and (4) the Division's theory that Penson was motivated

[32] *See In the Matter of Michael Bresner*, SEC Administrative Proceeding File 3-15015, Initial Decision Release No. 517 at 114-15 (Nov. 8, 2013).

[33] *See* Division's Opposition to Motion to Identify at 2; *see also id.* at 5 (". . . this case focuses on a systematic, intentional practice of violating Rule 204(a); *id.* at 4 (". . . the more important, overarching violation was the intentional practice of consistently violating Rule 204(a)"); Division's Opposition to Motion for More Definite Statement at 3 ("[T]he Division has alleged that Stock Loan instituted a policy and practice of intentionally and consistently violating Rule 204(a) with respect to a particular type of transaction—long sales of loaned securities.").

by profit is belied by the evidence, including the Division's own expert witness.

A. The evidence relied on by the Division to demonstrate a practice and policy of "intentionally and consistently" violating Rule 204(a) is unreliable.

The Division cannot carry its burden of proving by a preponderance of the evidence that Penson's Stock Loan department had a policy and practice of intentionally and consistently violating Rule 204(a) with respect to long sales of loaned securities. To support its theory, the Division relies on the testimony of its expert witness, Professor Larry Harris. Professor Harris asserts that Penson's Stock Loan department "did not close out before the Close-out Deadline delivery failures resulting from long sales of securities for which it had lent shares" on "82% of all days" that he examined.[34] But the evidence will show two independent flaws in Harris's conclusions.

First, Harris's methodology depends on the completeness of Penson's trade blotter. But as Respondent Delaney's expert witness, Professor Eric Sirri explains, the trade blotter was missing transactions for many security-settlement date combinations. As Professor Sirri explains, if a short sale transaction was missing from the trade blotter, a negative CNS position at the close of T+5 may have incorrectly been attributed to a long sale instead of a short sale.[35] Thus, Professor Harris relied on incomplete data in forming his conclusions. Because Professor Harris relied on incomplete data, his conclusions are unreliable.

Second, although Professor Harris concedes that many of the alleged Rule 204(a) violations he identifies closed out on T+6, he improperly assumes that these close-outs occurred ***after*** market open on T+6. As Professor Sirri explains, Professor Harris's conclusions fail to

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[34] Expert Report of Larry Harris at 8, ¶ 21 ("Harris Report").

[35] *See* Expert Report of Eric Sirri at 30-31, ¶¶ 84-87 ("Sirri Report").

account for shares delivered to the NSCC prior to market open on T+6.[36] This is important because CNS processes trades overnight. The evidence at the hearing will show that on the morning of T+6 Penson's Stock Loan department often borrowed shares to cover fails arising from long sales of loaned securities. Accordingly, Professor Harris's analysis is incomplete and flawed, and does not support the assertion that Penson had a "policy and practice" of intentionally and consistently violating Rule 204(a) with respect to long sales of loaned securities.

B. Even accepting the Division's expert's calculations, Penson's Stock Loan department was satisfying Rule 204(a) 99.3% of the time.

The Division cannot carry its burden of proving by a preponderance of the evidence that Penson's Stock Loan department had a policy and practice of violating Rule 204(a) with respect to long sales of loaned securities for a second, independent reason—only 1 out of every 800 long sale trades potentially associated with loaned shares contributed to a Rule 204(a) violation as identified by the Division's expert, Professor Larry Harris. The evidence at the hearing will show that for the relevant time period, the number of purported Rule 204(a) violations is infinitesimal compared to the number of transactions that Penson cleared every day. Indeed, as explained by Professor Sirri, of the 83.6 million long sale transactions that could be potentially associated with loaned shares over the time period that Professor Harris analyzed, only **.12%** could be potentially associated with a negative CNS position identified by Professor Harris as an alleged Rule 204(a) violation.[37] Thus, contrary to the Division's theory that Penson had a policy and practice of "intentionally and consistently violating Rule 204(a) with respect to long sales of

[36] *See* Sirri Report at 31-32, ¶¶ 88-90.

[37] *See* Sirri Report at 33-34, ¶ 92.

loaned securities," the evidence will demonstrate that Penson complied with Rule 204(a) in the overwhelming number of transactions involving these securities.

C. Penson's Stock Loan department attempted to comply with Rule 204(a).

The Division cannot carry its burden of proving a policy and practice of violating Rule 204(a) with respect to long sales of loaned securities because the evidence will show that the Stock Loan department consistently attempted to comply with Rule 204(a). Fact witnesses will testify that Penson's Stock Loan department began attempting to borrow to settle trades before market-open on T+6 and on earlier days. As Professor Harris concedes, "[a]ny such borrowings (if sufficiently large) would have allowed Penson to meet the close-out requirements of Rule 204."[38] Thus, the record will demonstrate that Penson's Stock Loan department diligently attempted to comply with Rule 204(a).

D. The evidence will not support the Division's "profit motive" theory.

The Division's theory of liability is that the Stock Loan department was actively seeking an economic benefit through a policy and practice of violating Rule 204(a)'s close out procedures. The Division alleges that Stock Loan "willfully ignored" Rule 204(a) because it "did not want the costs of compliance with [Rule 204(a)] to negatively affect Stock Loan's revenues" and that Delaney "affirmatively assisted the violations" because he was "[m]otivated by financial considerations."[39]

But the Division's theory of liability is belied by the evidence, including the conclusions of its own expert witness. Professor Harris calculated a purported economic gain to Penson of

[38] Harris Report at 35, ¶ 113.

[39] OIP at ¶¶ 5, 7.

$6.2 million as a result of the Stock Loan department's alleged policy of violating Rule 204(a).[40] But as Professor Sirri explains, Professor Harris's benefit calculations contained a computer coding error that overstated his results by a factor of 100.[41] The corrected calculation reduces Professor Harris's average gain calculation to $61,651 over a three-year period, or **.08%** of the revenue that Penson's Stock Loan department generated over the same time period.[42] Thus, the Division's theory of liability—that Penson's Stock Loan department violated Rule 204(a) for profit—is refuted *by its own expert witness*.

The Division's theory of liability is counter-factual for a second reason. The record will show that the Stock Loan department ***did*** borrow shares to close out fail positions on the morning of T+6 and earlier, and in many cases the costs that Penson incurred from these borrows eliminated any profit that Penson would have realized from the loan. Indeed, in many instances the fees that the Stock Loan department paid to borrow on the morning of T+6 greatly exceeded the slim margin that the Stock Loan department would have realized from the loan.

II. The Evidence Will Not Support the Division's Theory That Thomas Delaney and Michael Johnson Willfully Aided and Abetted a Policy and Practice of Intentionally and Consistently Violating Rule 204(a) With Respect to Long Sales of Loaned Securities.

As a further prerequisite to the Division's supervisory claim against Yancey, the Division must first prove that Michael Johnson or Thomas Delaney aided and abetted a "policy and practice of intentionally and consistently violating Rule 204(a)." Yancey has no duty to defend himself against the Division's aiding and abetting allegations. Respondent Delaney intends to

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[40] *See* Harris Report at 49.

[41] *See* Sirri Report at 25-27, ¶¶ 73-78.

[42] *See* Sirri Report at 27, ¶ 78.

defeat the Division's allegations that he aided and abetted a policy and practice of intentionally and consistently violated Rule 204(a) with respect to long sales of loaned securities. Yancey is confident that the evidence will not support the Division's aiding and abetting allegations, in which case the Division's supervisory claims against Yancey must fail as a matter of law.[43]

III. The Evidence Will Show That Bill Yancey Reasonably Delegated Supervision of Mike Johnson.

A. Yancey reasonably delegated supervision of Michael Johnson to Phil Pendergraft.

"The president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient."[44] The Commission "has long recognized that individuals . . . who may have overarching supervisory responsibilities for thousands of employees must be able to delegate supervisory responsibility . . . ."[45]

As explained in Judith Poppalardo's expert report,[46] the roles and responsibilities of a CEO in a large, complex financial services firm, such as Penson, are multi-faceted and demanding. To effectively and efficiently perform his job, a CEO like Yancey *must* delegate

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[43] *See In the Matter of IFG Network Sec., Inc.*, Exchange Act Release No. 34-54127, 88 SEC Docket 1195, 2006 WL 1976001 (July 11, 2006) ("Since the alleged violations of the three registered representatives are unproved, it must be concluded that the failure to supervise charge against IFG and Ledbetter is also unproved."); *In the Matter of Bresner*, Exchange Act Release No. 34-68464, 2012 WL 6608195, at *2 (Dec. 18, 2012) (denying as inefficient a request to sever action against supervisor and representative because, "as in all failure-to-supervise cases, the underlying violation must be proven as the first step in substantiating a charge of supervisory failure against [the supervisor]").

[44] *See Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995) (quoting *Universal Heritage Investments Corp.*, 47 S.E.C. 839, 845 (1982) (finding securities firm's president had properly delegated duties)).

[45] *Bellows*, 1998 WL 409445, at *8.

[46] The Expert Report of Judith Poppalardo ("Poppalardo Report") is attached hereto as Exhibit B.

supervisory responsibilities. Thus, although Yancey had overarching responsibility for hundreds of Penson's employees, he retained direct supervisory responsibility over only those employees for whom he did not delegate such responsibility.[47]

The evidence will show that in August 2008, Yancey delegated supervisory responsibility for Mike Johnson to Phil Pendergraft. Prior to August 2008, Johnson reported to Yancey.[48] In August 2008, Penson combined the stock lending departments of its various subsidiaries, including Penson, into a Global Stock Lending department. Johnson was selected to head that department and was transitioned out of the Penson organization and into the PWI organization. As part of Johnson's transition, Yancey and Pendergraft agreed that Pendergraft would undertake supervisory responsibility for Johnson, and Yancey delegated supervisory responsibility of Mike Johnson to Phil Pendergraft. Pendergraft informed Yancey that while Pendergraft was Johnson's primary and direct supervisor, he intended to rely on PWI President, Dan Son, to assist in oversight of Johnson and the Global Stock Lending department. Testimony and documents that will be presented at the hearing reflect Johnson's transition from Yancey's reporting chain to Pendergraft's reporting chain.[49]

B. Phil Pendergraft exercised close and active supervision over Mike Johnson, and Yancey had no reason to believe Pendergraft's supervision of Johnson was not reasonable.

The evidence will further show that Pendergraft actively supervised Johnson during the relevant time period. For purposes of Section 15(b)(4)(E), a supervisor has been defined as:

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[47] *See* Poppalardo Report at 6-7.

[48] *See* Ex. 555.

[49] *See, e.g.*, Ex. 571 (January 2009 Org. Chart); Ex. 608 (August 14, 2008 email from Pendergraft to Dawn Gardner regarding Mike Johnson).

> A person at the broker-dealer who has been given (and knows or reasonably should know he has been given) the authority and the responsibility for exercising such control over one or more specific activities of a supervised person . . . so that such person could take effective action to prevent a violation of the Commission's rules which involves such activity or activities by such supervised person.[50]

"Determining if a particular person is a supervisor depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue."[51] An individual's ability to discipline;[52] fire;[53] assess performance;[54] assign, direct, or approve activities;[55] promote;[56] and approve leave[57] are all indicia of supervisory authority over an employee.

The evidence will demonstrate that Pendergraft had the requisite authority and responsibility to supervise Johnson. Pendergraft co-founded Penson and had decades of experience managing securities lending activities. Pendergraft understood every aspect of securities lending and possessed unparalleled technical expertise with respect to securities

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[50] *Bresner*, Initial Decision Release No. 517 at 115 (Nov. 8, 2013); *see also Bellows*, Initial Decision Release No. 128, 1998 WL 409445, at *8 (July 23, 1998); *In the Matter of Huff*, 50 S.E.C. 524, 532, 1991 WL 296561, at *9 (March 28, 1991) (supervisors require the power to control the actions of their subordinates).

[51] *See In the Matter of John H. Gutfreund*, 51 S.E.C. 93, 113 (Dec. 3, 1992); *In the Matter of Theodore W. Urban*, SEC Admin. Proc. File 3-13655, Initial Decision Release No. 402 (Sept. 8, 2010); *see also In the Matter of George Kolar*, 202 SEC LEXIS 3420 (June 26, 2002).

[52] *See In the Matter of Ronald S. Bloomfield*, Exchange Act Release No. 34-71632, 2014 WL 768828, at *11 (Feb. 27, 2014) ("As we have held, an individual's ability to discipline and, especially, to fire an employee are indicia of supervisory authority over that employee."); *see also In the Matter of Midas Sec., LLC*, Exchange Act Release No. 34-66200, at *13 & n.73, 2012 WL 161938 (Jan. 20, 2012); *In the Matter of George J. Kolar*, Exchange Act Release No. 46127, 55 SEC 1009, 2002 WL 1393652, at *4 (June 26, 2002).

[53] *See In the Matter of Stephen J. Horning*, SEC Administrative Proceeding File 3-12156, Initial Decision Release No. 318, 2006 WL 2682464, at *10 (Sept. 19, 2006).

[54] *See Urban*, 2010 WL 3500928, at *27.

[55] *See id.*

[56] *See id.*

[57] *See Midas*, 2012 WL 161938, at *13.

lending. Pendergraft also maintained his principal license with Penson and, as CEO of PWI, had the requisite authority to control the activities of all of the employees in the Global Stock Lending department.

The evidence will further show that Pendergraft controlled Johnson's activities. Indeed, Pendergraft:

- Evaluated and reviewed Johnson's stock lending activities;[58]
- Reprimanded Johnson;[59]
- Determined Johnson's and other Stock Loan employees' compensation;[60]
- Approved Johnson's compensation budget for members of the Penson stock lending department;[61]
- Instructed Johnson regarding the staffing levels and budget of Penson's Stock Loan department;[62]
- Approved counter-party relationship changes in Penson's stock lending group;[63]
- Advised Johnson in resolving various Penson business and customer relations issues;[64]
- Instructed Johnson and his subordinates at Penson regarding the firm's financing, including lending and borrowing balances and hard-to-borrow rates;[65]

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[58] *See* Ex. 565.

[59] *See* Ex. 668.

[60] *See* Exs. 608, 662, 705.

[61] *See* Exs. 596, 598, 664.

[62] *See* Exs. 516, 529.

[63] *See* Exs. 573, 707.

[64] *See* Exs. 528, 667.

[65] *See* Exs. 599, 607, 667.

- Monitored Penson Stock Lending revenue and expenses, both in the monthly business review (MBR) meetings and in personal conversations with Johnson;[66]
- Approved Johnson's business development and client relations plans and budget;[67]
- Approved Johnson's travel budget;[68]
- Approved Johnson's time off to address medical concerns[69] and his vacation schedule;[70]
- Allowed Johnson to represent Penson in meetings with regulators;[71] and
- Advised Johnson about his career path and promotion potential.[72]

Thus, the record will show that Pendergraft actively supervised Johnson during the relevant time period. Pendergraft, *not Yancey*, determined Johnson's compensation. Hiring decisions within the Securities Lending group were made by Johnson and Pendergraft, *not Yancey*. Pendergraft, *not Yancey*, directed Johnson on strategy and operations.

The evidence will demonstrate that there was an effective, reasonable, and clear delegation of supervisory responsibilities by Yancey to Pendergraft and that Pendergraft closely and actively supervised Johnson. This delegation is reflected in communications, documents, organizational charts, and supervisory matrices. Penson employees also understood that Johnson

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[66] *See* Exs. 515, 556, 665.

[67] *See* Exs. 502, 522, 649.

[68] *See* Exs. 517, 591.

[69] *See* Exs. 548, 557.

[70] *See* Exs. 688, 605.

[71] *See* Exs. 563, 638.

[72] *See* Exs. 526, 549, 711.

reported into PWI and was supervised by Pendergraft. Johnson himself testified that during the relevant period, he reported to Son and Pendergraft.

The record will also reflect that Yancey diligently monitored Pendergraft's supervision of Johnson. Yancey met with Pendergraft regularly to discuss Johnson's performance. Pendergraft also included Yancey on many of his communications with Johnson. Additionally, Yancey communicated with PWI executives about Johnson's performance through weekly calls, meetings, and email communications. Not once did Yancey receive any indication that Pendergraft's supervision of Johnson was deficient or unreasonable.

The evidence will show that supervisory responsibility for Johnson was delegated to Pendergraft, Pendergraft controlled Johnson's activities, and Yancey reasonably monitored Pendergraft's supervision of Johnson. Pendergraft's supervision of Johnson was reasonable, and Yancey had no reason to believe that his delegation of Johnson's supervision was in any way deficient or ineffective.

IV. The Evidence Will Not Support the Division's Theory That Bill Yancey Failed Reasonably to Supervise Michael Johnson and Thomas Delaney.

A. There is no evidence that Yancey was aware of "systemic" or "intentional" violations of Rule 204(a) involving long sales of loaned securities.

While neither scienter nor willfulness is an element of a failure to supervise charge, "scienter may be considered in evaluating the reasonableness of supervision."[73] The evidence will show—and the Division acknowledges—that Yancey had no scienter. Yancey had absolutely *no knowledge* of a "policy and practice of intentionally and consistently violating Rule 204(a) with respect to . . . long sales of loaned securities."

[73] *In the Matter of Angelica Aguilera*, SEC Administrative Proceeding File 3-14999, Initial Decision Release No. 501, 25 (July 31, 2013); *In the Matter of Clarence Z. Wurts*, 54 S.E.C. 1121, 1132 (Jan. 16, 2001).

First, the SEC does not allege or suggest that Yancey was aware of such any "systematic" and "intentional" Rule 204(a) violations. In fact, the Division repeatedly alleges that Yancey was *not aware* of such violations. The Division acknowledges that nobody ever raised this issue with Yancey.

Second, not only does the Division concede that Delaney, Penson's CCO, never raised this issue with Yancey, the Division repeatedly asserts that Delaney ***actively concealed*** this issue from Yancey:

- "Delaney also substantially assisted the intentional Rule 204(a) violations relating to long sales of loaned securities by attempting to conceal them from Yancey."[74]
- Delaney withheld "critical information about Rule 204T(a)/204(a) violations relating to long sales of loaned securities, along with his and [Mike Johnson's] misconduct, in other key interactions with Yancey."[75]
- Delaney "direct[ed] Yancey away from Stock Loan's Rule 204T(a)/204(a) compliance and repeatedly [withheld] the critical information about [Mike Johnson's] own misconduct from Yancey. . . ."[76]

Because there is no competent evidence that Yancey knew about the violations at issue, the Division is left positing that Yancey *should have known* about the Stock Loan department's "policy and practice of intentionally and consistently violating Rule 204(a) with respect to . . . long sales of loaned securities." But the evidence will demonstrate that Yancey's supervision of Delaney and Johnson was reasonable and consistent with regulatory requirements and that Yancey was presented with no red flags indicating intentional and systemic violations of Rule 204(a) involving long sales of loaned securities.

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[74] OIP at ¶ 60.

[75] OIP at ¶ 64.

[76] OIP at ¶ 68.

B. Yancey reasonably supervised Tom Delaney.

1. Yancey's supervision of Delaney was reasonable.

As discussed above, reasonableness is the standard established by the SEC for evaluating the adequacy of supervision by broker-dealers and registered principals. Whether supervision is reasonable depends on the particular circumstances of each case.[77] As the NASD has counseled, Rule 3010's "reasonably designed" standard "recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations," only that the system "be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business."[78] As Ms. Poppalardo explains, the "reasonableness" standard allows for the manner in which supervision is carried out to differ among broker-dealers and principals within a broker-dealer.[79]

The evidence will show that Yancey appropriately delegated responsibilities to his management team and direct reports, who he reasonably relied on for their subject matter expertise. Yancey met with his direct reports twice a week for both group and one-on-one meetings. These meetings kept Yancey abreast of the firm's important issues and fostered an open dialogue between members of the management team. The evidence will further show that Yancey was a champion of compliance, often greatly exceeding the minimum regulatory requirements.

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[77] *See In the Matter of Eric J. Brown et. al.*, Exchange Act Release No. 34-66469, 2012 WL 625874 (Feb. 28, 2012); *In the Matter of Theodore W. Urban*, SEC Administrative Proceeding File 3-13655, Initial Decision Release No. 402 (Sept. 8, 2010) (citing *Kevin Upton*, 52 S.E.C. 145, 153 (1995)).

[78] *See* NASD Notice To Members 99-45.

[79] *See* Poppalardo Report at 13-14.

The record will show that Yancey reasonably supervised his direct reports, including Delaney. Documents and testimony will reflect that Yancey was accessible, engaged, and fostered a culture of open communication and accountability. Yancey promoted an environment of compliance through his words and actions, including the allocation of resources. Yancey consistently communicated with Delaney regarding the results of internal testing and regulatory examinations, and he conducted additional meetings where the status of necessary remediation was discussed. Yancey prioritized the Compliance department. He allocated numerous resources over several years to enhance the Compliance function. With his support and encouragement, the Compliance staff grew by over 400% from 2007 to 2011. Yancey continuously provided Delaney with the requested resources to fortify the Firm's compliance program and department. Testimony from individuals in Penson's compliance department will confirm that Yancey was a good partner and an ally of compliance.

2. None of the "red flags" advanced by the Division would have alerted Yancey to "systemic" and "intentional" violations of Rule 204(a) for long sales of loaned securities.

The Division alleges that the following red flags should have alerted Yancey to a policy and practice of intentional violations regarding long sales of loaned securities: (1) results from the December 2009 audit; (2) Mike Johnson's absence from a meeting; (3) Penson's March 2010 CEO certification to FINRA; and (4) Penson's response to OCIE's Reg SHO exam in November 2010.[80] None of these purported "red flags" would have alerted Yancey that the Stock Loan department had "instituted a policy and practice of intentionally and consistently violating Rule 204(a) with respect to . . . long sales of loaned securities."

[80] *See* OIP at ¶¶ 74-83.

a. The December 2009 audit results were not a red flag regarding long sales of loaned securities.

i. The Division's characterization of the December audit results is misleading.

As part of Penson's 3012 testing regime, Eric Alaniz in Compliance tested Rule 204 processes in December 2009. The December audit revealed that Penson's Buy-Ins department was not consistently closing out by market open fails to deliver arising on the customer side of the business. The Division asserts that "the 99% violation rate for Buy Ins' Rule 204T/204(a) procedures uncovered by the December 2009 [Rule 3012] audit was a significant red flag to Yancey that Penson had systemic Rule 204 deficiencies and that Delaney, whom he supervised, might bear responsibility for those deficiencies."[81]

The Division's characterization of the audit results as reflecting a "99% violation rate" is remarkably misleading. The December audit was conducted over a 10-day period, November 16-20, 2009 and December 7-11, 2009.[82] Based on the average number of trades that Penson cleared on a daily basis, Penson would have cleared between 7 and 10 million trades during this two-week period. The audit results reflect that out of these ***7 to 10 million*** trades, approximately ***113*** total transactions resulted in fail to deliver positions that potentially necessitated a buy in.[83]

The December audit results do not reflect a failure to ever close out fails to deliver arising from customer long and short sales; rather, the audit results reflect a failure to close out fails to deliver resulting from customer transactions by *market open* on T+6. For customer short sales,

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[81] OIP at ¶ 74.

[82] *See* Ex. 70 at 2.

[83] *See* Ex. 70. The test was conducted by analyzing daily "Securities Lending query/reports" for T+4 fails and daily EXT816 reports for T+6 fails. Each day's fail to deliver positions were summed to arrive at a total possible fail to deliver number of 113.

Penson was 30 to 75 minutes late in closing out the fail to deliver position.[84] For customer long sales, Penson was 240 to 379 minutes late in closing out the fail to deliver position.[85] Thus, *all of* the tested transactions resulted in T+6 close outs, albeit not all before market open. While this data may show difficulties in strict compliance given the volume of trading activity, the data does not reflect a "systemic" or "intentional" failure.

ii. The Division acknowledges that the December audit did not reveal any deficiencies regarding long sales of loaned securities.

The actual audit, testimony, and the Division's own Order Instituting Proceedings ("OIP") indicate that the audit findings related to timely Rule 204(a) close-outs were limited to the Buy-Ins department and fails to deliver resulting from *customers*.[86] The allegations in this proceeding, however, involve only timely Rule 204(a) close-outs related to "long sales of loaned securities" performed by an entirely separate department—the Stock Loan department.[87] Penson's Buy-Ins department handled close out obligations arising from fails on long and short sales caused by Penson's customers. On the other hand, Penson's Stock Loan department handled close out obligations arising from "long sales of loaned securities." The Buy-Ins and Stock Loan departments were located on different floors, had different managers, and were staffed by different personnel.

As Mr. Paz explains, that the Buy-Ins department handled Rule 204(a) obligations arising from *customer fails* while the Stock Loan department handled Rule 204(a) obligations arising

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[84] *See* Ex. 70.

[85] *Id.*

[86] *See* Ex. 70; OIP at ¶ 30.

[87] *See* OIP at ¶ 3.

from "long sales of loaned securities" is not unusual.[88] The December 2009 Rule 204 3012 audit only tested Buy-Ins' Rule 204(a) obligations; it did not test Stock Loan's Rule 204(a) obligations. Thus, the results were confined to Buy-Ins' Rule 204(a) close-out procedures. The Division admits that close-outs of "long sales of loaned securities" is not evidenced in the audit.[89] On that basis alone, the audit is not a red flag.

Presumably to address this chasm, the Division alleges that there was a "direct nexus" between the Buy-Ins and Stock Loan Departments' Rule 204(a) procedures "such that a meaningful inquiry into the December 2009 audit results would have led directly to knowledge of the allegedly intentional Stock Loan violations."[90] But as Ms. Poppalardo explains, it is not reasonable to expect Yancey—nor any large clearing firm CEO—to be aware of the specific procedures or practices involved in complying with such an operational rule.[91] It is unreasonable to expect that Yancey would have had the detailed knowledge with which to make any such "meaningful inquiry." Thus, it would not be unreasonable for Yancey to accept the December audit report on its face and focus only on Buy-Ins' handling of customer close-outs since that is precisely what was tested.[92]

Yancey, however, *did* make a "meaningful inquiry," and he was assured by both Alaniz and Delaney that the Rule 204(a) close-out deficiencies were limited to the Buy-Ins department.

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[88] *See* Paz Report at 21.

[89] *See* OIP at ¶ 30.

[90] OIP at ¶ 74.

[91] *See* Poppalardo Report at 15.

[92] *See* Poppalardo Report at 17-18.

Yancey asked Delaney and Alaniz whether they needed to get Mike Johnson involved.[93] Both said no, there was no need to get Johnson involved. Moreover, Yancey was assured that personnel in the Buy-Ins department, with the assistance of Stock Loan personnel, were remediating and cooperating fully with corrective action. Therefore, this audit did not serve as a red flag to Yancey of Stock Loan's long sales of loaned security close-out issues.[94]

The evidence will show that Yancey's response to the December 2009 Rule 204 3012 audit was reasonable. If Delaney was aware that Stock Loan's long sales of loaned securities procedures were implicated by the 3012 testing and that such procedures or practices were deficient, it was his duty to escalate that knowledge to Yancey. That did not happen either because Delaney was either unaware or because, as the Division alleges, he actively concealed it from Yancey.[95] A CEO cannot operate effectively if he must continually second-guess factual data and information he is told by his direct reports.[96] Setting such a standard contradicts the long-accepted concept of delegation and sets a standard of diligence that would paralyze CEOs.

iii. The Division acknowledges that the deficiencies identified in the December audit were remediated.

The Division concedes that Penson remediated the issues identified in the December audit.[97] The audit report included detailed recommendations and responses for remediating the issues identified in the audit.[98] The Compliance department communicated the December audit

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[93] Rule 204(b) procedures were tested and deficiencies identified in the December 2009 audit, but the Division *does not advance any claims* relating to Rule 204(b) in its OIP.

[94] *See* Poppalardo Report at 16-18.

[95] *See* OIP at ¶¶ 35, 63, 64.

[96] *See* Poppalardo Report at 16.

[97] *See* OIP at ¶¶ 36, 64, 77.

[98] *See* Exs. 70, 577.

results, and the remediation plan, to Yancey at a January 28, 2010 meeting.[99] The Compliance department assured Yancey that the issues identified in the audit were the focus of prompt remediation.[100]

Consistent with a reasonably designed supervisory system, the Buy-Ins department's procedures related to fails caused by customer shorts were tested again in June 2010 (the "June audit") and spot checked in 2011. The results showed significant improvement.[101] The June audit tested a one-month period (May 2010) during which Penson cleared approximately 15-20 million trades.[102] Out of these millions of transactions, the June audit identified 24 required buy-ins that were submitted to the trade desk. Of these 24 transactions, 11 were not performed by market open.[103] The average length of delay for these 11 transactions was ***6.2 minutes*** after market open. In his 2011 spot check, Alaniz testified that he observed that market open close-outs were being met a hundred percent of the time.

The record reflects that Penson had controls in place to continually test and evaluate its supervisory systems and procedures. Pursuant to this system, Penson conducted routine 3012 audits. One of the audits, the December audit, uncovered an issue with the Buy-Ins department's ability to close out fails to deliver caused by Penson's customers. Yancey was assured by the Compliance department that the issue was being remediated and that it was limited to the Buy-Ins department. And, indeed, the issue was promptly remediated, retested, and spot checked.

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[99] *See* Exhibit 134 (email from Eric Alaniz to Bill Yancey, dated January 28, 2010, stating: "Currently the Compliance Department has tested, among other areas, SEC Rule 204 and the Transmittal of Funds. These two areas are now the focus of prompt remediation.").

[100] *Id.*

[101] *See* Ex. 85.

[102] *Id.*

[103] *Id.*

The Division itself concedes that the remediation efforts were swift, extensive, and successful.[104] For these reasons, the December audit results were not a "red flag" for Yancey with respect to the Stock Loan department's compliance with Rule 204 procedures for "long sales of loaned securities."

b. Johnson's absence from a March 2010 meeting was not a red flag.

The Division next asserts that Johnson's absence from a March 31, 2010 meeting at which the results from the December audit were discussed was "another fact that should have prompted vigorous follow up from Yancey."[105] This does not constitute a red flag. In fact, testimony indicates that Johnson did not "refuse to attend" the meeting, as the Division claims. Also, Yancey had already inquired in January as to whether Johnson needed to be involved, and Delaney told him that Johnson did *not* need to be involved. Having been assured by his CCO and others that Johnson's involvement was unnecessary, Johnson's absence from a single meeting would not have been a red flag to a reasonable CEO.[106] Moreover, the record indicates Johnson sent two Stock Loan officers in his place, as suggested by the meeting invitation. Lastly, the March 31, 2010 meeting invitation to Johnson was not even sent by Yancey.[107] Regardless, the absence of Johnson from the March 31, 2010 meeting would not have been a red flag to Yancey given the assurances he received from Alaniz and Delaney that Johnson was not critical to the remediation discussions and that the Rule 204(a) issues uncovered by the audit related only to Buy-Ins procedures.

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[104] *See* OIP at ¶ 36 (characterizing the remediation efforts as "extensive").

[105] OIP at ¶ 75.

[106] *See* Poppalardo Report at 17.

[107] *See* Ex. 674.

c. The Summary Report appended to the FINRA 3130 CEO Certification was not a red flag.

The Division next asserts that the absence of the December audit results in Penson's Rule 3130 Annual CEO Certification and Summary Report should have alerted Yancey to the "systemic" and "intentional" Rule 204(a) violations allegedly caused by Penson's Stock Loan department.[108] Per FINRA, the proper and necessary content of a 3130 report is "document[ation of] the member's processes for establishing, maintaining, reviewing, testing and modifying compliance policies that are reasonably designed to achieve compliance" with applicable SEC and SRO rules.[109] The report "should include the manner and frequency in which the processes are administered, as well as the identification of officers and supervisors who have responsibility for such administration."[110] The report "need not contain any conclusions produced as a result of following the processes set forth [in Rule 3130]."[111]

As Mr. Paz explains, the 3130 CEO Certification and Summary Report that Penson submitted to FINRA on March 31, 2010 is consistent with the requirements of the rule. The certification tracks the language recommended by FINRA and the report: (1) successfully identifies the officer responsible for the report (Tom Delaney); (2) identifies which department is responsible for the testing (internal compliance department); (3) identifies the amount of time spent executing the testing plan (1760 hours); (4) identifies additional testing (by AML consultants); (5) identifies factors considered for determining which areas would be tested; and

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[108] OIP at ¶¶ 76-80.

[109] FINRA Rule 3130, Supplemental Material 3130.10.

[110] *Id.*

[111] *Id.*

(6) states that the tests in some instances resulted in remedial measures.[112] There was no omission from the Summary Report that would have made a reasonable CEO of a large broker dealer aware of purported "systemic" and "intentional" violations of Rule 204(a) with respect to long sales of loaned securities.[113]

First, the Summary Report appended to the CEO Certification was just that—a ***summary report***. By definition, it would not have included all issues or the results from every 3012 audit that the Firm performed throughout the year. Second, the results of the December audit were discussed at the March 31, 2010 meeting.[114] As the Division concedes, Yancey was assured at this meeting that remediation measures were underway.[115] Trial testimony will demonstrate Yancey's operations managers, John Kenny (COO) and Brian Gover (Vice President of Operations), discussed at this meeting their Rule 204 remediation and compliance efforts. Third, the Summary Report was prepared by qualified compliance officers, including CCO Tom Delaney.[116] To the extent that Penson's WSPs required the Summary Report to include a review of "key compliance issues," it was Delaney's responsibility to assess whether any deficiency, or combination of deficiencies, identified by internal or external sources would have risen to the level of a "key compliance issue."[117] Delaney, as the CCO, had knowledge of all the exams and testing and had the expertise to assess the materiality of the findings. It is both reasonable and customary for the CEO of a broker-dealer to rely on the recommendations and conclusions of his

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[112] *See* Ex. 135.

[113] *See* Poppalardo Report at18; Paz Report at 22-23.

[114] *See* Exs. 674, 633, 133.

[115] *See* OIP at ¶ 64.

[116] *See* Ex. 135.

[117] *See* Poppalardo Report at 18.

or her Chief Compliance Officer.[118] Thus, Yancey, like most CEOs in the industry, reasonably relied on the report prepared by his CCO.[119]

Determining "key compliance issues" for inclusion in the Summary Report involves a great amount of judgment as to materiality and risk.[120] As discussed, the December 2009 Rule 204 audit revealed an extraordinarily small subset of customer fails that the Buy-Ins department failed to close out before market open via a buy in. The facts known to Yancey about the audit were that the compliance processes identified *delays* in effecting the buy-ins. Yancey knew that Penson's relevant business unit supervisors had agreed to a proposed action plan, and remediation was underway, including follow-up testing. Given the host of issues that came before Yancey on a daily basis, the issue of *delayed* buy-ins on a hyper-technical rule was likely (and reasonably) perceived to be a nuanced finding from an internal review that was currently being addressed.[121]

Further, Yancey understood all 3012 testing issues to be appropriately subsumed within the section of the Summary Report that states "deficiencies from internal and external audits are tracked and assigned to the appropriate business unit for remediation."[122] Indeed, the fact that Delaney did not highlight the Rule 204 issues in the Summary Report served to underscore to Yancey that this particular issue was being addressed and remediated, consistent with the messages and assurances he was receiving from others. Therefore, the lack of detail regarding

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[118] *See* Paz Report at 23; Poppalardo Report at 18.

[119] *Id.*

[120] *Id.*

[121] *Id.*

[122] Ex. 135.

the December audit in the Summary Report was not a red flag.

d. Penson's November 24, 2010 OCIE response was not a red flag.

The Division claims that Yancey was aware of another red flag regarding Delaney's misconduct -- alleged misrepresentations Penson made to OCIE in November 2010 that the Firm's Rule 204(a) processes were "reasonable," "effective," and "performed as designed."[123] This statement was not a red flag. Penson's OCIE response would not have alerted a reasonable CEO that individuals in the firm's Stock Loan department were systematically and intentionally violating Rule 204(a).[124]

First, it had been repeatedly communicated to Yancey that the issues identified in the December audit were the focus of prompt remediation efforts.[125] This fact was confirmed by the follow-up test conducted in June 2010.[126] Thus, Penson's testing procedures were, in fact, "effective and performed as designed," particularly given the highly technical nature of Rule 204(a). Second, the record reflects that Yancey was not involved in the drafting of the OCIE response. The response at issue was drafted by Brian Gover, Vice President of Operations responsible for overseeing the Buy-Ins department.[127] The draft was also reviewed and approved by the CCO, Delaney. Yancey was entitled to rely on the conclusions reached by these qualified individuals, especially when Yancey had independently confirmed that the issues identified in

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[123] OIP at ¶ 82.

[124] *See* Paz Report at 23-24; *See* Poppalardo Report at 18-19.

[125] *See supra* n.97, 99.

[126] *See* Ex. 610.

[127] *See* Ex. 86.

the December 3012 audit had been the focus of prompt remediation efforts.[128]

Finally, the Firm made no misrepresentations to OCIE. Penson had been in continuous conversations with OCIE beginning in 2008 through 2010 regarding these very issues. The Firm was both prompt and fulsome in its disclosures and communications with OCIE. In fact, in an April 22, 2010 letter to OCIE, Penson disclosed its prior difficulties with Rule 204(a) Buy-Ins department compliance and its corresponding remediation efforts.[129] Thus, there was no "overt misrepresentation" in the November 24, 2010 OCIE response, and certainly no red flag to Yancey regarding Stock Loan's intentional Rule 204(a) violations involving "long sales of loaned securities."

The testimony and documents will demonstrate that Yancey reasonably discharged his duties and obligations. Yancey reasonably supervised his direct reports, including Delaney, and properly delegated supervisory responsibility. Yancey and Delaney had a robust routine that included meeting at least twice a week. The purported red flags identified by the Division were not red flags, but rather alleged flags of omission, which are not red flags at all. Furthermore, the Division concedes that these omissions were *actively concealed* from Yancey.[130] For issues that rose to Yancey's attention, he responded reasonably and decisively. To find a failure to supervise in this case would suggest that CEOs cannot rely on business line supervisors and properly qualified licensed individuals, including supervisory delegates, to perform their duties. The Division suggests a standard in which CEOs must actively ferret out misdeeds despite their active concealment. Such a standard is wholly unreasonable and contravenes the purpose and

[128] *See* Paz Report at 23-24; Poppalardo Report at 18-19.

[129] *See* Ex. 600.

[130] *See* OIP at ¶ 8.

design of Rule 204.[131] Moreover, a finding of supervisory failures in this case would impose an insurmountable standard of diligence that no CEO could meet.

V. The Evidence Will Show That Penson had Established Procedures, and a System for Applying Such Procedures, to Prevent and Detect Violations and That Bill Yancey Reasonably Satisfied His Duties and Obligations Without Reasonable Cause to Believe That the Procedures and System Were Not Being Followed.

A. Penson had procedures and systems reasonably designed to prevent and detect violations.

As Ms. Poppalardo explains, a reasonably designed supervisory system consists of policies, procedures and controls that designate qualified supervisors and reasonably allocate responsibilities, assign registered representatives to appropriate supervisors, and identify areas of business in which the firm engages and the rules governing those activities.[132] In addition to reasonable policies and procedures, controls must be in place to test and evaluate a firm's systems and procedures to assess their effectiveness.[133] There is no definition or description of a "perfect" supervisory system, nor is that the standard. Just because a system could have been "more reasonably designed" does not mean that it is unreasonable as designed.[134] The reasonableness standard recognizes that "a supervisory system cannot guarantee firm-wide

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[131] *See* Paz Report at 4, 17-19, 24-25; Poppalardo Report at 4, 16.

[132] *See* Poppalardo Report at 5-6.

[133] NASD Rule 3012(a)(1), which became effective on January 31, 2005, specifically requires that firms identify one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the firm's supervisory procedures are reasonably designed to comply with applicable securities laws and NASD rules and amend those procedures when necessary. Related NASD Rule 3013 requires a firm's CEO to annually certify the adequacy of the firm's compliance and supervisory processes. The legacy NASD Supervision and Supervisory Control Rules will be codified in the FINRA Rulebook as FINRA Rules 3110, 3120 and 3130. The FINRA Rules have been approved by the SEC and will become effective on December 1, 2014.

[134] *See In the Matter of IFG Network Sec., Inc.*, Exchange Act Release No. 34-54127, 88 SEC Docket 1195, 2006 WL 1976001 (July 11, 2006) (the Commission rejected the Division's arguments that the broker-dealer President failed to exercise reasonable supervision, in part because a different system would have been "more reasonably designed" to prevent the violations).

compliance with all laws and regulations. However, this standard does require that the system be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a [firm's] business."[135]

During the relevant period Penson had systems and procedures reasonably designed to achieve compliance with applicable securities laws, rules, and regulations.[136] Business units were supervised by appropriately qualified individuals, reasonable written policies and procedures were in place, and specific areas were subject to regular testing to ensure that supervisory procedures were being carried out effectively and modified as regulatory and/or business changes dictated.[137]

1. Business units were supervised by qualified individuals.

Many of the responsibilities under Penson's supervisory system were properly delegated to the Compliance department, in particular, to the CCO Delaney, who reported directly to Yancey. The supervisory system documented by Delaney assigned qualified experts over each line of business and included written policies and procedures designed to prevent and detect violations of the securities laws and rules and regulations thereunder.[138]

Yancey had frequent, substantive discussions with those to whom he delegated supervisory responsibility. Yancey exercised diligent supervision over his direct reports and facilitated the free flow of information by meeting with each direct report twice a week—as a group and one-on-one. Yancey took input, offered guidance, and kept abreast of issues brought

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[135] NASD Notice to Members 99-45 (June 1999) (NASD Provides Guidance on Supervisory Responsibilities).

[136] *See* Poppalardo Report at 7-13.

[137] *Id.*

[138] *See* Poppalardo Report at 7-8.

to his attention. His direct reports will testify to his high standards, accessibility, and engagement. Yancey also met regularly with Pendergraft, who supervised Johnson, to follow-up on Stock Loan activities.

2. Penson's policies and procedures were reasonable.

Penson's policies and procedures during the relevant period were reasonably designed.[139] The WSPs were sufficient to put registered personnel on notice of regulatory requirements and Firm practices, they clearly vested supervisory responsibility in specific individuals, and they addressed an array of subjects consistent with what the SEC and FINRA would reasonably expect the WSPs to contain.[140]

The specific policies and procedures pertaining to Reg SHO and Rule 204 address all elements of the rule, including the responsibility to timely close out open fail-to-deliver positions.[141] The procedures identify responsible individuals and supervisors and set out the procedure to be followed and the documentation to be used.[142] The Stock Loan policies and procedures address aspects of Reg SHO that were handled by the Stock Loan Department, including the borrowing and lending of securities, the approval of short sale locates, and the obligation to issue recalls and buy-in positions.[143] In addition to the WSPs, the evidence will show that the Firm employed additional methods to ensure compliance with various elements of the Rule, such as embedding compliance features in automated systems and using checklists,

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[139] *See* Poppalardo Report at 9-10.

[140] *See, e.g.,* FINRA Supervisory Checklist, contained in FINRA Continuing Membership Guide, located at http://www.finra.org/industry/compliance/registration/memberapplicationprogram/cmguide/p009725.

[141] *See e.g.,* Exs. 540, 746.

[142] *Id.*

[143] *See* Ex. 746.

training, and orally-communicated protocols, such as guidance from senior staff and supervisors.[144]

3. Regular and robust testing ensured that the procedures were effective.

As Ms. Poppalardo details, Penson had a robust 3012 testing process.[145] Dedicated staff were responsible for testing throughout the year, areas tested were risk-based, and there was a system for tracking and following up on necessary remediation.[146] A significant amount of testing occurred each year and deficiencies identified in 3012 testing and regulatory examinations were tracked and assigned to the appropriate business unit for remediation. It was the Firm's practice during the relevant time period to conduct several tests each quarter across a variety of different areas that were the focus of new regulatory rules and priorities.[147] In addition to the 3012 testing program, PWI's Internal Audit program also conducted audits of Penson departments and reported those findings to PFSI and PWI management.[148]

In fact, in connection with the Rule 3130 CEO certification process, Yancey met *more frequently* than the annual basis that the Rule required to discuss issues identified in the 3012 testing process. The record demonstrates that Yancey met quarterly with Compliance staff to review 3012 testing and remediation plans and that Yancey was thorough, decisive, and engaged.[149]

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[144] *See, e.g.,* Exs. 519, 582. Penson maintained procedures for deficit determination and resolution that provide the specific steps in calculating the Firm's segregation requirements, which includes recall of bank and stock loan, issuance of buy-ins, attempts to borrow, etc.

[145] *See* Poppalardo Report at 12-13.

[146] *See* Exs. 543, 654, 738.

[147] *See, e.g.*, Ex. 722 (evidencing that in one year, Penson conducted testing in at least 14 different areas).

[148] *See e.g.*, Ex. 724.

[149] *See* Ex. 692.

B. Yancey reasonably discharged his duties and obligations without reasonable cause to believe the procedures and systems were not being complied with.

As discussed above, no red flags were raised to Yancey that would have given him reasonable cause to believe the reasonably-designed systems and procedures were not being complied with.[150] The purported red flags identified by the Division are not red flags, but rather the *absence* of red flags. Furthermore, the Division's OIP concedes that these omissions were actively concealed from Yancey.

Yancey exercised effective supervision over all of his direct reports, including Penson's CCO Tom Delaney, and followed up on the delegation of supervisory responsibilities. Yancey was an engaged and accessible CEO. Because of Penson's size and complexity, Yancey relied on the many qualified licensed individuals at Penson to employ good judgment, take decisive action, and escalate unresolved issues to his attention. Yancey and Delaney had a robust routine that included meeting at least twice a week. Yancey likewise followed-up on his supervisory delegations to Pendergraft on a regular basis. At no point during communications with Delaney or Pendergraft, did Yancey become aware of systematic and intentional Rule 204(a) compliance issues regarding Stock Loan and "long sales of loaned securities."

CONCLUSION

For the foregoing reasons, Yancey respectfully urges this Court to rule that: (1) Yancey did not fail to supervise Michael Johnson; (2) Yancey did not fail to supervise Thomas Delaney; and (3) dismiss this administrative proceeding.

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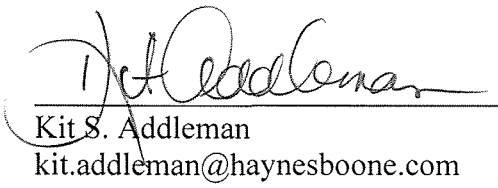
[150] *See supra* § IV(B)(2).

November 10, 2014

Respectfully Submitted,



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ATTORNEYS FOR RESPONDENT CHARLES W. YANCEY

Exhibit A

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15873

In the Matter of Thomas R. Delaney II and Charles W. Yancey Respondents

INDEPENDENT EXPERT WITNESS REPORT OF JUDITH POPPALARDO

I have been retained by Charles W. ("Bill") Yancey, former Chief Executive Officer ("CEO") of Penson Financial Services, Inc. ("PFSI" or the "Firm"), to review the PFSI supervisory system and state an opinion as to whether it was reasonably designed and whether Mr. Yancey appropriately and reasonably carried out his supervisory responsibility under that system. My opinion is based on almost 30 years of experience in the financial services industry with a focus on supervision and supervisory controls.

I. Background and Qualifications

In 2000, I launched the Financial Industry Service Group LLC ("Finseg") with Karen O'Brien, former General Counsel of the North American Securities Administrators Association ("NASAA"). Finseg is a regulatory consulting firm that specializes in helping firms maintain ongoing compliance with the federal securities laws and Self-Regulatory Organization ("SRO") rules through the development of policies, procedures, and supervisory controls tailored to the business of an organization. Specifically relevant to this matter, Finseg assisted several large firms in implementing the supervisory control rules adopted by NASD (now known as "FINRA") in 2004. Currently Finseg is assisting a large self-clearing firm in the assessment of its surveillance program, including methods used to monitor for compliance with Regulation SHO ("Reg SHO"). I have also previously testified as an expert on supervisory issues for an independent brokerage firm in an action before the California Unemployment Insurance Appeals Board regarding the status of a registered person as an independent contractor (versus an employee). I have also served as an expert on industry practices relating to anti-money laundering ("AML") for both FINRA and NYSE Regulation (prior to the merger of NYSE Regulation into FINRA) in disciplinary actions against member firms. Finseg, subject to agreement by SEC and FINRA staff, has conducted over 25 regulatory reviews pursuant to administrative orders and letters of Acceptance, Waiver and Consent. Importantly, Finseg has

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been engaged by three SROs, including FINRA, to review various aspects of the SROs' regulatory programs. The Audit Committee of another SRO, one of the primary exchanges, engaged Finseg to conduct a review in anticipation of regulatory action after experiencing technical problems in connection with an initial public offering. Finseg also conducts independent AML audits. All of these engagements involve a critical assessment of supervisory systems, including policies, procedures and controls, experience and level of staffing, and adequacy of training.

Prior to founding Finseg, I was Vice President and Associate General Counsel at the Securities Industry Association ("SIA") (now known as the Securities Industry and Financial Markets Association, or SIFMA). In this position, I worked on compliance issues with several SIA national committees: the Self-Regulation and Supervisory Practices Committee, the Trading Committee, and the Operations Committee, among others. Prior to joining SIA, I served ten years at the SEC in the Division of Market Regulation (now known as Trading and Markets) and the Office of Compliance Inspections and Examinations ("OCIE"), where I oversaw the Commission's broker-dealer examination program and inspections of the SROs. I also served as Assistant General Counsel at National Securities Clearing Corporation ("NSCC") where I was responsible for ensuring compliance with federal laws and regulations governing clearing corporation operations. A copy of my resume and summary of qualifications is attached as Exhibit B.

In these various positions, I have had firsthand responsibility for drafting, enforcing, and ensuring compliance with laws, regulations, and policies and procedures. Over the last 14 years, Finseg has been retained by a diverse group of firms with a wide variety of business models, including several SROs. I am therefore able to provide perspective on industry practices and to benchmark PFSI's practices and procedures against other firms in the industry.

II. Summary of Allegations

This case arises out of PFSI's alleged violations of Rule 204T(a)/Rule 204(a) of Reg SHO, 17 C.F.R. 242.204. The SEC's Division of Enforcement ("Division") alleges that PFSI violated Rule 204T(a)/204(a) by failing to timely close-out fails-to-deliver for "long sales of loaned securities." The Division alleges that Michael Johnson, a Penson Worldwide, Inc. ("PWI") Senior Vice President ("SVP") of Stock Lending,[1] and Tom Delaney, PFSI's Chief Compliance Officer ("CCO"), aided and abetted the purported violations. The Division further alleges that Bill Yancey, PFSI's former CEO, failed to supervise these individuals.

III. Materials Reviewed

A list of materials I reviewed in rendering this Report is contained within Exhibit A. Other materials I have reviewed in connection with rendering this Report include statutes, administrative decisions, commission opinions, federal court decisions, and other related

[1] The materials I reviewed in connection with this case refer to stock lending using a variety of terms, all of which are intended to refer to PFSI's securities lending activities. Accordingly, the terms "Stock Loan," "Securities Lending," and "Stock Lending" when used in this report reference PFSI's securities lending activities.

releases, articles, and speeches. I have also had personal discussions with Mr. Yancey regarding these topics.

IV. Summary of Opinions

Based on my review of the foregoing documents and materials, and my experience as a securities industry regulatory and compliance consultant and expert, former Assistant General Counsel for SIA and NSCC, and former SEC regulator, it is my opinion that PFSI had a **reasonably designed supervisory system** that included designation of appropriately qualified licensed individuals over business lines, reasonable policies and procedures, a deliberate and thorough system for regularly testing and revising those procedures as necessary, and an engaged, accessible CEO who reasonably discharged his duties and obligations. Specifically:

- The standard established by the SEC and FINRA for evaluating the adequacy of supervision by broker-dealers and registered principals is "reasonable." SEC guidance states that broker-dealers may choose to structure their supervisory and compliance systems in different ways. The manner in which supervision is carried out varies from one registered principal to another based on what each deems to be reasonable for the registered persons he/she supervises and the business they conduct. In my professional opinion, Mr. Yancey reasonably supervised his direct reports and properly delegated supervisory responsibilities.
- Supervisory delegations to appropriately qualified licensed individuals were clear and effective.
- PFSI's policies and procedures, including written supervisory procedures ("WSPs"), were reasonably designed and satisfied the Firm's regulatory responsibilities by notifying employees of rule requirements and assigning supervisory responsibility to qualified individuals.
- PFSI's procedures and compliance systems were reasonably designed to prevent and detect violations. PFSI had a robust testing process with dedicated staff responsible for conducting risk-based testing and a system for tracking and following up on necessary remediation. Those systems and procedures address the regulatory areas applicable to PFSI's business activities and are consistent with industry standards.
- Mr. Yancey reasonably discharged his duties and obligations. Mr. Yancey reasonably supervised his direct reports and properly delegated supervisory responsibility. The purported "red flags" identified by the Division were not, in fact, red flags. For issues that did rise to Mr. Yancey's attention, he responded reasonably.

The materials I reviewed evidence clear delegation of supervisory responsibilities at PFSI and effective supervision by Mr. Yancey over all of his direct reports, including PFSI CCO Tom Delaney, as well as over the delegation of supervisory responsibilities generally. Mr. Yancey fostered an environment of open communication among his direct reports and was an engaged and accessible CEO. Mr. Yancey and Mr. Delaney had a robust routine that included meeting at least twice a week. Because of PFSI's size and complexity, Mr. Yancey relied on the many

qualified licensed individuals at Penson to employ good judgment, take decisive action, and escalate unresolved issues to his attention. The purported red flags identified by the Division are not red flags, but rather the *absence* of red flags, or alleged flags of omission. Furthermore, the Division's Order Instituting Proceedings ("OIP") concedes that these omissions were actively concealed from Mr. Yancey. To find a failure to supervise in this case would suggest that CEOs cannot rely on business line supervisors and properly qualified licensed individuals and that CEOs must themselves ferret out misdeeds despite their active concealment. Such a standard contradicts the long-accepted concept of delegation. Moreover, such a finding would impose an insurmountable standard of diligence that no CEO could meet without being derelict in his day-to-day responsibilities as a steward of the firm.

The materials I reviewed demonstrate that Mr. Yancey was *not* the direct supervisor of the PWI SVP of Stock Lending, Michael Johnson, during the time period at issue. In my opinion, a finding that Mr. Yancey was Mr. Johnson's direct supervisor during this period is unsupported by the combined facts and circumstances. Not only was Mr. Johnson a PWI employee, rather than a PFSI employee, but the vast majority of the evidence and testimony confirms that supervisory responsibility over Mr. Johnson and the PFSI stock lending department was explicitly and fully delegated to principals in PWI, who closely supervised Mr. Johnson's activities from the Fall of 2008 through 2011. Although I believe it is unsupported by the facts and circumstances, if Mr. Yancey is found to have had supervisory responsibility for Mr. Johnson, he had both reasonably designed policies and procedures and an effective system for implementing those policies and procedures to supervise Mr. Johnson's activities. Further, based on the materials and testimony I reviewed, Mr. Yancey had no reason to believe those systems were not operating effectively.

V. Reasonably Designed Supervisory Systems and the Responsibilities of a CEO in the Financial Services Industry

Business practices within the financial services industry are so complex that no single individual can possibly know each task required to operate a business, let alone ensure every facet is operating in compliance with all applicable regulations. There are hundreds of applicable federal securities laws and regulations that span thousands of pages. Additionally, firms must comply with the rules of each market center in which they participate, state securities laws and regulations and, in most cases, with FINRA rules. Clearing firms must also comply with the rules of NSCC and the Depository Trust and Clearing Corporation ("DTCC"), the SROs responsible for clearing and settling the vast majority of trades in the United States. Regulators recognize the complexity of these businesses and the applicable rules and regulations. To assist regulated entities in complying with applicable laws and regulations, regulators have issued guidance on supervision and the elements of an effective supervisory system.[2]

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[2] FINRA imposes supervisory responsibilities on broker-dealers through NASD Conduct Rule 3010. Rule 3010 requires broker-dealers to: (a) establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities law and regulations, and with applicable NASD rules; (b) 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, and with applicable Rules of NASD; and (c) conduct a

None of these rules prescribe specific supervisory procedures to be followed by all firms, but they do set forth minimum requirements for a supervisory system that should enable a firm to properly supervise the activities of each associated person to ensure compliance with applicable securities laws, rules, and regulations.[3] There is no definition or description of a "perfect" supervisory system, nor is that the standard.[4] In fact, just because a system could have been "more reasonably designed" does not mean that it is unreasonable as designed.[5] **The standard is mere reasonableness.**

A *reasonably designed* supervisory system consists of policies, procedures, and controls that designate qualified supervisors and reasonably allocate responsibilities, assign registered representatives to appropriate supervisors, and identify areas of business in which the firm engages and the rules governing those activities. In addition to reasonable policies and procedures, controls must exist to test and evaluate a firm's systems and procedures to assess their effectiveness.[6] Specifically, a broker-dealer must develop a system for implementing its procedures that could reasonably be expected to prevent and detect securities law violations. In addition, a broker-dealer must have an appropriate system of follow-up.[7] Where testing uncovers deficiencies in process and controls, reasonable and prompt remediation should occur.

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review, at least annually, of the business in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities law and regulations, and with applicable NASD rules [including] the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses. NASD Conduct Rule 3010(a), (b), (c).

[3] *See* NASD Notice to Members 98-38 (May 1998) (NASD Reminds Members of Supervisory and Inspection Obligations).

[4] As SEC Commissioner Edward Fleishman stated: "The standard is reasonableness, with a range of reasonable responses, and the standard doesn't require perfection." ("Perspectives from the Commission Table: Supervision," Address to the 1989 Compliance and Legal Division Seminar of the SIA, April 5, 1989). NASD has also reiterated this reasonableness standard on a number of occasions. For example, in Notice to Members 99-45, NASD noted: "Because reasonableness is determined in light of the particular facts and circumstances surrounding a situation, it is difficult to articulate with any specificity a standard that would be applicable in all circumstances." NASD further noted in Notice to Members 98-96: "NASD . . . is not mandating any particular type or method of supervision . . . . Ultimately, an effective supervisory system may be comprised of many different elements, both objective—such as regular reviews of specific areas of activity—and subjective, including placing competent, qualified, and experienced individuals in supervisory roles."

[5] *See In the Matter of IFG Network Sec., Inc.*, Exchange Act Release No. 34-54127, 88 SEC Docket 1195, 2006 WL 1976001 (July 11, 2006) (the Commission rejected the Division's arguments that the broker-dealer President failed to exercise reasonable supervision, in part because a different system would have been "more reasonably designed" to prevent the violations).

[6] NASD Rule 3012(a)(1), which became effective on January 31, 2005, specifically requires that firms identify one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the firm's supervisory procedures are reasonably designed to comply with applicable securities laws and NASD rules and amend those procedures when necessary. Related NASD Rule 3013 requires a firm's CEO to annually certify the adequacy of the firm's compliance and supervisory processes. The legacy NASD Supervision and Supervisory Control Rules will be codified in the FINRA Rulebook as FINRA Rules 3110, 3120 and 3130. The FINRA Rules have been approved by the SEC and will become effective on December 1, 2014.

[7] *See W.J. Nolan & Co., et al.*, Exchange Act Release No. 34-44833 (September 24, 2001). *See also* SEC Staff Legal Bulletin No. 17: Remote Office Supervision, March 19, 2004.

Section 15(b)(4)(E) of the Securities and Exchange Act ("Exchange Act") authorizes the SEC to impose sanctions on an associated person who has failed *reasonably* to supervise, with a view to preventing violations of the federal securities statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. Implicit in Section 15(b)(4)(E) are the elements of a failure to supervise charge: an underlying violation, responsibility for supervision, and a failure by the supervisor to act reasonably.

The manner in which supervision is carried out differs among broker-dealers. The supervisory systems and procedures established by firms will vary based on what each firm deems to be reasonable for the business it conducts, the supervisors it employs, and its customer base.[8] A broker-dealer's compliance and supervisory policies and procedures are constructed based on what the broker-dealer's senior officers deem is necessary and appropriate to reasonably supervise the activities of their registered persons.

Particularly in large, complex organizations, supervisory responsibilities often cannot be determined or described by a single document or policy. In a settled proceeding, the SEC set forth the following principle: "Determining if a particular person is a 'supervisor' depends on whether, under the ***facts and circumstances*** of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue."[9]

In a financial services firm, supervision rests, initially, with the CEO, unless and until he reasonably delegates supervisory responsibility by assigning experienced, qualified individuals to supervise the business activities of the firm.[10] The roles and responsibilities of a CEO in a large, complex financial services firm are multi-faceted and demanding. A CEO provides leadership and ensures that the firm has the technology, resources, and processes to comply with all regulatory requirements, while at the same time is responsible for optimizing business performance and profitability. Thus, it is reasonable for a CEO to delegate certain responsibilities and to rely on his or her delegates. In fact, to effectively and efficiently perform the job, a CEO *must* delegate supervisory responsibilities. These supervisors are qualified licensed principals and are responsible for, among other things, developing and implementing policies and processes to ensure compliance with the rules applicable to their respective responsibilities. Thus, a CEO's direct supervisory responsibility is generally limited by the

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[8] *See* NASD Notice To Members 99-45 (noting that NASD Rule 3010's "reasonably designed" standard "recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations" but that the "reasonably designed" standard requires that the system "be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business").

[9] *In the Matter of John H. Gutfreund, et al.*, 51 S.E.C. 93, 113 (December 3, 1992) (emphasis added).

[10] *See Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995) ("The president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient.") (quoting *Universal Heritage Investments Corp.*, 47 S.E.C. 839, 845 (1982) (finding securities firm's president had properly delegated duties)). *See also John B. Busacca III*, Exchange Act Release No. 63312, at 16 (Nov. 12, 2010) (The President of a brokerage firm is responsible for the firm's compliance . . . "unless and until he or she delegates a particular function to another person in the firm, and neither knows nor has reason to know that such a person is not properly performing his or her duties.").

number of direct reports he has, although he may have overarching supervisory responsibility for thousands of employees.

Recognizing that a firm's CEO, as the ultimate supervisor, could be strictly liable for the misdeeds of all employees, Securities Exchange Act Section 15(b)(4)(E) provides a safe harbor under which no person can be liable for failure to supervise where: (1) there have been established procedures and systems which would reasonably be expected to prevent and detect violations and (2) the supervisor has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe such procedures and systems are not being complied with. Generally, a CEO can assure himself that the firm's policies and procedures are reasonably effective and operating as intended by meeting regularly with properly qualified and experienced supervisors who have been delegated supervisory responsibility, by reviewing the results of internal and external examinations, and, where necessary, confirming that prompt remediation has occurred for findings that have been identified.

VI. PFSI had a Reasonably Designed Supervisory System

I have reviewed PFSI's supervisory system, and it is my opinion that during the relevant period PFSI's system was reasonably designed to achieve compliance with applicable securities laws, rules, and regulations. As discussed below, business units were supervised by appropriately qualified individuals, reasonable written policies and procedures were in place, and specific areas were subject to regular testing to ensure that supervisory procedures were being carried out effectively and modified as regulatory and/or business changes dictated.

A. Supervisory Responsibilities Were Clearly Delegated to Appropriately Qualified Personnel

PFSI, an operating subsidiary of PWI, provided clearing services including trade execution, clearing and custody, trade settlement, technology and risk management services, customer account processing, customized data processing, and securities lending and borrowing. CEO Bill Yancey ensured that each of these areas of the Firm was properly supervised by a qualified supervisor. As a diversified firm in an increasingly complex regulatory environment, supervisory delegation was crucial.[11]

As soon as he was hired in 2005, Mr. Yancey began recruiting a number of qualified supervisors to augment the existing PFSI senior staff. Key hires included the Chief Administrative Officer, the Chief Operating Officer, the Chief Information/Technology Officer, and the Chief Compliance Officer. Mr. Yancey had frequent substantive discussions with staff to whom supervisory responsibility was delegated. He exercised diligent supervision over his direct reports and facilitated the free flow of information throughout the Firm by meeting with each direct report twice a week—as a group and one-on-one. Mr. Yancey took input, offered guidance, and kept abreast of issues brought to his attention. His direct reports testified to his high standards, accessibility, and engagement. Mr. Yancey also had a weekly call with PWI

[11] PFSI was the second-largest clearing firm with over 600 employees clearing millions of trades per day.

executives and met regularly with Phil Pendergraft, the principal at PWI to whom he and other senior executives reported.

In addition to selecting qualified supervisory personnel, Mr. Yancey also prioritized Compliance. Mr. Yancey and Mr. Delaney, the PFSI CCO, worked together to strengthen the Firm's Compliance department and program. Mr. Yancey allocated substantial resources over many years to enhance the compliance function. With his support and encouragement, from 2007 to 2011, the Compliance staff grew by over 400%. This growth was instrumental to PFSI's ability to implement policies and procedures to comply with the numerous changes in rules and regulations and respond to the regulatory examinations and inquiries that PFSI received during the time period in question.

Many of the responsibilities under the PFSI supervisory system were properly delegated to the Compliance department, in particular, to the CCO Delaney, who reported directly to Mr. Yancey. Specifically, PFSI's procedures assign the CCO responsibility for establishing and maintaining the PFSI supervisory system. The supervisory system documented by Mr. Delaney assigned qualified experts over each line of business and included written policies and procedures designed to prevent and detect violations of the securities laws and rules and regulations thereunder. If the CCO became aware that policies, procedures, or business practices were inconsistent with rule requirements or if he had any compliance concerns regarding the supervisory system, it was his responsibility to escalate those issues to the CEO and see that the policies, procedures, or systems were revised. Mr. Delaney met frequently with Mr. Yancey and had many opportunities to convey any compliance concerns to him. To the extent any compliance concerns were raised, Mr. Yancey acted reasonably and decisively to see that they were addressed.

I reviewed documentation that shows the delegation of supervisory responsibilities for various business activities was clear and documented in organizational charts, policies and procedures, and other communications. The documentation reflects the reporting lines of Mr. Yancey and other senior managers up to PWI principals Phil Pendergraft and Dan Son, as well as reporting lines into Mr. Yancey, the CEO of PFSI (*i.e.*, direct reports and their subordinates).

One indication of the supervisory hierarchy within a firm is the organizational charts. PFSI organizational charts show the CCO, Tom Delaney, and other of Mr. Yancey's PFSI senior managers reporting directly to Mr. Yancey. The Firm's policies and procedures also incorporate a Supervisory Matrix prepared by the Compliance department.[12] The Supervisory Matrix shows the CCO, Mr. Delaney, reporting directly to Mr. Yancey. Testimony and other communications further support that Mr. Yancey was the supervisor of Mr. Delaney.

The SVP of Securities Lending, Mike Johnson, initially reported to Mr. Yancey when he held the position of SVP of Equity Finance at PFSI. In August 2008, Mr. Johnson was promoted to SVP of the Global Securities Lending Group in PWI and became a PWI employee. In conjunction with this change, Mr. Yancey delegated complete supervisory responsibility for Mr. Johnson to Mr. Pendergraft. The January 2009 organizational charts clearly reflect this change

[12] It appears to me that the Supervisory Matrix was drafted in an attempt to comply with NASD Conduct Rule 3010. Paragraph (a)(5) of the Rule requires that each registered person be assigned to at least one supervisor.

in Mr. Johnson's reporting structure. When Mr. Johnson became a PWI employee, both he and Mr. Yancey reported up to the three principals of PWI, Phil Pendergraft, Dan Son, and Roger Engemoen.

It was widely known that Mr. Engemoen was not active in the day-to-day operations of PWI, and that Mr. Pendergraft and Mr. Son, the founders of Penson, were jointly responsible for PWI management. Both principals, who jointly ran PWI, held appropriate principal licenses for supervising stock loan activity, which is primarily a financial and operational function.[13] Nevertheless, the documents, facts, and circumstances show that, while Mr. Son remained peripherally involved, Mr. Pendergraft, who was a licensed supervisor with PFSI and a principal in PWI, was Mr. Johnson's active supervisor.

The Supervisory Matrix in PFSI's policies and procedures, which was prepared by the Compliance department, supports this position. The matrix indicates that Mr. Johnson reported to Phil Pendergraft. Bill Yancey is listed as a regulatory supervisor. In my opinion, the Supervisory Matrix reflects the transition of Securities Lending to a global operation at the PWI level, with substantive supervision of Mr. Johnson delegated to Mr. Pendergraft. It also reflects Mr. Yancey's overarching responsibility for all PFSI activities, as PFSI CEO. Notably, Mr. Pendergraft maintained his principal license with PFSI through 2011, which would have been unnecessary unless he was supervising a regulated PFSI activity or regulated person, like Mr. Johnson's PFSI-related functions.

Perhaps the best indication of the supervisory role of Mr. Pendergraft is email communications over a three-year period showing Mr. Pendergraft's constant and close supervision of Mr. Johnson's Securities Lending activities. In my opinion, both the organizational charts and the Supervisory Matrix reflect Mr. Yancey's delegation of Mr. Johnson's supervision to Mr. Pendergraft, a PWI supervisor and registered supervisory principal at PFSI. I further believe this to be confirmed by various other documents and testimony.

The material I reviewed demonstrates Mr. Yancey appropriately delegated supervisory responsibility to subject matter experts of the business lines of this very large, diverse company, and effectively exercised his overarching supervisory responsibilities by communicating regularly with those to whom supervisory responsibility was delegated.

B. PFSI had Reasonable Policies and Procedures

Written Supervisory Procedures, or "WSPs," are an important part of a firm's overall supervisory system and serve to document the firm's supervisory systems and procedures. A firm's supervisory procedures must be in writing, tailored to the firm's business, and *reasonably designed* to achieve compliance with applicable securities laws, rules, and regulations. The reasonableness standard recognizes that "a supervisory system cannot guarantee firm-wide compliance with all laws and regulations. However, this standard does require that the system be

[13] Phil Pendergraft held a General Securities Principal license (Series 24) and a Financial and Operations Principal license (Series 27). Daniel Son also held a Financial and Operations Principal license (Series 27). See FINRA BrokerCheck Reports for Philip Allen Pendergraft and Daniel Paul Son. Both are principal licenses, although the Series 27 is focused on maintenance of books and records, financial responsibility, and other activities commonly known as back office operations.

a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a [firm's] business."[14]

I have reviewed the relevant PFSI policies and procedures in place during the relevant period and conclude that they are reasonably designed. PFSI's WSPs generally state rule requirements or prohibitions (citing to the relevant regulation in most cases), the designated principal(s) (by title) who is responsible for supervising the activity, and how the supervisor documents his or her review of the activity. The policies and procedures are sufficient to put registered personnel on notice of regulatory requirements and Firm practices, and they clearly vest supervisory responsibility in specific individuals as required by NASD Conduct Rule 3010.

PFSI WSPs address an array of subjects. The scope of the areas addressed in these documents is consistent with similar documents prepared by other broker-dealers and, in my opinion, also consistent with what the SEC and FINRA would reasonably expect the WSPs to contain. The policies and procedures address training requirements, *i.e.*, annual Compliance meeting and Firm Element training, hiring, on-boarding of correspondents, and other important elements of a supervisory system. Notably, PFSI had separate procedures that governed the activities and responsibilities of Compliance department personnel. This is not a regulatory requirement, but a *best practice* that Finseg typically recommends when assisting firms in developing policies and procedures.

The role of the PFSI Compliance department is to advise business units on how to comply with applicable laws and regulations, to monitor business activity and employee conduct, to identify violations (or potential violations) of rules, regulations, policies, procedures and industry standards, and to recommend remediation when issues are discovered. PFSI Compliance does this through an organizational structure that assigns dedicated staff to AML, Operations, and Regulatory matters. This is a reasonable and effective model that I have observed at other firms. The Compliance department plays an integral support function for Firm compliance efforts.[15] Senior management and business line supervisors are also responsible for ensuring Firm compliance with laws and regulations.

PFSI WSPs were prepared by business unit leaders in conjunction with Compliance personnel in order to ensure compliance with applicable regulatory requirements. While the Compliance department may assist in *developing* policies and procedures, designated supervisors in the business lines are responsible for *establishing and enforcing* policies and procedures in their respective business lines. Consistent with the practices at most registered broker-dealers, the PFSI WSPs state that the Compliance department, headed by the CCO Delaney, is responsible for the issuance and dissemination of all policies, procedures and directives in place to govern the conduct of this firm and its registered employees. Additionally, the Compliance department updates the Written Supervisory Procedures on a regular basis and publishes them to the Penson Pi (Penson Intranet) Website.

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[14] NASD Notice to Members 99-45 (June 1999) (NASD Provides Guidance on Supervisory Responsibilities).

[15] Roles and responsibilities of Compliance department personnel include, among other things, updating policies and procedures, coordinating inter-departmental responses to regulatory inquiries, and developing and tracking training.

The specific policies and procedures at issue in this matter, Regulation SHO-Supervisory Structure and Stock Loan Procedures, apply to highly technical rules that were changing on a near-daily basis to address issues relating to the financial crisis in 2008. These two sets of policies apply to different departments within PFSI. The Regulation SHO-Supervisory Structure procedures address all elements of the rule, including the responsibility to timely close-out open fail-to-deliver positions. The procedures identify responsible individuals and supervisors and generally set out the procedure to be followed and the documentation to be used. The Stock Loan policies and procedures address related aspects of Reg SHO that were handled by the Stock Loan department, specifically the borrowing and lending of securities and approval of short sale locates. The obligation to issue recalls and buy in positions is also addressed.

I find these policies to be reasonably designed as required by NASD Rule 3010. Compliance policies need not include with detailed specificity how a firm will comply with every element of the requirements. In fact, to do so in an organization as large as PFSI may turn the WSPS from what is intended to be a frequently-referenced and practical document into an unwieldy and neglected one. Thus, firms may reasonably use a variety of methods to ensure compliance with various elements of the rules, such as embedding compliance features in automated systems and using checklists, training, and unwritten protocols, such as guidance from senior staff and supervisors. Such controls and practices are not always reflected in the WSPs and other compliance policies, but the identification of a designated principal who is responsible for supervising the activity serves to ensure accountability.

As a general matter, when assisting firms in developing policies and procedures, Finseg typically advises against compliance policies that are overly detailed because they can become quickly outdated and result in inaccurate information, or they can contain information that is irrelevant. In fact, in my experience, many firms employ their policies and procedures as a resource tool and caution that employees should not place total reliance upon them because it is impossible, based upon the extensive number of applicable securities laws and regulations, for policies and procedures to set forth all possible scenarios related to the Firm's business activities at any given time. Where detailed directions for specific job functions are required, it is a reasonable and common practice for firms to develop checklists or desk procedures to supplement the compliance policies, and to also rely on longstanding, unwritten practices, especially for complex, technical rules.

In hindsight, particularly where there are alleged violations, it may be tempting to speculate about specific tools that could have been reflected in the compliance policies, or practices that may have been documented to provide *better* guidance to staff on how to achieve compliance with particular rules, but that does not make the existing policies deficient or unreasonable. The Division itself could not find an affirmative misstatement in the Firm's policies and procedures but stated, in discussing the Securities Lending procedures:

> The first part *correctly articulated* the regulatory requirement that CNS failures to deliver resulting from long sales had to be closed out by market open T+6. But the subsequent part contained no discussion of any procedures Penson had adopted in accordance with that Rule 204(a) requirement. Instead, the section detailed Stock Loan's procedures for maintaining an easy-to-borrow list and providing locates—procedures that were relevant to Penson's compliance with

Rule 203, not Rule 204. The second part finished with a brief description of procedures designed to ensure close-outs of CNS failures to deliver resulting from short sales by T+4.[16]

I have reviewed Reg SHO compliance policies and procedures at other firms, both during the relevant time period and afterwards. I observed that many firms labored to document and implement the continually-evolving new rules. Rule 204 was particularly challenging for firms, like PFSI, that employed automated processes that had to be programmed and tested practically overnight. I believe PFSI's policies and procedures in this area reasonably notified employees of the elements of the Rule and directed the supervisory personnel who had obligations to enforce compliance.

C. PFSI had a Robust Testing Process

FINRA rules require that firms establish, maintain, and enforce supervisory control systems and procedures through an annual testing and verification process. In addition, a CEO must certify annually that the firm has in place written supervisory procedures that are reasonably designed to achieve compliance with applicable rules and laws and processes to review, test, and modify written compliance procedures as necessary.[17] As required by FINRA rules, PFSI had a reasonable process in place to test the effectiveness of policies and procedures on a periodic basis in order to ensure continuing compliance with federal securities laws and regulations.

The testimony and written materials I reviewed demonstrate that PFSI had a robust 3012 testing process. PFSI had dedicated staff responsible for testing throughout the year, areas tested were risk-based, and there was a system for tracking and following up on necessary remediation. Specifically, PFSI maintained a spreadsheet that listed areas for testing and risk-ranked them high, moderate, or low. A significant amount of testing occurred each year and deficiencies identified in both 3012 testing and regulatory examinations were tracked and assigned to the appropriate business unit for remediation. It was the Firm's practice during the time period at issue to conduct several tests each quarter over a variety of different areas. In my opinion, the areas of testing reflected careful attention to new regulatory rules and priorities. In addition to the 3012 testing program, PWI's Internal Audit program also conducted audits of PFSI departments and reported those findings to PFSI and PWI management.

A CEO in the securities industry acts reasonably by ensuring that there are effective policies and procedures in place, that those policies are being continually tested, and that they are being revised as necessary. I saw evidence of regular follow-up on remediation plans and reporting to the CEO, Mr. Yancey, on the testing and status of remediation. In fact, the Rule 3130 CEO certification process requires the CEO to meet annually with the CCO to discuss issues identified in the 3012 process. Mr. Yancey met with his CCO *four times a year*. Email communications and testimony that I reviewed indicate that Mr. Yancey met quarterly with Compliance staff to review 3012 testing and remediation plans. In advance of the CEO

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[16] SEC's Order Instituting Administrative and Cease-and-Desist Proceedings (hereinafter, "OIP") ¶ 41 (emphasis added).

[17] *See* NASD Rule 3012 and FINRA Rule 3130.

certification meetings, Compliance staff responsible for the 3012 testing forwarded the following materials to Mr. Yancey: (1) a summary report explaining the overall testing program; (2) a 3012 testing log reflecting the business activities tested during the cycle; and (3) a remediation tracking logs showing items to be remediated and the current status of the remediation.

One 3012 test pertinent to this proceeding was the December 2009 Rule 204 audit. Buy-Ins department deficiencies revealed by the testing and the remediation efforts were discussed at meetings with Mr. Yancey held in January and March of 2010. In fact, in his testimony, Mr. Alaniz highlights the level of attention Mr. Yancey accorded the 3012 testing and remediation efforts:

> We had found that Bill Yancey had asked us questions that we could not answer that were more directed to the business owners. So this year . . .we found it would be more beneficial for Bill Yancey to have these individuals to ask them directly.

It is also apparent that the Compliance department tracked remediation efforts through completion. In connection with the 2009 Rule 204 test, Compliance conducted follow-up testing in June 2010 to confirm the progress of remediation efforts. When testing revealed reduced but continued delays in the buy-in process, the Buy-Ins department increased their efforts to ensure compliance. Individuals were also required to certify when remediation was complete.

Mr. Yancey's quarterly meetings further demonstrate the reasonableness of the Firm's 3012 process. In these meetings, he sought input from Compliance staff and subject matter experts. In my opinion, the cumulative nature of the activities discussed above confirms that PFSI had robust 3012 testing processes in place and that Mr. Yancey was an engaged CEO who acted reasonably by participating in these efforts, which are an integral part of the overall supervisory system.

VII. CEO Bill Yancey Effectively Discharged His Duties and Responsibilities Without Reasonable Cause to Believe the Systems and Procedures Were Not Being Complied With

A. Bill Yancey Reasonably Supervised the CCO, Tom Delaney

As noted above, both the SEC and NASD/FINRA have established the standard for evaluating the adequacy of supervision as "*reasonable*." Section 15(b) of the Exchange Act provides that the SEC can take action against someone who has failed *reasonably* to supervise. NASD Conduct Rule 3010 similarly requires broker-dealers to establish supervisory systems that are "*reasonably* designed to achieve compliance with applicable securities laws and regulations." And as noted by former SEC Commissioner Edward Fleishman: "The standard is reasonableness, with a range of reasonable responses, and the standard doesn't require perfection."[18]

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[18] "Perspectives from the Commission Table: Supervision," Address to the 1989 Compliance and Legal Division Seminar of the SIA, April 5, 1989. *See also In the Matter of IFG Network Sec., Inc.*, Exchange Act Release No. 34-54127, at 18, 88 SEC Docket 1195, 2006 WL 1976001 (July 11, 2006) (the Commission rejected the Division's

Reasonable supervision is a standard that is determined based on the particular circumstances of each case.[19] There are minimum steps a registered principal should take to fulfill his supervisory obligations, yet a registered principal must employ judgment and experience in order to reach a decision that he believes is most appropriate under the particular circumstances.

SEC guidance states that broker-dealers may choose to structure their supervisory and compliance systems in different ways.[20] Just as supervisory systems and procedures may vary among broker-dealers, the manner in which individual registered principals carry out their supervisory responsibilities will differ. This is true even when registered principals are associated with the same broker-dealer. The reasons are obvious: the experience of the registered principals is different, the knowledge and experience of the registered persons they supervise is different, the types of business conducted by those registered persons is different, and the types of customers those registered persons deal with are different. Thus, liability for failure to supervise is a facts and circumstances determination.[21]

A CEO generally exercises reasonable supervision by ensuring the free flow of information throughout the organization and setting expectations that business line supervisors will, among other things, identify the relevancy and potential impact of new or revised regulations and take necessary action to establish, and enforce compliance with, appropriate policies and procedures. A CEO reasonably supervises when he creates and cultivates a corporate culture that empowers supervisors to take action to solve problems but also fosters escalation of complex issues, particularly complex compliance issues. If red flags come to the CEO's attention, he should address them promptly and hold supervisors accountable for appropriately assessing and effectively managing the risks associated with their activities.

In my opinion, Mr. Yancey met each of these standards and reasonably supervised his direct reports, including the CCO, Tom Delaney. Documents and testimony show that Mr. Yancey was accessible and engaged, fostered a culture of open communication and accountability, and promoted an environment of compliance through his words and actions, including the allocation of resources. As detailed above, Mr. Yancey met regularly with his direct reports, including Tom Delaney. Mr. Yancey discussed with Mr. Delaney the results of internal testing and regulatory examinations and conducted additional meetings where the status of necessary remediation was discussed. Mr. Yancey continuously provided Mr. Delaney with the requested resources to fortify the Firm's Compliance program and department.

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arguments that the broker-dealer President failed to exercise reasonable supervision, in part because a different system would have been "more reasonably designed" to prevent the violations).

[19] *See In the Matter of Eric J. Brown et. al.*, Exchange Act Release No. 34-66469, 2012 WL 625874 (Feb. 28, 2012); *In the Matter of Theodore W. Urban*, SEC Administrative Proceeding File 3-13655, Initial Decision Release No. 402 (ALJ September 8, 2010) (citing *Kevin Upton*, 52 S.E.C. 145, 153 (1995)).

[20] SEC Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Section 15(b)(4) and 15(b)(6) of the Exchange Act, http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm#6.

[21] *Eric J. Brown, et. al.*, Exchange Act Release No. 34-66469, 2012 WL 625874, at *11 (Feb. 28, 2012) (noting that The standard for supervision is whether a person exercises "reasonable supervision under the attendant circumstances"); *Urban*, Exchange Act Release No. 402, at 52.

The Division alleges that Mr. Yancey failed to fulfill his supervisory obligations by failing to follow up on red flags of Mr. Delaney's misconduct relating to his alleged aiding and abetting PFSI's violations of Rule 204T(a)/204(a). I disagree with the Division's characterization of any of the incidents discussed below as red flags.

(i) The 2009 3012 Rule 204 Audit was Not a Red Flag Regarding Stock Loan's Procedures Involving Long Sales of Loaned Securities

As part of PFSI's 3012 testing regime, Eric Alaniz in PFSI Compliance tested Rule 204 processes in December 2009. The actual audit, testimony, and the Division's own OIP indicate that the findings related to timely Rule 204(a) close-outs were limited to the **Buy-Ins department** and fails to deliver resulting from the customer side of the business.[22] The allegations in this proceeding, however, involve only timely Rule 204(a) close-outs related to "long sales of loaned securities" performed by the **Stock Loan department.**[23] Based on my review of the audit and testimony, the two departments had separate and distinct responsibilities relating to fails to deliver, and close-outs arising from "long sales of loaned securities" are not evidenced in the audit. On that basis alone, I find that the audit cannot, by definition, be a red flag.

The Division alleges that there was a "direct nexus" between the Buy-Ins and Stock Loan departments' Rule 204T(a)/204(a) procedures "such that a meaningful inquiry into the December 2009 audit results would have led directly to knowledge of the intentional Stock Loan violations."[24] I do not agree.

First, I would not reasonably expect Mr. Yancey—the CEO of the second-largest clearing firm in the country—to be aware of all the Firm-specific policies and procedures or practices involved in complying with such a hyper-technical rule, much less know that the Stock Loan department had its own set of Rule 204(a) procedures, different from the Buy-Ins department. Thus, it is not reasonable to expect Mr. Yancey to have had the detailed knowledge with which to make any such "meaningful inquiry." Only lower-level Compliance and Operations personnel, who are likely more familiar with the granular policies and procedures, would know of any separate Stock Lending procedures or practices and whether such procedures could contribute to alleged Rule 204(a) deficiencies. Furthermore, it is not the duty of a CEO to conduct "a meaningful inquiry" into the results of an audit or to duplicate the efforts of his CCO or his CCO's Compliance team.[25] Thus, it would not be unreasonable for Mr. Yancey to take the 2009 Rule 204 audit on its face and focus solely on the findings related to Buy-Ins and customer close-outs since that is precisely what was tested.

Second, the testimony indicates Mr. Yancey *did* make a meaningful inquiry and was assured by both Mr. Alaniz and Mr. Delaney that the deficiencies in the audit were limited to the

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[22] OIP ¶ 30.

[23] OIP ¶ 3.

[24] OIP ¶ 74.

[25] *In the Matter of Huff*, 50 S.E.C. 524, March 28, 1991 (finding that although a more thorough investigation might have revealed the misconduct at issue, all that is required is *reasonable* supervision under the circumstances).

Buy-Ins department 204(a) close-out processes. Mr. Alaniz and Mr. Delaney testified that they had a quarterly 3012 meeting with Mr. Yancey on January 28, 2010 to discuss the 2009 Rule 204 audit, among other 3012 audits. Mr. Alaniz and Mr. Delaney testified that after reviewing the audit Mr. Yancey did indeed ask whether any Stock Loan managers were needed to discuss and resolve the findings. Both Mr. Alaniz and Mr. Delaney assured Mr. Yancey the issues were not Stock Loan issues, but a Buy-In issue. Moreover, Mr. Yancey was assured that personnel in the Buy Ins group, with the assistance of Stock Loan personnel, were remediating and cooperating fully with corrective action. Therefore, there can be no reasonable expectation that this audit served as a red flag to Mr. Yancey of Stock Loan's purported issues closing-out "long sales of loaned securities."

Mr. Yancey's response to the December 2009 Rule 204 3012 test was reasonable. If Mr. Delaney was aware that Stock Loan's "long sales of loaned securities" procedures were implicated by the 3012 testing, and that such procedures or practices were deficient, it was his duty to escalate that knowledge to Mr. Yancey. That did not happen, either because Mr. Delaney was also not aware or because, as the Division alleges, Mr. Delaney actively concealed it. At best, this Rule 204 audit was a "flag of omission," which is no flag at all. In fact, the Commission has held that "[a] firm's President is not automatically at fault when other individuals in the firm engage in misconduct of which he has no reason to be aware."[26] A CEO cannot operate effectively if he must continually second-guess factual data and information he is told by his direct reports. In fact, to find a failure to supervise based on this flag of omission would suggest that CEOs cannot rely on business line supervisors and must themselves ferret out misdeeds, despite assurances to the contrary. Setting such a standard contradicts the long-accepted concept of delegation and sets a standard of diligence that would paralyze CEOs.

(ii) Purported "Omissions" in the 3012 Summary Report and 3130 CEO Certification Submitted in 2010 were Not Red Flags

The Division alleges that Delaney's March 31, 2010 3012 Summary Report appended to Mr. Yancey's CEO certification omitted two critical facts relating to PFSI's Rule 204 compliance: (1) the results of the December 2009 Rule 3012 audit revealing Buy-In's Rule 204T(a)/204(a) compliance failures; and (2) the ongoing, willful Rule 204(a) violations relating to long sales of loaned securities by Stock Lending.[27] The Division further claims Mr. Yancey "failed to ensure that the report discussed Penson's 'key compliance issues'" as required by the Firm's WSPs.[28] I find that there was no omission in the 3012 Report issued in 2010, nor any other "red flags" that would have warranted follow-up by Mr. Yancey.

Mr. Yancey became aware of the Firm's issues with Buy-Ins department procedures at the January 28, 2010 quarterly 3012 meeting. As detailed above, that audit did not include any findings of "violations relating to long sales of loaned securities by Stock Lending."[29] Thus, Mr.

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[26] *In the Matter of Smartwood Hesse, Inc.*, Exchange Act Release No. 34-31212, SEC Docket 1557, 1992 WL 252184, at *6 (September 22, 1992).

[27] OIP ¶ 44

[28] OIP ¶ 79.

[29] OIP ¶ 44.

Yancey could not have even known about purported "ongoing, willful" violations, let alone recognize their alleged omission from the Summary Report. Further, the test indicated that buy-ins of customer fails executed by the Buy-In department were *delayed*, not that certain buy-ins were not happening at all. At the January 28, 2010 meeting, Mr. Alaniz, the Compliance officer responsible for the testing, assured Mr. Yancey that the issues identified in the audit were the focus of prompt remediation.

At another meeting on March 31, 2010, the same day he executed the Rule 3130 CEO certification, Mr. Yancey was again assured that remediation was underway. In fact, the Division alleges:

> The meeting focused primarily on Penson's Rule 204T(a)/204(a) deficiencies in Buy Ins, but Delaney did not inform Yancey of the closely-related Rule 204T(a)/204(a) violations relating to Stock Loan and long sales of loaned securities" and "[i]nstead, Delaney focused solely on remediation efforts relating to Buy Ins.[30]

Again, it is unclear how Mr. Yancey would have become aware of non-compliant Stock Loan procedures or practices that were allegedly *deliberately concealed* from him or how he would know that ". . . Delaney, whom he supervised, might bear responsibility for those deficiencies."[31] Given these facts, I do not believe that the purported omission of "the ongoing, willful Rule 204(a) violations relating to long sales of loaned securities by Stock Lending" was a red flag to Mr. Yancey.

The Division also states that Mr. Johnson's conspicuous absence from the March 31, 2010 meeting regarding the December 2009 audit was another fact that should have prompted vigorous follow-up from Mr. Yancey.[32] This does not constitute a red flag. In fact, testimony indicates that Mr. Johnson did not "refuse to attend" the meeting. Rather, the meeting invitation was declined because it was during business hours when Stock Loan personnel are largely occupied performing their job functions. Moreover, other testimony indicates Mr. Johnson sent two Stock Loan officers in his place, as suggested by the meeting invitation. Regardless, the absence of Mr. Johnson from the March 31, 2010 meeting would not have been a red flag to Mr. Yancey given the assurances he received from Mr. Alaniz and Mr. Delaney that Mr. Johnson was not critical to the remediation discussions and that the issues uncovered by the audit related only to Buy-Ins' Rule 204(a) procedures.

What Mr. Yancey *did* know was that there was a process in place to detect the Buy-Ins department's Rule 204(a) deficiencies. Part of that process involved assigning remediation to specific individuals in the appropriate business lines. As of March 31, 2010, Mr. Yancey was aware of audit findings regarding time delays for buy-ins, that an action plan was formulated, that relevant staff had agreed with the findings, and that remediation was underway by technical experts to be completed by July 2010. This is a reasonable process for responding to 3012 audit

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[30] OIP ¶ 64.

[31] OIP ¶ 74.

[32] OIP ¶ 75.

deficiency findings and, in my opinion and experience, an industry practice relied upon by most CEOs.

I do not believe there was an omission in the 3012 Summary Report regarding the results of the December 2009 Rule 3012 audit or that Mr. Yancey falsely certified the CEO certification. It is the responsibility of the CCO to assess whether any deficiency, or combination of deficiencies, identified by internal or external sources would have been important enough to merit the attention of the CEO. Mr. Delaney, as the CCO, had knowledge of all the exams and testing and the expertise to assess the materiality of the findings and, in fact, was responsible for compiling the report. Mr. Yancey, like most CEOs in the industry, relied on the report prepared by his CCO, and I believe his reliance was reasonable.

Determining "key compliance issues" for inclusion in the 3012 Summary Report involves judgment as to materiality and risk. Given the host of issues that came before Mr. Yancey on a daily basis, the issue of *delayed* buy-ins on a hyper-technical rule was likely (and reasonably) perceived to be a nuanced finding from an internal review that was currently being addressed. As noted above, it appears that all deficiencies identified in internal and external audits are tracked by the Compliance department. The 3012 process would quickly become unwieldy if firms included all regulatory and internal testing findings in their 3012 reports. Rather, I believe Mr. Yancey understood the 3012 testing issues to be appropriately subsumed within the section of the PFSI 3012 Summary Report that states "deficiencies from internal and external audits are tracked and assigned to the appropriate business unit for remediation."

Indeed, the fact that his CCO did not highlight the Rule 204 issues in the 3012 Report served to underscore to Mr. Yancey that this particular issue was being addressed and remediated, consistent with the messages and assurances he was receiving from others. Therefore, it is my opinion that the lack of detail regarding the December 2009 Rule 204 testing in the summary report was not a "glaring" omission.[33] The facts known to Mr. Yancey about the audit were that the compliance processes identified *delays* in effecting buy-ins. Mr. Yancey knew that, in response, PFSI's relevant supervisors had formulated an action plan, and remediation was underway, including follow-up testing. Thus, in my opinion, Mr. Yancey acted reasonably in relying on Mr. Delaney's preparation of the 3012 Summary Report and in signing the CEO certification.

(iii) Purported "Misrepresentations" in the OCIE Letter were Not Red Flags

The Division claims that Mr. Yancey was aware of another significant red flag regarding Mr. Delaney's misconduct, specifically alleged misrepresentations to OCIE in November 2010. The Division asserts that Mr. Yancey knew the statement in the November 24, 2010 letter to OCIE that PFSI's Rule 204T processes were "reasonable" "effective" and "performed as designed" was "false in light of the 2009 audit results" and that these overt misrepresentations to OCIE were "an emergency beacon."[34] In my opinion, this statement was not a red flag.

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[33] OIP ¶ 80.

[34] OIP ¶¶ 82-83.

First, I disagree with the Division's characterization of Mr. Yancey's involvement in the November 24, 2010 OCIE response letter to the SEC's Reg SHO examination findings. In my experience, it would be highly unusual for a CEO to participate in drafting a response to a regulatory deficiency letter.[35] This would be entirely within the purview of the CCO. The fact that Mr. Yancey was a recipient of emails circulating drafts of the OCIE response is consistent with his management style, which promoted open and frequent communication.

Second, given the demands on any CEO's time, it would be unlikely that Mr. Yancey even read early ***drafts***, which is entirely reasonable. If he did review early drafts, it is likely he did so without an eye for misrepresentations, but rather, to assure himself that the drafts were responsive to the questions asked. In my experience, CEOs do not often review documents anticipating misrepresentations – nor would that be a reasonable expectation. A CEO must be able to rely on his qualified staff and trust that they will adhere to the high standards of compliance upheld by the CEO.

Finally, by the time Mr. Yancey saw the final draft, he would have reasonably concluded that his senior managers were effectively discharging their duties.[36] The draft was produced by Brian Gover, a Vice President of Operations responsible for overseeing the Buy-Ins department. The draft had also been reviewed and approved by his CCO. As detailed at length above, Mr. Yancey had no awareness of Stock Loan Rule 204(a) compliance issues, and he was given multiple assurances of remediation regarding the Buy-Ins Rule 204(a) procedures. By November 2010, Mr. Yancey reasonably believed that the firm had "reasonable processes" that were "effective" and "performed as designed." The Firm had been in continuous, ongoing conversations with OCIE during the prior two years regarding these very issues. From my review of the documents, it appears PFSI was both prompt and fulsome in its disclosures and communications with OCIE. In fact, in an April 22, 2010 letter to OCIE, PFSI disclosed its difficulties with Rule 204(a) Buy-Ins compliance and its remediation efforts. Thus, there was no overt misrepresentation in the November 24, 2010 letter and certainly no "emergency beacon" to Mr. Yancey regarding Stock Loan's Rule 204(a) violations involving "long sales of loaned securities."[37]

B. Bill Yancey Effectively Delegated Supervision of Mike Johnson, the Global SVP of Stock Lending, to Phil Pendergraft

No single document can be relied on to determine whether a particular person is a supervisor. Rather, many courts employ the *Gutfreund* "facts and circumstances" test for supervision. Courts have stated that "[d]etermining if a particular person is a supervisor depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose

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[35] OIP ¶ 82.

[36] *See In the Matter of Theodore W. Urban*, SEC Administrative Proceeding File 3-13655, Initial Decision Release No. 402 (ALJ Sept. 8, 2010) (Urban did not just rely on the unverified representations of employees, he relied on continuous representations by multiple individuals in high level managerial roles, some of whom he had known for years, and had no reason to distrust).

[37] OIP ¶ 83.

behavior is at issue."[38] *Huff* provides another meaningful principle that fits within the confines of *Gutfreund*:

> [A] supervisor for purposes of Section 15(b)(4)(E) ought to be defined by the Commission as a person at a broker-dealer who has been given (and knows or reasonably should know he has been given) the authority and responsibility for exercising such control over one or more specific activities of a supervised person which fall within the Commission's purview so that such person could take effective action to prevent a violation of the Commission's rules which involves such activity or activities by such supervised person.[39]
>
> The statute requires a supervisory relationship and such a relationship can only be found in those circumstances when, among other things, it should have been clear to the individual in question that he was responsible for the actions of another and that he could take effective action to fulfill that responsibility.[40]

Thus, while in some instances the identification of a supervisor may simply be a matter of reviewing positions in an organizational chart or supervisory chart, those documents are not definitive.

It is fairly common for multi-entity financial organizations to have a business line reporting structure that cuts across legal entities. The organizational charts evidence Mr. Yancey's delegation of Mr. Johnson's supervision to Mr. Pendergraft when Mr. Johnson became a PWI employee and Global Head of Stock Loan. Various supervisory matrices also evidence this delegation. Moreover, the ***facts and circumstances*** support a finding that Mr. Yancey effectively delegated supervision of Mr. Johnson, SVP of Global Stock Lending, to Mr. Pendergraft. Mr. Pendergraft had the requisite control and understanding, and Mr. Johnson himself, as well as other Stock Lending and PFSI employees, recognized Mr. Pendergraft as Mr. Johnson's supervisor. On the record testimony and other documentation that I reviewed supports this position.

In August 2008, a Global Stock Lending department was established, which combined the stock lending departments of various subsidiaries, including PFSI. Mr. Pendergraft selected Mr. Johnson to head that department and transitioned Mr. Johnson into his reporting chain at PWI. An August 2008 email from Mr. Pendergraft to Human Resources confirmed this change. As part of Mr. Johnson's change in responsibilities and shift to PWI, both Mr. Yancey and Mr. Pendergraft understood that Mr. Pendergraft would undertake complete supervisory responsibility for Mr. Johnson. In my opinion, given Mr. Pendergraft's qualifications and expertise in Stock Lending, this was an effective, reasonable, and clear delegation of supervisory

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[38] *In the Matter of John H. Gutfreund, et al.*, 51 S.E.C. 93, 113 (December 3, 1992); *In the Matter of Theodore W. Urban*, SEC Administrative Proceeding File 3-13655, Initial Decision Release No. 402 (ALJ September 8, 2010); *In the Matter of George J. Kolar*, 2002 SEC LEXIS 3420 (June 26, 2002).

[39] *In the Matter of Huff*, Securities and Exchange Release No. 29017, 1991 SEC Lexis 551 at *25-26 (1991) (concurring opinion of Commissions Lochner and Schapiro).

[40] *See id.* at *18-19.

responsibilities by Mr. Yancey.[41] The change in Mr. Johnson's supervisory chain is further confirmed by organizational charts throughout the period at issue.[42] Additionally, countless emails over the period from 2008 to 2011 demonstrate that Mr. Pendergraft was closely and actively supervising Mr. Johnson both as to the Global Stock Loan department and, specifically, to PFSI's stock lending activities.

Email communications between Mr. Pendergraft and Mr. Johnson clearly evidence that Mr. Pendergraft had the "requisite degree of responsibility, ability, or authority to affect [Johnson's] conduct."[43] Indeed, the categories of communication between Mr. Johnson and Mr. Pendergraft constitute the epitome of supervision. Mr. Pendergraft and Mr. Johnson communicated regularly regarding:

- client issues;
- personnel matters;
- compensation and bonuses;
- regulatory issues;
- revenue;
- travel plans; and
- industry issues.

These communications demonstrate a clear and exclusive supervisory relationship between Mr. Pendergraft and Mr. Johnson.

Former Commissioner and Chairman Mary Schapiro offered the following guidance: "[i]n our view the most probative factor that would indicate whether a person is responsible for the actions of another is whether that person has the power to control the other's conduct. . . . Control . . . is the essence of . . . supervision."[44] The supervisory communications between Mr.

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[41] In a financial services firm, supervision rests, initially, with the CEO, unless and until he reasonably delegates supervisory responsibility by assigning experienced, qualified individuals to supervise the business activities of the firm. *See Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995) ("The president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient."), *quoting Universal Heritage Investments Corp.*, 47 S.E.C. 839, 845 (1982) (finding securities firm's president had properly delegated duties). *See also John B. Busacca III*, Exchange Act Release No. 63312, at 16 (Nov. 12, 2010) (The President of a brokerage firm is responsible for the firm's compliance . . . "unless and until he or she delegates a particular function to another person in the firm, and neither knows nor has reason to know that such a person is not properly performing his or her duties.").

[42] The organizational charts reflect that Mr. Son may have also had some supervisory responsibility for Mr. Johnson. Mr. Son and Mr. Pendergraft were co-founders of Penson and jointly ran the company. It is my understanding that due to Mr. Pendergraft's demands as a CEO he relied on Mr. Son to assist in overseeing Stock Loan activities. In my opinion, in light of all the facts and circumstances, this does not negate or diminish Mr. Yancey's delegation of supervision to Mr. Pendergraft.

[43] *In the Matter of John H. Gutfreund, et al.*, 51 S.E.C. 93, 113 (December 3, 1992).

[44] Speech at the March 1993 Securities Industry Association ("SIA") Compliance and Legal Seminar: "Broker-Dealer Failure to Supervise: Determining Who is a 'supervisor'" (March 24, 1993).

Pendergraft and Mr. Johnson demonstrate Mr. Pendergraft's control. Mr. Pendergraft, not Mr. Yancey, determined Mr. Johnson's compensation. Hiring decisions within the Securities Lending group were made by Mr. Johnson and Mr. Pendergraft, not Mr. Yancey. Mr. Pendergraft, not Mr. Yancey, directed Mr. Johnson on strategy and operations.

Mr. Yancey's weekly meetings conducted with direct reports did not include Mr. Johnson, which supports Mr. Yancey's contention that he fully delegated responsibility for directly supervising Mr. Johnson to Mr. Pendergraft. Monthly Business Reviews ("MBRs") that Mr. Yancey submitted to PWI's management on behalf of PFSI were *exclusive* of Securities Lending activity. Rather, the MBR for Securities Lending for all subsidiaries was presented solely by Mr. Johnson, as the Global SVP of Securities Lending. PFSI employees also understood that Mr. Johnson reported into PWI. Mr. Johnson himself stated that during the relevant period, he reported to Dan Son and Phil Pendergraft.

Moreover, the dozens of communications I reviewed illustrate Mr. Pendergraft was a reasonable, effective, and engaged supervisor of Mr. Johnson. I have not seen any materials that would indicate to Mr. Yancey that his delegation to Mr. Pendergraft was ineffective. Mr. Yancey had frequent contact with PWI executives and weekly meetings and communications with Mr. Pendergraft, yet I saw no concerns exchanged regarding Mr. Johnson that would rise to the level of a red flag. As discussed above, I disagree that any of the Division's assertions of "red flags" were red flags that would have alerted Mr. Yancey to Stock Loan Rule 204(a) violations.

In conclusion, there is no reasonable basis to conclude that Mr. Yancey had any direct supervisory authority, other than his overarching responsibility as CEO of PFSI, for Mr. Johnson, the Global SVP of Securities Lending. Rather, the facts and circumstances are clear that complete supervisory responsibility for Mr. Johnson was delegated to Mr. Pendergraft. Mr. Pendergraft knew he had and, in fact, exercised the requisite degree of responsibility, ability, and authority over Mr. Johnson. In my opinion, Mr. Pendergraft's supervision appeared reasonable and Mr. Yancey had no reason to believe that delegation was ineffective.

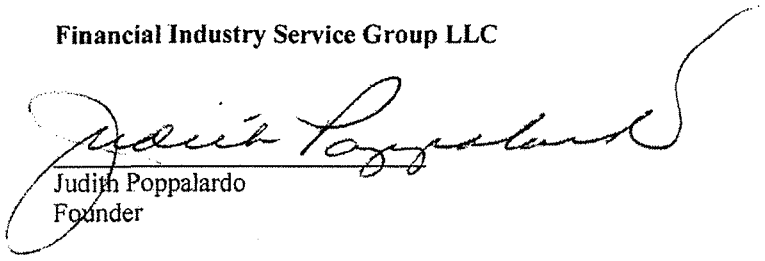
VIII. Conclusion

I have reviewed the PFSI supervisory system and concluded that there were adequate procedures and systems for applying such procedures that would reasonably be expected to prevent and detect violations of the federal securities laws. I also find that Mr. Yancey reasonably discharged his duties and obligations under such procedures without reasonable cause to believe that such procedures and system were not being complied with. No matter how well-conceived and operated, no supervisory system can provide absolute assurance regarding achievement of its objectives or that all deficiencies will be identified and escalated as appropriate. There may always be instances where judgments made in good faith in hindsight will be deemed inappropriate. Therefore the standard is — are the procedures and controls *reasonable* such that Mr. Yancey was justified in relying on the supervisory system in place? I conclude that they were and that he was.

I reserve the right to modify, supplement, or otherwise amend this report and the opinions expressed herein should I be provided with any additional documentation or information

regarding this matter. Further, if requested by counsel, I may also offer rebuttal testimony in this matter.

Financial Industry Service Group LLC



Judith Poppalardo
Founder

EXHIBIT A – Facts and Data Reviewed

In preparation of this report I reviewed the OIP and a variety of documents provided to me by Haynes and Boone, including:

- A copy of the Formal Order dated July 6, 2011.
- A copy of the Wells Notice to Yancey dated April 3, 2013.
- A copy of the Wells Submission from Yancey dated June 7, 2013, July 24, 2013, September 18, 2013, and March 10, 2014.
- A copy of the Wells Submission from Delaney.
- A copy of the Wells Submission from Hasty dated May 23, 2013.
- Copies of the investigative testimony of the following:
  - Eric Alaniz (4/13/2013)
  - Thomas Delaney (4/4/2012, 8/28/2012, 7/31/2013)
  - Rudy DeLaSierra (4/3/2012, 1/10/2013)
  - Scott Fertig (9/10/2012)
  - Brian Gover (8/16/2011)
  - Brian Hall (7/7/2011)
  - Holly Hasty (4/4/2012, 8/31/2012)
  - Michael Johnson (1/11/2013)
  - Bart McCain (1/23/2013)
  - Marc McCain (8/17/2011)
  - Kimberly Miller (4/3/2012, 8/31/2012)
  - Phil Pendergraft (9/26/2013)
  - Summer Poldrack (8/10/2011)
  - Angel Shofner (8/17/2011)
  - Lindsey Wetzig (8/18/2011)
  - Bill Yancey (1/23/2013)
- Copies of the Division's investigative and trial exhibits (Exs. 1-244).
- Copies of Yancey's trial exhibits (Exs. 501 – 759).
- Copies of PFSI/PWI Organizational Charts for 2007 – 2011.
- Copies of emails between Pendergraft and Johnson from 2008 – 2011.
- Copies of FINRA Broker Check Reports for Pendergraft and Son.

- Copies of other documents related to PFSI's compliance and supervisory systems, including:
    - Compliance department Written Procedures for 2008 – 2011 (PFSI2085406 & PFSI1380794).
    - WSP Testing Remediation Tracking Log (PFSI1384546).
    - Email from Eric Alaniz to Doug Gorenflo, dated October 14, 2009, re: 3012 Test Result Registration and Licensing Department (PFSI1401731).
    - Email from Eric Alaniz to Randy Mardell, dated March 17, 2010, re: Suitability Notification Remediation (PFSI1385030).
    - Email from Eric Alaniz to Gary Weidman, dated September 24, 2010, re: Transmittal of Funds Remediation (PFSI1397113).
    - Email from Eric Alaniz to Bill Yancey, dated March 25, 2009, re: Annual Certification of Compliance and Supervisory Processes (PFSI2351991).
- A copy of the Declaration of Brian Gover dated January 7, 2014.
- A copy of the cooperation agreement of Brian Hall dated September 13, 2013.
- A copy of the cooperation agreement of Rudy DeLaSierra dated September 17, 2013.
- Copies of Brady Statements provided by the Division on June 30, 2014 and October 6, 2014.
- Expert Report of David Paulukaitis.

EXHIBIT B

JUDITH POPPALARDO
Financial Industry Service Group LLC
703.465.4494
202.437.1914 (cell)
jpoppalardo@finseg.com
www.finseg.com

Professional Experience

Financial Industry Service Group LLC 2000-present
Washington, D.C.
Managing Partner

Financial Industry Service Group LLC ("Finseg") provides regulatory consulting services in the area of broker-dealer and investment adviser compliance. Recent projects include: acting as the independent consultant on settlement-related regulatory audits; conducting internal examinations/investigations; drafting, revising and updating compliance policies and supervisory and internal control procedures; conducting anti-money laundering audits; and assisting firms with privacy, outsourcing and system assessment issues. In addition, Finseg principals have prepared firms for "culture of compliance" examinations by various SROs and the SEC, and have provided benchmarking services for firms seeking to establish "best practices." Finseg principals also have provided expert testimony on various topics for both regulators and financial services firms.

Securities Industry Association 1996-2000
Washington, D.C.
Associate General Counsel

Advised standing committees on regulatory and legislative initiatives. Helped committees influence initiatives through comment letters and meetings with regulators and legislators. Committees included: Self-Regulation and Supervisory Practices, Trading, Operations, and Market Structure.

Securities and Exchange Commission 1991-1996
Washington, D.C.
Assistant Director

Office of Compliance Inspections and Examinations ("OCIE")
Responsible for the organization and execution of the Commission's broker-dealer examination program and inspections of the self-regulatory organizations.

National Securities Clearing Corporation 1990-1991
New York, NY
Assistant General Counsel

Responsible for ensuring compliance with federal laws and regulations governing clearing corporation operations.

Securities and Exchange Commission 1986-1990
Washington, D.C.
Assistant Director

Division of Market Regulation

Conducted research, reviewed proposed rule changes by self-regulatory organizations, and supervised staff in the area of options, exchange, and securities processing regulation.

Professional Affiliations

SIFMA Legal & Compliance Division, Member

Licenses

Virginia State Bar

Regulatory Reviews Pursuant to SEC and FINRA Actions

Finseg has been deemed acceptable by the SEC and FINRA to conduct over 25 regulatory reviews pursuant to administrative orders and letters of Acceptance, Waiver and Consent.

Prior Testimony and Expert Experience

Regulatory Enforcement Matters:

I served as an expert witness on behalf of FINRA and NYSE Regulation in the following matters alleging violations of federal and SRO rules relating to anti-money laundering:

FINRA Department of Enforcement v. Sterne, Agee & Leach, Inc. (Disciplinary Proceeding No. E052005007501).

FINRA Department of Enforcement v. Domestic Securities, Inc. (Disciplinary Proceeding No. 2005001819101).

NYSE Disciplinary Proceeding against Wedbush Morgan Securities, Inc.

Litigation:

I testified as an expert on behalf of the respondent in Alan R. Marcum v. First Allied Securities (EDD Case Nos. 4717640, 4686613 and 4796954) in a matter before the California Unemployment Insurance Appeals Board regarding the status of a registered person as an

independent contractor, a determination that turned on the supervisory control exercised by the respondent over the registered person's activities as required under SEC and FINRA rules.

I served as an expert on behalf of the plaintiff in a matter alleging violations of the federal securities laws, Heritage Equity Group 401(k) Savings Plan, et al., v. Mid-Atlantic Capital Corporation and Sungard Institutional Brokerage, Inc. The matter settled prior to trial.

Arbitration:

FINRA Case No. 11-02918, Alan R. Marcum v. Advanced Equities, Inc. et al. (testifying for respondent in a wrongful termination case scheduled for December 2014).

Publications

Karen O'Brien and Judith Poppalardo, "A Practical Guide to Implementing the New Books and Records Rules by the Foremost Industry Experts," Books and Records Manual, BD Week, August 2002.

Brandon Becker, Cherie Macauley, Stuart Kaswell, and Judith Poppalardo, "Is It Time to Revamp the Current Regulatory Structure of the Markets" Journal of Investment Compliance, June 22, 2000.

Exhibit B

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15873

In the Matter of

Thomas R. Delaney II and
Charles W. Yancey

Respondents

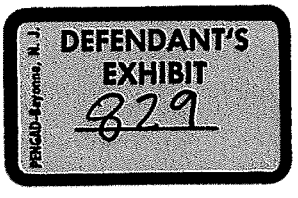
AMENDED EXPERT REPORT OF MARLON Q. PAZ

My name is Marlon Paz. I am a partner at the Washington, D.C. office of the law firm Locke Lord LLP, where I concentrate my practice on securities matters, internal investigations, and business litigation. I am also an Adjunct Professor at Georgetown University Law Center, where I teach courses in the areas of Securities Law, including the regulation of broker-dealers. I am licensed to practice law in the District of Columbia, Delaware, New York, and California. I am also a Certified Fraud Examiner and frequent speaker and consultant on issues related to the regulation of broker-dealers. I have been retained by Respondent Charles W. Yancey to testify as an expert witness in conjunction with an Administrative Proceeding initiated against Mr. Yancey.

I. Background and Qualifications

My legal practice, consulting, and academic engagements routinely involve the regulation of broker-dealers. I have experience with a wide range of complex securities issues in the regulatory and litigation context, compliance, and global anti-corruption matters. Some of my recent legal engagements involve regulatory advice to large broker-dealers, assisting a large broker-dealer to convert from a carrying firm to an introducing broker, representing a broker-dealer in federal court in an action involving Ponzi scheme allegations, and advising on net capital, customer protection, and anti-money laundering issues during an examination.

At Georgetown Law School, where I have served as Adjunct Professor since 2008, I teach courses with particular emphasis on broker-dealer regulation. I am currently teaching, and have offered for some time, LAW 760-09, "SEC Regulation of Financial Institutions and the Securities Markets," which covers the operation and regulation of the securities markets, brokerage firms, and other financial institutions. During the last term, I taught LAW 940-09, "Securities Law and the Internet," which covered the impact of technology on the brokerage business. My courses on broker-dealer regulation include the regulation of trading practices, and specifically, short selling. My Securities Law and the Internet course was offered last summer to



staff of the U.S. Securities and Exchange Commission ("SEC") as part of "SEC University" – with over 100 SEC staff members enrolled.

I also routinely work with the Securities Industry and Financial Markets Association ("SIFMA"), and its members, on analysis of regulatory and enforcement action by the SEC and the Financial Industry Regulatory Authority ("FINRA"). Finally, I serve as the Vice-Chair of the American Bar Association's Trading and Markets Subcommittee (in charge of broker-dealer and related issues), which is part of the Federal Regulation of Securities Committee of the Business Law Section. My work with SIFMA, the American Bar Association, and others, at times involves the preparation of comment letters, requests for no-action letters, amicus briefs, and other advocacy work.

Prior to joining Locke Lord, I was the Principal Integrity Officer of the Inter-American Development Bank, where I led a team of lawyers and investigators in the development, investigation, and prosecution of fraud and corruption cases. I was also responsible for compliance procedures relating to issues such as integrity due diligence, anti-money laundering, offshore financial centers, and the Office of Foreign Assets Control Specially Designated Nationals List.

Prior to joining the Inter-American Development Bank, I spent six years with the SEC. During my six-year tenure with the SEC, I served in various capacities in the staff of the Division of Trading and Markets, including in the Office of Trading Practices and Processing, and as the Senior Special Counsel to the Director of Trading and Markets. In addition to focusing on the financial crisis, my teams focused on a number of regulatory measures, including fraud, anti-manipulation, credit ratings agency reform, the respective fiduciary duties of broker-dealers and investment advisers, hedge funds, and enhancements to capital and financial controls over broker-dealers. While at the SEC, I worked on over 100 enforcement matters involving complex securities issues, including a number of regulatory actions. I also worked closely with other senior members of the SEC on issues related to the oversight of the securities markets, broker-dealers, clearance and settlement, transfer agents, and credit rating agencies.

During my tenure with the SEC, I assisted with the development of a number of releases and Commission initiatives, including status as broker-dealer and registration requirements, particularly Rule 15a-6, Exemption of Certain Foreign Brokers or Dealers, 73 FR 39182 (Jul. 8, 2008); Regulation M – Anti-manipulation Rules Concerning Securities Offerings, Rule 105 – Short Selling in Connection With a Public Offering, 71 FR 75002 (Dec. 13, 2006); use of soft-dollars by money managers, Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, 71 FR 41978 (Jul. 24, 2006); Broker-dealer financial responsibility issues, Rule 15c3-1 (net capital) and Rule 15c3-3 (customer protection), and Rules 17h-1T and 17h-2T (risk assessment); and Self-Regulatory Organizations, Commission Guidance and Amendment to the Rules Relating to Organization and Program Management Concerning Proposed Rule Changes Filed by Self-Regulatory Organizations, 73 FR 40144 (July 11, 2008).

I have substantial personal experience with the rules at issue in this case—Rules 204T and 204(a) of Regulation SHO, 17 C.F.R. 242.204 ("Rule 204T/204(a)"). During my tenure with

the SEC, I was significantly involved in the rulemaking process for Rule 204T/204(a). As part of that process, I, along with other SEC staff, helped write the rule, revise and edit the rule, solicit comment and feedback on the rule, and analyze whether the rule was in the public interest and would promote efficiency, competition, and capital formation. In addition, pursuant to Section 23(a) of the Exchange Act, I, along with other SEC staff, analyzed the impact Rule 204T/204(a) would have on competition. A copy of my curriculum vitae is attached hereto as Exhibit A.

II. Materials Reviewed

In addition to reviewing the OIP, I reviewed a substantial number of documents and transcripts of investigative testimony. Other materials I have reviewed in connection with rendering this Report include statutes, administrative decisions, commission opinions, federal court decisions, and other related releases, articles, and speeches. A list of those materials is attached hereto as Exhibit B.

III. Summary of Opinions

Based upon my review of the materials listed on Exhibit B to this report, interviews with Mr. Yancey, and my experience, among other things, as a former SEC regulator, I offer the following opinions:

1. **Rule 204T/204(a) is a highly technical rule that was adopted primarily to curb the abusive practice of naked short selling, an issue not present in this case.**

Rule 204T/204(a) is an exceedingly technical rule that was adopted primarily to curb the abusive practice of naked short selling, which is an issue not present in this case. The method and speed of Rule 204(a)'s adoption—without the customary notice and comment period—precluded substantial modifications to the rule and resulted in a complex, challenging compliance environment. I played a central role in the rulemaking process for consideration and ultimate adoption by the SEC of Rule 204T/204(a), and I have remained current with the rule in my professional and academic capacity. In my opinion, based on my experience with Rule 204T/204(a) and the available public record, Rule 204T/204(a) was not to be administered by the most senior executives at a broker-dealer; rather, Rule 204T/204(a) was designed to be implemented and managed by associated persons of the broker-dealer at the operational level. I am not aware of any public statement by the SEC, or any current or former SEC staff members, that would indicate otherwise.

2. **None of the "red flags" advanced by the Division would have alerted Mr. Yancey to "systemic" and "intentional" violations of Rule 204T/204(a) for "long sales of loaned securities."**

The materials submitted by the Division do not clearly demonstrate Rule 204T/204(a) violations arising from "long sales of loaned securities." Nor is there any evidence that Mr. Yancey was aware of "systemic" and "intentional" violations of Rule 204(a). In fact, the Division concedes that Mr. Yancey was ***not aware*** of any "systemic" or "intentional" violations

of Rule 204T/204(a).

None of the "red flags" advanced by the Division would have alerted Mr. Yancey to "systemic" and "intentional" violations of Rule 204T/204(a) for "long sales of loaned securities." The record clearly reflects that Penson was successfully closing out, through the delivery or borrowing of shares, the ***overwhelming majority*** of its transactions. The Division's suggestion that an audit reflecting the failure to timely close out 112 transactions—out of the millions of transactions that Penson cleared during the same time—should have alerted the CEO of the second largest clearing firm in the United States to "systemic" and "intentional" violations of Rule 204 is unreasonable. No broker-dealer is perfect. The fact that some violations of a highly technical rule like Rule 204 were found is not surprising. This is particularly the case when the broker-dealer is as complex an operation as Penson. The record further reflects that Mr. Yancey repeatedly was assured that the issues were being promptly remediated.

3. The policy basis underlying Rule 204T/204(a) was not intended to address the conduct in which Mr. Yancey is alleged to have engaged.

It is my opinion that to hold Mr. Yancey responsible for failing to supervise Thomas R. Delaney II and Michael H. Johnson based on purported violations of a highly technical rule, and of which the Division concedes Mr. Yancey was not made aware, would result in a significant extension of Rule 204T/204(a) and would cause uncertainty and confusion among senior-level managers at broker-dealers as to their supervisory responsibilities. Neither Rule 204T/204(a), nor any case of which I am aware, imposes liability of a president/CEO of a broker dealer not involved in operations, based on "red flags by omission."

This report reflects my current opinions in this matter. I reserve the right to supplement or revise my opinions should new information become available. Further, if requested by counsel, I may also offer rebuttal testimony in this matter.

IV. Opinions

A. Rule 204T/204(a) is a highly technical rule that was adopted primarily to curb the abusive practice of naked short selling, an issue not present in this case.

1. *The Mechanics of Securities Clearing*

The Depository Trust & Clearing Corporation ("DTCC") stands at the center of most securities transactions in the United States equities markets. DTCC subsidiaries, the Depository Trust Company ("DTC") and the National Securities Clearing Corporation ("NSCC"), clear and settle nearly all securities transactions in the United States.[1]

[1] *Life Cycle of a Security*, Virginia B. Morris & Stuart Z. Goldstein 2010 at 8. Both entities are subsidiaries of the Depository Trust & Clearing Corporation. The DTC is one of the world's largest securities depositories. The DTC holds trillions of dollars' worth of securities in custody. The majority of all equities that have been issued in paper form in the U.S. are held and immobilized by DTC. The shares are registered with their issuers in DTC's nominee name, Cede & Co., also known as "street name."

The NSCC serves as the central counterparty to nearly all U.S. equity trades. NSCC becomes the buyer for every seller and the seller for every buyer.[2] This helps minimize risk. When a stock is sold, the shares are debited electronically from the seller's broker's account at NSCC and credited to the NSCC account of the brokerage firm whose client bought the shares.[3] By offsetting a firm's buy orders for a particular security against its sell orders for that security ("netting"), NSCC is able to reduce the total number of trade obligations requiring financial settlement by 98% each trading day.[4]

The Continuous Net Settlement System ("CNS") is NSCC's core netting system.[5] Within CNS, each security is netted on a daily basis to one position per participant, which results in a single settlement obligation of shares for each participant. NSCC is the central counterparty to each participant (through the legal concept of "novation").[6] CNS either owes shares of a security to the participant, or the participant owes shares of that security to CNS. The participant's ***customers*** are invisible to CNS, even if there are thousands of them.

Trades in the U.S. are generally finalized on the third day after the trade, often referred to as "T+3" or "trade date plus three days." The date specified for the settlement of the transaction, generally T+3, is known as "settlement date." If the CNS participant (*i.e.*, the broker-dealer) does not have enough shares in its account with DTC to satisfy its net obligation to NSCC on the settlement date, the participant will have a short position vis-à-vis the CNS and the participant is said to have a "fail-to-deliver."

There is nothing inherently nefarious about a fail-to-deliver position. As the SEC Staff noted in its Responses to Frequently Asked Questions Concerning Regulation SHO, "fails to deliver can occur for a variety of legitimate reasons, and flexibility is necessary in order to ensure an orderly market and to facilitate liquidity."[7] The SEC Staff elaborated:

> There are many reasons why NSCC members do not or cannot deliver securities to NSCC on the settlement date. Many times the member will experience a problem that is either unanticipated or is out of its control, such as (1) delays in customer delivery of shares to the broker-dealer; (2) an inability to borrow shares in time for settlement; (3) delays in obtaining transfer of title; (4) an inability to obtain transfer of title; and (5) deliberate failure to produce stock at settlement which may result in a broker-dealer not receiving shares it had purchased to fulfill its delivery obligations.[8]

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[2] *Id.*

[3] *Id.*

[4] *Id.*

[5] About CNS, available at http://www.dtcc.com/clearing-services/equities-clearing-services/cns.aspx.

[6] During "novation" the delivery obligation of each party to a securities transaction is discharged, and the NSCC assumes the delivery obligation owed to the counterparty. After "novation" the original selling party owes NSCC delivery of the securities (not the purchaser of the securities).

[7] *See* Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, Response to Question 7.1, located at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

[8] *Id.* at Response to Question 7.3.

Indeed, as the SEC Staff has observed with respect to threshold securities (securities experiencing a *substantial* amount of failures to deliver) "[a] security's appearance on a threshold list does not necessarily mean that any improper activity has occurred or is occurring."[9]

Moreover, the SEC has repeatedly acknowledged that the vast majority of all trades settle on time:

> According to the National Securities Clearing Corporation ("NSCC"), 99% (by dollar value) of all trades settle on time. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle. The vast majority of these fails are closed out within five days after T+3.[10]

The Commission has further noted that more than 70% of all fail to deliver positions are closed out within two settlement days after settlement date.[11]

2. *The SEC adopts Regulation SHO to curb "naked" short selling.*

In 2004, the SEC adopted Regulation SHO.[12] Regulation SHO was designed to provide a new regulatory framework governing short selling of securities. The SEC designed Regulation SHO to accomplish three objectives: (1) establish uniform locate and delivery requirements in order to address, among other things, potentially abusive "naked" short selling (*i.e.*, selling short without having first borrowed the securities to make delivery); (2) create uniform marking requirements for sales of all equity securities; and (3) establish a procedure to temporarily suspend short sale price tests in order to evaluate the overall effectiveness and necessity of such restrictions.[13]

Initially, Regulation SHO's delivery requirements contained "closeout" obligations that applied only to "threshold securities," or securities that were experiencing a substantial amount of failures to deliver.[14] During the financial crisis of 2008, however, the SEC became increasingly concerned about *abusive* naked short selling. The SEC noted that "possible unnecessary or artificial price movements" were occurring based on unfounded rumors and

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[9] *See* Division of Market Regulation: Key Points About Regulation SHO, April 11, 2005.

[10] *See* Exchange Act Release No. 58774, 73 FR 61666, 61667 (October 17, 2008) (adopting the new antifraud rule, Rule 10b-21).

[11] Release 34-60388 (July 27, 2009), 74 FR 38266.

[12] Regulation SHO became effective on September 7, 2004 (Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) ("Adopting Release").

[13] "Responses to frequently asked questions concerning Regulation SHO," Introduction, SEC, Division of Market Regulation (originally issued December 17, 2004).

[14] *See* Rule 203(b)(3). A "threshold security" refers to certain equity securities for which there is an aggregate failure to deliver position above a specified level. Pursuant to Rule 203(c)(6), a security will make the threshold list if it meets the following criteria over five consecutive settlement days: (1) the total number of fails to deliver exceed 10,000 shares; (2) the total number of shares that have failed to deliver exceed .5% of the issuer's total shares outstanding; and (3) the security is listed on a similar list by a self-regulatory organization.

"exacerbated by 'naked' short selling."[15] The SEC noted that "some persons [might] take advantage of issuers that [had] become temporarily weakened by current market conditions to engage in inappropriate short selling" in the securities of such issuers:

> Given the importance of confidence in our financial markets as a whole, we have become concerned about sudden and unexplained declines in the prices of securities. Such price declines can give rise to questions about the underlying financial condition of an issuer, which in turn can create a crisis of confidence without a fundamental underlying basis. This crisis of confidence can impair the liquidity and ultimate viability of an issuer, with potentially broad market consequences.[16]

As a result of these concerns, on September 17, 2008, the SEC adopted Rule 204T of Regulation SHO on an expedited basis as an "emergency temporary rule."[17]

On October 14, 2008, less than one month after the issuance of the emergency temporary rule, the SEC adopted temporary Rule 204T as an "interim final temporary rule."[18]

On July 27, 2009, the eve of the rule's expiration, the SEC adopted Rule 204, with minor modifications, as a final rule.[19]

3. *The Mechanics of Rule 204T/204.*

Rule 204 is a highly-technical, complex rule. Rule 204 is focused on failures-to-deliver equity securities for timely settlement of trades to the CNS. Rule 204(a) requires CNS participants (broker-dealers, such as Penson) to close out fail-to-deliver positions resulting from both short and long sales by borrowing or buying securities in sufficient quantities to close out those fails at the beginning of regular trading on T+4 for short sales and T+6 for long sales:

> A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity

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[15] Release 34-58572, 73 FR 54875 (Sept. 23, 2008) ("September Emergency Order").

[16] *Id.*

[17] *Id.* Rule 204T was adopted in September 2008 at the height of the financial crisis. The SEC took the unusual step of issuing the Emergency Order announcing Rule 204T under Section 12(k) of the Securities Exchange Act of 1934. *See id.* As the SEC explained, "Pursuant to Section 12(k)(2), in appropriate circumstances the Commission may issue *summarily* an order to alter, supplement, suspend, or impose requirements or restrictions with respect to matters or actions subject to regulation by the Commission." *Id.* (emphasis added).

[18] Exchange Act Release No. 58733. The Order announced that the temporary rule would expire on July 31, 2009.

[19] Release 34-60388 (July 27, 2009), 74 FR 38266. Ordinarily there is a minimum 30-day period before a rule can become effective. The SEC bypassed this requirement for Rule 204T by relying on one of the exceptions enumerated in 5 U.S. Code § 553, which provides an exception to the 30-day requirement where an agency finds "good cause" for providing a shorter effective date.

> security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity.[20]

Among other things, Rule 204(a) dramatically shortened the Regulation SHO close-out period of 13 consecutive settlement days after the regular settlement date. With respect to short sales, any fail to deliver by regular settlement date (trade date plus three or "T+3") must be closed out by borrowing or purchasing securities of like kind and quantity no later than the beginning of trading (9:30 a.m. EST) the following day ("T+4").[21] With respect to long sales, any fail to deliver by regular settlement date must be closed out by borrowing or purchasing securities of like kind and quantity no later than the open of trading on T+6.

Pursuant to Rule 204(b), if a CNS participant does not close out a fail-to-deliver position within that time period, it may be temporarily prohibited from effecting short sales in that security for any customer unless it pre-borrows that security:

> If a participant of a registered clearing agency has a fail to deliver position in any equity security at a registered clearing agency and does not close out such fail to deliver position in accordance with the requirements of [204(a)], the participant and any broker-dealer from which it receives trades for clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in § 242.203(b)(2)(iii), 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, to the extent that the broker or dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security, or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency; Provided, however: a broker or dealer shall not be subject to the requirements of this paragraph if the broker or dealer timely certifies to the participant of a registered clearing agency that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that broker or dealer is in compliance with paragraph (e) of this section.[22]

This "pre-borrow" requirement is often referred to as the "penalty box."[23]

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[20] 17 C.F.R. § 242.204(a).

[21] Investors generally settle their transactions in exchange-traded securities within three settlement days, often referred to a "T+3" or "trade date plus three days." When a trade occurs, the participants to the trade deliver, and pay for, the securities at a clearing agency three settlement days after the trade is executed, which allows the brokerage firm to exchange the funds for the securities on the third settlement day.

[22] 17 C.F.R. § 242.204(b).

[23] There is no allegation in the OIP that Penson violated Rule 204(b).

Pursuant to Rule 204(d), a participant of a registered clearing agency can allocate a fail to deliver position to another registered broker-dealer for which it clears trades or from which it receives trades for settlement.[24] Thus, a participant can allocate responsibility for the fail to deliver to another broker-dealer. In such situations, the requirements of Rule 204 apply to the broker-dealer that was allocated the fail to deliver position, rather than the participant of the registered clearing agency.

Although Rule 204 applies to purchase and sale transactions in all equity securities, the SEC designed Rule 204 primarily to "address abusive 'naked' short selling."[25] As the SEC observed in the Rule 204T Release, "[w]e intend that the temporary rule will address potentially abusive 'naked' short selling by requiring that securities be purchased or borrowed to close out any fail to deliver position in an equity security by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred."[26] The SEC further noted that the "rule should provide a powerful disincentive to those who might otherwise engage in potentially abusive 'naked' short selling."[27]

Importantly, long sellers are situated differently from short sellers. Unlike short sellers, long sellers own the shares that they are selling and are looking for the best price. Thus, unlike "naked short sellers," long sellers generally have no incentive to depress the price of the security, which is the type of activity that Rule 204 was principally designed to address.

4. *The Complexities and Ambiguities of Rule 204(a).*

The method and speed of Rule 204T/204(a)'s adoption—without the customary notice and comment period—precluded substantial modifications to the rule and resulted in a complex, challenging compliance environment. As some industry members observed, "[t]he business of securities lending was turned on its head by the events of 2008."[28] SIFMA expressed the industry perspective as follows:

> The greatly compressed timeframe provided for currently under Rule 204T, however, is unduly restrictive and does not allow participants sufficient time to fully evaluate and responsibly close-out all their open fail positions.[29]

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[24] 17 C.F.R. § 242.204(d).

[25] Exchange Act Release No. 58733 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) ("Rule 204T Adopting Release"); *see also* 2007 Regulation SHO Final Amendments, 72 FR at 45544 (stating that "[a]mong other things, Regulation SHO imposes a close-out requirement to address persistent failures to deliver stock on trade settlement date and to target potentially abusive 'naked' short selling in certain equity securities").

[26] *Id.*

[27] *Id.*

[28] Kathy Rulong, Bank of New York Mellon Corporation (Sep. 28, 2009), available at http://www.sec.gov/comments/4-590/4590-22.pdf.

[29] *See Letter from Securities Industry and Financial Markets Association to Ms. Florence E. Harmon*, U.S. Securities and Exchange Commission (December 16, 2008), available at http://edgar.sec.gov/comments/s7-30-08/s73008-52.pdf.

The complexities and ambiguities of Rule 204 have necessitated multiple rounds of additional interpretative guidance by the SEC and its staff.[30] But even today the rule continues to have areas of uncertainty and ambiguity.

For example, Rule 204(a) permits a participant to "borrow" to satisfy a closeout obligation as an alternative to making a purchase to eliminate a fail to deliver position. The obligation may be satisfied by borrowing the required amount of securities by no later than the opening of regular trading hours on the applicable closeout date. But the SEC has not specified the requirements for a borrow transaction. Although the SEC has indicated that it is familiar with industry practice applying to securities borrowing and lending,[31] it has not stated that industry practice must be followed to have a valid borrow, or how the agreement should be documented. Nor has the SEC specified whether it is necessary to obtain delivery of borrowed shares to have a valid closeout "borrow."

Similarly, the SEC has taken an interpretive position that, if a person that has loaned a security to another person sells the security, the person will be "deemed to own" the security for purposes of Rule 200(b) of Regulation SHO, and the sale will not be treated as a short sale and may be marked "long" for purposes of Rule 200(g) of Regulation SHO, if a bona fide recall of the loaned security is initiated within two business days after trade date (*i.e.*, by T+2). As a long sale, the closeout date under Rule 204(a)(1) would be T+6. But if the recall were not issued by T+2, logic would suggest that the sale would not have the benefit of the interpretation, and therefore it would be a short sale that must be closed out by the opening of trading on T+4. The interpretation initially was issued in the heat of the 2008 financial crisis and literally addressed a special case: where a *person* has loaned a security to *another person* and then sells the security (and a bona fide recall is initiated within two business days after the trade date). The various iterations of the interpretation do not address the more complex situation where a customer sells stock held in a brokerage margin account, and does not know if his or her shares have been loaned out by the broker, such as in the situations reflected in the allegations in this proceeding. On various occasions, the SEC staff has been asked to address the application of the interpretation beyond the limited context of the published interpretation, but, to date, the SEC has failed to do so.

Another highly technical, ambiguous area of Rule 204T/204(a) involves the concept of a "pre-fail credit." Aware of industry-wide issues with implementation, SEC staff issued an FAQ regarding whether a broker-dealer could claim credit for purchases made to close out an open short position prior to settlement date.[32] The SEC noted that a broker-dealer could receive credit for purchasing securities prior to the beginning of regular trading hours on the settlement day

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[30] *See, e.g.*, Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors against "Naked" Short Selling Abuses, September 22, 2008; Amendment to Regulation SHO to adopt Exchange Act Rule 204 – A Small Entity Compliance Guide, August 3, 2009; Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, April 10, 2012.

[31] *See, e.g.*, Release 34-60388 (July 27, 2009), 74 FR 38266, 38270-38272.

[32] Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors against "Naked" Short Selling Abuses, available at http://www.sec.gov/divisions/marketreg/204tfaq.htm.

after the settlement date, including on trade date, T+1, 2, or 3 if: (a) the purchase was bona fide; (b) the purchase was executed on, or after, trade date but no later than the end of regular trading hours on settlement date; (c) the purchase was of a quantity of securities sufficient to cover the entire amount of the open short position for which the broker-dealer was claiming pre-fail credit; and (d) the broker-dealer could demonstrate that it had a net long position or net flat position on its books and records on the settlement day for which the broker-dealer was claiming pre-fail credit.[33] The SEC did not, however, clarify whether being net long or net flat at the end of the trading day meant being net long or net flat on the trading day on which the close-out purchase was effected.

In light of the high degree of industry uncertainty around implementation of the Emergency Order enacting Rule 204T, several commenters expressed their view that the rule had unintended negative consequences for some market participants.[34] As SIFMA observed, the rule "inadvertently contributed to increased market volatility, dramatic price spikes, instability in the securities lending markets, and increased costs to investors."[35] For example, since the passage of the rule, certain market participants (including some large mutual fund complexes and some smaller investment companies) suspended their securities lending programs altogether.[36]

Importantly, because of the complexities and ambiguities of the rule, commenters expressed the view that NSCC participants would not always be able to comply with Rule 204T/204(a). In my opinion, it is precisely for this reason that the SEC created Rule 204(b), the "penalty box" prong of Rule 204, which requires NSCC members and their introducing brokers to refrain from short selling the security that was the subject of the short sale fail other than on a pre-borrow basis.

5. *The Division Alleges Highly Technical Violations of Rule 204(a) Unrelated to Abusive Naked Short Sales.*

Against this backdrop, the Division alleges that Penson violated Rule 204T/204(a). More specifically, the Division narrowly alleges that Penson "violated Rule 204T(a)/204(a)'s market-open CNS close-out requirement for long sales of loaned securities from October 2008 until

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[33] *Id.*

[34] *Supra* n.29; Addressing the changes to Reg SHO in spring 2009, Chairperson Mary Schapiro observed that "[t]his is an issue that has both strong supporters and detractors—and we will be very deliberative in our effort to determine what is in the best interest of investors." Address to the Council of Institutional Investors, Chairperson Mary L. Schapiro, SEC, Spring 2009 meeting.

[35] *See supra* n.29.

[36] *See, e.g., SEC Securities Lending And Short Sale Roundtable,* September 29, 2009, transcript available at http://www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf ("...they decided to shut their lending program down..." (remarks by William Pridmore); "Indeed, we have seen...reductions with respect to securities available for loan. Agree that that has created a great deal of pressure on firms, particularly in the environment of the temporary rules and the shift in Reg SHO." (remarks by Richard Ketchum, Chairman and CEO of FINRA); "What we did not expect was the kind of disaster in the securities lending program that we experienced." (Jerry Davis is the Chairman of the Board of Trustees for the New Orleans Employees' Retirement System)).

November 2011."[37] Neither the OIP, nor any of the evidence that I have reviewed, correlate a single fail-to-deliver (much less a close-out requirement), to any long sale of the very same security that was out on loan.

The Division's allegations involve sales of securities that were out on loan—securities held by customers in margin accounts that Penson had loaned out, or rehypothecated, pursuant to a margin account agreement.[38] Broker-dealers such as Penson routinely borrow and re-lend securities held in customer margin accounts, as permitted by Exchange Act Section 15c3-3 and authorized by a customer's margin-account agreement. Among other things, securities lending allows broker-dealers to fund customer margin accounts, make delivery in respect of other customers' short sales, and lend securities to other market participants, all of which has the effect of "improv[ing] market liquidity, reduc[ing] the risk of failed trades, and add[ing] significantly to the incremental return of investors."[39] If a customer sells shares that are out on loan, the broker-dealer can issue a recall notice to its borrowing counterparty, and the borrowing counterparty will return the shares. If the borrowing counterparty does not return the shares by market open on T+6, a Rule 204T/204(a) close out obligation *may* arise.

Only in extraordinarily rare circumstances, is it possible to trace a specific stock loan to a specific customer of a broker-dealer.[40] Similarly, and relevant for Rule 204T/204(a) compliance, the CNS position (long or short) is a *cumulative and aggregate* position (without reference to particularly identified shares in the account). That is particularly challenging at one of the largest clearing firms (during the period at issue) and for transactions involving highly liquid securities. The Division has not traced, nor shown how it could trace, that certain shares were at once the subject of a long sale corresponding to a fail-to-deliver at CNS and simultaneously out on loan as part of a stock loan. Importantly, the type of link/tracing inherent in the Division's allegations has not been part of any rulemaking related to Rule 204T/204(a). It is not found in the SEC's release or other statements related to the regulation of short sales relevant here. Indeed, the Commission has asked for comment on whether tracing may be done.[41] Industry participants have routinely noted that such tracing is not possible,[42] and SEC staff have publicly

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[37] *See* OIP at 3.

[38] The OIP refers to these situations as "long sales of loaned securities."

[39] *See* ICGN Securities Lending Code of Best Practice (2007), available at https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/sec_lending/2007_securities_lending_code_of_best_practice.pdf.

[40] In general, investors' holdings of stock are not matched with particular shares of stock. Broker-dealers like Penson hold securities at DTC in "street name." The broker-dealer's shares are held in "fungible bulk" for the benefit of DTC participants. Broker-dealer participants of DTC own a pro rata interest in an aggregate number of shares of a security held by DTC, and their beneficial owners (*i.e.*, the broker-dealers' customers) own an undivided part interest in the shares in which their broker-dealers have an interest. There are no specific shares directly owned by either the participants (broker-dealers) or the underlying beneficial owner (customers).

[41] See *Short Sales,* SEC Release No. 34-48709 ("Can you trace offering shares in a person's account to show that they are used to cover the preexisting short position as opposed to the short sales executed five days prior to pricing?").

[42] *See, e.g.,* Comments of Alden James on S7-23-03 - U.S. Securities and Exchange Commission, stating that "Lacking a system to trace down which stock is being loaned, it is impossible to determine in any individual case

acknowledged that more data points are needed to effectively track orders.[43]

Indeed, many of the concerns identified by the Commission when it enacted Regulation SHO and Rule 204T/204(a) are not present in this case. The Division does not allege that Penson engaged in or facilitated abusive naked short selling—the type of activity that Rule 204 was primarily designed to address. Nor does the Division allege that Penson facilitated fails to deliver as part of a "scheme" to manipulate the price of any security. Rather, the Division alleges that Penson failed to timely close out CNS failures to deliver resulting from certain "long sale of loaned security" transactions.[44]

These transactions, however, involve significantly less risk than naked short sale transactions. Unlike naked short sale transactions, in a long-sale-of-loaned security transaction the seller owns the shares that are being sold. The shares exist, they just need to be returned by the borrowing counterparty, which the borrowing counterparty is contractually obligated to do.[45]

Further, the Division does not allege that Penson *wholly failed* to close out CNS failures to deliver resulting from long sales of loaned securities; rather, the Division alleges that Penson failed to close out CNS failures to deliver resulting from some "long sales of loaned securities" *by market open T+6.*[46]

B. None of the "red flags" advanced by the Division would have alerted Mr. Yancey to "systemic" and "intentional" violations of Rule 204T/204(a) for "long sales of loaned securities."

I have been asked to opine about whether the "red flags" advanced by the Division would have alerted Mr. Yancey to "systemic" and "intentional" violations of Rule 204T/204(a) for "long sales of loaned securities." It is my opinion that none of the "red flags" advanced by the Division would have alerted Mr. Yancey to "systemic" and "intentional" violations of Rule 204T/204(a) for "long sales of loaned securities." My opinion is based on my knowledge and experience with clearing firms, my knowledge and experience with trading and markets, my knowledge and experience of the general hierarchy of rules and regulations applicable to clearing firms, and my personal involvement in the rulemaking process for the adoption by the SEC of Rule 204T/204(a) during my tenure at the SEC.

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whose stock is being sold or is being purchased in a short sale and, ultimately, who it is who holds real shares and who holds artificial shares." available at http://www.sec.gov/rules/proposed/s72303/ajames121103.htm.

[43] Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission, *Short Sale Reporting Study; Required by As Required by Section 417 of the Dodd - Frank Wall Street Reform And Consumer Protection Act,* available at http://www.sec.gov/dera/reportspubs/special-studies/short-sale-position-and-transaction-reporting.pdf ("Comparison of the Current and Potential Future Data - Relative to currently available data, identified Real-Time Short Position Reporting would provide to the Commission and FINRA readily available information on the short seller and would better enable them to track individual short sellers' positions and changes in those positions.")

[44] *See* OIP at 5.

[45] This contract is known as the Master Securities Lending Agreement.

[46] *See* OIP at 5.

There are four essential elements of a failure to supervise claim: (1) an underlying violation of the securities laws; (2) association of the registered representative or other person who committed the violation; (3) supervisory jurisdiction over that person; and (iv) failure to reasonably supervise the person committing the violation.[47]

"Reasonableness" is the standard established by the SEC and FINRA for evaluating the adequacy of supervision by broker-dealers and registered principals. Accordingly, supervisory structures, policies, and procedures differ from one broker-dealer to another depending on a number of factors, including the size of the firm and what each firm deems to be reasonable for the type of business that it operates.

1. The evidence submitted by the Division does not clearly demonstrate Rule 204T/204(a) violations arising from "long sales of loaned securities."

At the outset, I note that evidence submitted by the Division fails to clearly demonstrate Rule 204T/204(a) violations arising from "long sales of loaned securities" and is inconsistent with the Division's allegations in the OIP. The Division alleges that Penson "systematically" and "intentionally" violated Rule 204(a):

> Penson's Stock Loan generated revenue and financed Penson's operations by loaning out shares held in customer margin accounts. When the customers sold those shares, Penson had a CNS delivery obligation arising from the sale but, due to the open stock loan, did not have shares on hand with which to fulfill that obligation.[48]

But the evidence submitted by the Division is far too tenuous to support this conclusion.

a. The evidence previously identified by the Division as reflecting 222 purportedly violative transactions does not clearly demonstrate Rule 204(a) violations arising from "long sales of loaned securities."

I reviewed a letter from Michael MacPhail to Jonathan M. Warner dated March 12, 2012, and I have analyzed the documents attached to that letter. The Division has asserted to the Court that the documents attached to the letter "show[] that Penson's Stock Loan department violated Rule 204(a) as many as 222 times in one representative month."[49] This assertion is incorrect. These materials do not demonstrate Rule 204T/204(a) violations because: (1) they lack important information about closeout activity and (2) they do not consider other factors that could reduce or eliminate fail positions.

The 222 rows of data listed in Attachment B to the letter are insufficient to determine whether any Rule 204(a) violation occurred because they lack important information about close-out activity. Attachment B includes data for 222 transactions in the following categories:

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[47] *See Dean Witter Reynolds, Inc.*, Admin. Proc. Rulings Release No. 179, 2001 WL 47244 at *38 (Jan. 22, 2001).

[48] *See* OIP at 2.

[49] *See* Division's Opposition to Respondent Yancey's Motion for a More Definite Statement at 6-7.

"BIZDATE; BOOK-GROUP; SECID; CLOSING PRICE; T+5 AGED QTY; AMT EXTENDED; RECALL QTY EXTENDED; and RECALLED COUNTERPARTIES EXTENDED QTY." Although one column is titled "T+5 AGED QTY," it is unclear whether and how to count the CNS balance for any of the CUSIPS noted therein. For example, the spreadsheet does not reflect whether Penson had a pre-fail credit that it could claim for purchases made during the prior days. Nor does the spreadsheet reflect whether Penson had shares in inventory that it could use for delivery. Nor does it reflect whether the transactions resulted solely from purchase and sale transactions. Rule 204(a) closeout obligations apply only to a net fail to deliver position that results from purchase and sale transactions. Because NSCC aggregates all of a participant's receive and delivery obligations, the net position will include delivery obligations, which may be in a fail to deliver status, that *do not result from purchase and sale transactions*.

Attachment B is also insufficient to determine whether any Rule 204(a) violation occurred because it does not account for other factors that could reduce or eliminate the a fail position. Because Rule 204 allows the clearing firm to purchase shares to close out a fail to deliver position before market open on the morning of T+6—and there is a three-day settlement delay between execution and settlement of that trade—the CNS report may show a fail for four consecutive days notwithstanding that the clearing firm has fully complied with Rule 204.

Thus it is impossible to determine whether a Rule 204(a) violation occurred from the information contained in this data. The data do not even reflect 222 fail-to-deliver positions, let alone 222 Rule 204T/204(a) violations. It is my opinion that the Division's representation to the Court that this data "show[s] that Penson's Stock Loan department violated Rule 204(a) as many as 222 times in one representative month" is inaccurate and misleading.

b. The investigative testimony does not clearly demonstrate Rule 204(a) violations arising from "long sales of loaned securities."

I have also reviewed investigative testimony from Brian Hall, Penson's former Vice President of Global Equities Finance, Mr. Hall's cooperation agreement, and the cooperation agreements of Rudy DeLaSierra, Penson's former Vice President of Global Equities Finance, and Brian Gover, Penson's former Vice President of Operations, in which these individuals state that Penson's Stock Loan Department was not consistently closing out failures to deliver resulting from long sales of loaned securities by market open T+6. As discussed above, this testimony does not—in and of itself—in any way demonstrate "systematic" and "intentional" violations of Rule 204(a). The additional factors I discussed above would also have to be considered before a determination could be made regarding a possible Rule 204T/204(a) violation.

2. There is no evidence that Mr. Yancey was aware of "systemic" and "intentional" violations of Rule 204(a).

While neither scienter nor willfulness is an element of a failure-to-supervise charge, scienter is an important consideration in evaluating the <u>*reasonableness*</u> of supervision. I begin with the conclusion that Mr. Yancey had no knowledge of "intentional Stock Loan Rule 204(a)

violations."[50] I arrive at this conclusion for several, independent reasons.

First, the SEC does not allege or suggest that Mr. Yancey was aware of systemic, intentional Rule 204(a) violations. In fact, the Division repeatedly alleges that Mr. Yancey was *not aware* of such conduct. Indeed, if the SEC believed that Mr. Yancey knew about systemic, intentional Rule 204(a) violations, it likely would have asserted aiding and abetting claims against Mr. Yancey, rather than supervisory claims.

Second, the Division does not allege that anyone raised the issue of intentional Rule 204(a) violations to Mr. Yancey. For example, the Division alleges that a supervisor in the Buy-Ins department became aware of Rule 204(a) issues involving long sales of loaned securities, but the Division does not allege that this supervisor brought the issue to Mr. Yancey's attention. Similarly, the Division alleges that Mr. Delaney, the Chief Compliance Officer, also never raised the issue of intentional Rule 204(a) violations with Mr. Yancey:

> Delaney did not investigate the violations or report his findings to members of senior management where Stock Loan supervisors reported. Indeed, Delaney never escalated his knowledge about Stock Loan's Rule 204T(a)/204(a) violations to Yancey . . . .[51]

Third, the Division repeatedly alleges that the purported Rule 204(a) issues were *actively concealed* from Mr. Yancey:

- "Delaney also substantially assisted the intentional Rule 204(a) violations relating to long sales of loaned securities by attempting to conceal them from Yancey."[52]
- "Delaney withheld this critical information from Yancey."[53]
- "Delaney withheld this critical information about the Rule 204T(a)/204(a) violations relating to long sales of loaned securities, along with his and [Mr. Johnson's] misconduct, in other key interactions with Yancey."[54]
- "Delaney direct[ed] Yancey away from Stock Loan's Rule 204T(a)/204(a) compliance and repeatedly [withheld] the critical information about [Mr. Johnson's] own misconduct from Yancey . . . ."[55]

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[50] *See* OIP at 3.

[51] *See* OIP at 7. *See also* OIP at 13 (stating that (1) "Delaney did not inform Yancey of the closely-related, ongoing Rule 204(a) violations relating to long sales of loaned securities" and (2) "Delaney [did not] inform Yancey of his agreement just months earlier with the Senior Vice President of Stock Loan not to implement compliant procedures and to reject procedures that would have brought Penson into compliance with Rule 204(a) for long sales of loaned securities").

[52] *See* OIP at 12.

[53] *See* OIP at 12.

[54] *See* OIP at 12.

[55] *See* OIP at 13.

Fourth, I have reviewed the cooperation agreements that the Division obtained from former Penson employees Rudy DeLaSierra, Brian Hall, and Brian Gover in connection with this litigation. None of these three witnesses claim to have raised the alleged Rule 204(a) issues with Mr. Yancey. None of these individuals suggest, explicitly or implicitly, that Mr. Yancey knew about systemic, intentional Rule 204(a) violations.

Accordingly, based on the evidence that I reviewed as described above, I conclude that Mr. Yancey had no knowledge of "systemic and intentional" Rule 204(a) violations during the relevant time period.

Because there is no competent evidence that Mr. Yancey knew about "systemic" and "intentional" Rule 204T/204(a) violations, the Division posits that Yancey ***should have known*** about "intentional Stock Loan violations" of Rule 204T/204(a). The Division argues that Mr. Yancey, the president and CEO of the second-largest clearing firm in the United States, should have "detect[ed] and prevent[ed]" intentional violations of Rule 204T/204(a) with respect to long sales of loaned securities.[56] For the reasons stated below, I disagree. It is my opinion that, with respect to Rule 204T/204(a), Mr. Yancey acted in accordance with a reasonably designed supervisory system.

3. Penson was one of the largest clearing firms in the United States.

As noted in the OIP, Penson was one of the largest independent clearing firms in the United States.[57] Penson had over 250 active securities clearing correspondents and over 60 futures clearing correspondents. Penson was the second largest clearing and settlement firm in the United States by number of correspondents, which included online, direct access, and traditional brokers, as well as hedge funds, large banks, institutional investors, and financial technology firms in the United States, Canada, Europe, and Asia.[58] At its height, Penson had approximately 600 employees worldwide.

Penson cleared a massive volume of trades during the relevant time period. At times, Penson was clearing between one and two million trades per day. The trade data produced by the Division in connection with this litigation, which I have reviewed, reflects that Penson cleared approximately one billion trades during the relevant time period. Moreover, the record reflects that Penson's operations were complex; a large percentage of Penson's correspondents were very complicated, high-frequency trading firms.

Thus, Mr. Yancey was not the President and CEO of a small one or two person shop—he was the chief executive of a global securities clearing organization that settled an enormous number of trades on a daily basis.

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[56] *See* OIP at 3.

[57] *See* OIP at 1, 4 ("[F]rom at least 2010 to 2012, [Penson] was one of the largest clearing firms in the United States as measured by the number of correspondent brokers for which it cleared.").

[58] *See* InvestmentNews, "Clearing firms ranked by number of broker-dealer clients," July 11, 2010, available at http://www.investmentnews.com/article/20100711/CHART02/100709894&issuedate=20100711&sid=CLEAR. At this time, Penson served over 200 broker-dealer clients.

4. Rule 204T/204(a) is a highly technical rule that is not implemented at the senior management level.

The securities, futures, and derivatives industries are among the most regulated businesses in the United States. The Securities Exchange Act of 1934, rules of the SEC promulgated under the Act, and rules prescribed by self-regulatory organizations ("SROs"), such as FINRA, comprise an extensive scheme of regulation for broker-dealers. Within the broker-dealer, senior management plays a significant role in the adoption and maintenance of a comprehensive system of policies and procedures that are reasonably designed to achieve compliance with the federal securities laws and FINRA rules.

As a result, in addition to managing the company to profitability and delivering shareholder value, the CEO of a broker-dealer must also prioritize an extensive number of rules and regulations regarding, among other things:

- Net Capital
- Customer Protection
- Bank Secrecy Act Requirements and Anti-Money Laundering regulations
- Sales Practices, which include, for example, rules by the SEC and by FINRA related to marketing, suitability, know your customer obligations, and trade confirmations
- Trading Practices, which include, for example, Regulation SHO and Regulation M, among others
- Regulation T, Regulation U, and other banking regulations applicable to broker-dealers
- Licensing and registration requirements

Because of the breadth and complexity of this regulatory framework, a CEO of a large broker-dealer is not expected to have significant involvement in the operational aspects of regulatory compliance. Rather, a reasonable CEO is expected to build a capable management team comprised of individuals who possess the requisite knowledge, skill, and experience to implement policies and procedures designed to ensure compliance. Accordingly, while the president of a corporate broker-dealer is generally responsible for compliance with all of the requirements imposed on his or her firm, the president may reasonably delegate particular functions to other qualified persons in the firm, provided the president neither knows nor has reason to know that such person's performance is deficient.[59]

As FINRA explains, a broker-dealer is not required to conduct "detailed reviews of each transaction;" rather, the broker-dealer may use a reasonably designed risk-based review system that allows it to focus on the areas at greatest risk of violations.[60]

SEC rules and regulations are designed to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. Each rule serves a purpose, and each rule is important. But it is widely-recognized—particularly within the securities industry—that while

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[59] *See, e.g., Sheldon v. SEC*, 45 F.3d 1515, 1517 (11th Cir. 1995), *quoting Universal Heritage Invest. Corp.*, 47 S.E.C. 839, 845 (1982) (finding securities firm's president had properly delegated duties).

[60] *See* FINRA Rule 3110.05 Risk-based Review of Member's Investment Banking and Securities Business.

the CEO sets the tone at the top, the day-to-day implementation of a framework for compliance will be handled at the operational level. This was the case with Rule 204T/204(a).

Rule 204T/204(a) is an exceedingly technical rule, which the SEC designed to be implemented at the operational level. In my opinion, based on my experience with Rule 204T/204(a) and the available public record, Rule 204T/204(a) was not to be administered by the most senior executives at a broker-dealer; rather, Rule 204T/204(a) was designed to be implemented and managed by associated persons of the broker-dealer at the operational level. I am not aware of any public statement by the SEC, or any current or former SEC staff members, that would indicate otherwise.

My opinion is supported by the diligence that SEC staff performed during the development of Rule 204T/204(a). I am not aware of anything in the public record reflecting efforts by SEC staff to seek, during the development of Rule 204T/204(a), comments from the President/CEO of any broker-dealer regarding the mechanics of complying with the rule; rather, SEC staff solicited comment from market participants at the operational, line-level regarding the proposed requirements of Rule 204T/204(a).

5. None of the "red flags" advanced by the Division would have alerted a reasonable CEO to systemic, intentional violations of Rule 204T/204(a) for long sales of loaned securities.

The Division asserts that Mr. Yancey failed to supervise Mr. Delaney by failing to follow up on red flags regarding intentional violations of Rule 204T/204(a) involving "long sales of loaned securities."[61] The Division alleges that the following red flags should have alerted Mr. Yancey: (1) results from a December 2009 audit; (2) Mr. Johnson's absence from a meeting; (3) Penson's March 2010 CEO certification to FINRA; and (4) Penson's response to the Office of Compliance Inspections and Examinations' ("OCIE") Regulation SHO exam in November 2010. It is my opinion that none of these four instances would have alerted Mr. Yancey of "systemic" and "intentional" violations of Rule 204T/204(a) for long sales of loaned securities.

a. The results of the 2009 audit were not a red flag.

The Division asserts that "the 99% violation rate for Buy-Ins' Rule 204T/204(a) procedures uncovered by the December 2009 [Rule 3012] audit was a significant red flag to Yancey that Penson had systemic Rule 204 deficiencies and that Delaney, whom he supervised, might bear responsibility for those deficiencies."[62] I have reviewed the results of the December 21, 2009 3012 audit ("December audit"), as well as documents and testimony related to this audit, and it is my opinion that the December audit results would not have alerted a reasonable CEO of a large broker-dealer of systemic, intentional violations of Rule 204T/204(a) involving "long sales of loaned securities."

FINRA Rule 3012 requires designated principals to submit, no less frequently than

[61] *See* OIP at 14-16.

[62] *See* OIP at 14.

annually, a report to the member's senior management that details the firm's system of supervisory controls, the summary of the test results, and any additional or amended supervisory procedures that have been created in response to those results.[63] Testimony demonstrates that, consistent with Rule 3012, Penson had a robust, risk-based 3012 testing program, which included resources dedicated to 3012 testing. The results of each test were communicated to the relevant parties via a form that discussed the test's objectives, procedures, results, recommendations, response from the business units, remedial measure plan, deadline for remedial measures, and the parties responsible for remediation.

For multiple reasons, the December audit results would not have alerted the President/CEO to "systemic" and "intentional" violations of Rule 204T/204(a) involving "long sales of loaned securities." First, the Division's characterization of the audit results as reflecting a "99% violation rate" is misleading. The December audit was conducted over a 10-day period, November 16-20, 2009 and December 7-11, 2009. Based on the average number of trades that Penson cleared on a daily basis, Penson would have cleared between 7 and 10 million trades during this two-week period. As the below diagram illustrates, the December audit results reflect that out of these 7 to 10 million trades, approximately ***113 total transactions*** resulted in fail to deliver positions that necessitated a Rule 204T/204(a) buy in.

Thus, Penson was successfully closing out, through the delivery or borrowing of shares, the overwhelming majority of its transactions. No broker-dealer is perfect. The fact that some violations of a highly technical rule like Rule 204T/204(a) were found is not surprising. This is particularly the case when the broker-dealer is as complex an operation as Penson. In the context of the volume of trades that Penson was successfully clearing, these results would not have been a "red flag" to a CEO, particularly where the CEO is promptly assured that remediation efforts were underway.

Second, the December audit results do not reflect a failure to ever, or with lengthy delay, close out fails to deliver arising from customer long and short sales; rather, the audit results reflect a failure to close out fails to deliver resulting from customer transactions by *market open* on T+6. For short sales, Penson was 30 to 75 minutes late in closing out the fail to deliver position. For long sales, Penson was 240 to 379 minutes late in closing out the fail to deliver

[63] *See* FINRA Rule 3012.

position. Thus, all of the tested transactions resulted in T+6 close outs, albeit not all before market open. While this data may show difficulties in compliance, the data do not reflect a "systemic" or "intentional" failure.

Third, as the Division concedes, the December audit did not test the buy-in procedures of the Stock Loan department. ***Thus, the December audit did not test buy-in procedures related to "long sales of loaned securities."***[64] The December audit tested: (1) the timing of buy-ins executed to close out fails to deliver arising from the *customer side* of the business (fails arising from customer long and customer short transactions) and (2) Penson's penalty box procedures. The Buy-Ins department was responsible for closing out fails arising from these customer transactions. On the other hand, Penson's Stock Loan department was responsible for closing out fails arising from stock loans. The December audit only tested the buy-in procedures of the Buy-Ins department (the customer side); it did not test the buy-in procedures handled by the Stock Loan department ("long sales of loaned securities").

The Buy-Ins and Stock Loan departments were completely separate departments. They were located on different floors, had different managers, and were staffed by different personnel. This is not unusual as there are significant benefits to this structure. The two departments dealt with different groups. The Buy-Ins department dealt with customer relationships, which necessarily required softer handling. The Stock Loan department, on the other hand, dealt with lending and borrowing counterparties. The different groups required different levels of relationship management. To the extent that the December audit reflected issues closing out fails to deliver on the ***customer*** side of the business, this was in no respect a "red flag" regarding the buy in procedures of Penson's Stock Loan department.

Importantly, even though the December audit was not a red flag with respect to long sales of loaned securities, Mr. Yancey asked the Compliance department whether they needed to get Mr. Johnson involved, presumably because the Stock Loan department handled Penson's obligations with respect to Rule 204(b), the penalty box provision of Rule 204. The December audit noted that the securities that were not timely closed out were placed in the "penalty box." Both Mr. Delaney and Eric Alaniz, an employee in Penson's Compliance department, told Mr. Yancey that there was no need to get Mr. Johnson involved.

The results of the December audit became the focus of prompt remediation. The audit resulted in detailed recommendations for remedying the issues identified in the test. Mr. Yancey was made aware of the December audit results and the remediation plan at a January 28, 2010 meeting. The Compliance department assured Mr. Yancey that the issues identified in the audit were the focus of prompt remediation. Indeed, the Division concedes that these issues identified in the December audit became the subject of extensive remediation efforts.[65]

Consistent with a reasonably designed supervisory system, the Buy-Ins department's procedures related to fails caused by customer shorts were tested again in June 2010 (the "June audit") and spot checked in 2011. The results showed significant improvement. The June audit

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[64] *See* OIP at 14.

[65] *See* OIP at 8.

tested a one-month period (May 2010) during which Penson cleared approximately 15-20 million trades. Out of these millions of transactions, the June audit identified 24 required buy-ins that were submitted to the trade desk. Of these 24 transactions, 11 were not performed by market open. The average length of delay for these 11 transactions was ***6.2 minutes*** after market open. In the 2011 spot check, the compliance department observed that market open close-outs were consistently being met.

The record reflects that Penson had controls in place to continually test and evaluate its supervisory systems and procedures. Pursuant to this system, Penson conducted routine 3012 audits. One of the audits, the December audit, uncovered an issue with the Buy-Ins department's ability to close out fails to deliver caused by Penson's customers. The issue became the focus of prompt remediation efforts. Mr. Yancey was assured by the Compliance department that the issue was being remediated. And the issue was promptly remediated, retested, and spot checked. The Division itself concedes that the remediation efforts were swift, extensive, and successful.

For these reasons, it is my opinion that the December audit was not a "red flag" for Mr. Yancey with respect to the Stock Loan department's compliance with Rule 204 procedures for long sales of loaned securities.

b. Mike Johnson's absence from a March 2010 meeting was not a red flag.

The Division next asserts that Mr. Johnson's absence from a March 2010 meeting at which the results from the December 2009 audit were discussed was "another fact that should have prompted vigorous follow up from Yancey."[66] It is my opinion that Mr. Johnson's absence from this meeting would not have been a red flag to the CEO of a broker-dealer regarding 204T/204(a) procedures. First, Mr. Yancey had already inquired in January as to whether Mr. Johnson needed to be involved, and he was told by his Chief Compliance Officer that Mr. Johnson did *not* need to be involved. Having been assured by his CCO and others that Mr. Johnson's involvement was not needed, Mr. Johnson's absence from a single meeting would not have been a red flag to a reasonable CEO. Second, the record reflects that another member from the Stock Loan department attended the meeting. Lastly, the March 2010 meeting invitation to Mr. Johnson was not even sent by Mr. Yancey. The invitation was sent from a line-level member of the Compliance department. Any suggestion that Mr. Yancey instructed the head of Stock Loan to attend this meeting, and he refused, is incorrect.

c. Penson's March 2010 CEO certification was not a red flag.

The Division next asserts that the absence of the December audit results from Penson's Rule 3130 Annual CEO Certification in March 2010 should have alerted Mr. Yancey to the "systemic" and "intentional" Rule 204(a) violations allegedly caused by Penson's Stock Loan department.[67] I disagree.

Per FINRA, the proper and necessary content of a 3130 report is "document[ation of] the

[66] *See* OIP at 14.

[67] *See* OIP at 15.

member's processes for establishing, maintaining, reviewing, testing and modifying compliance policies that are reasonably designed to achieve compliance" with applicable SEC and SRO rules.[68] The report "should include the manner and frequency in which the processes are administered, as well as the identification of officers and supervisors who have responsibility for such administration."[69] The report "need not contain any conclusions produced as a result of following the processes set forth [in Rule 3130]."[70]

The 3130 CEO Certification and Report that Penson submitted to FINRA on March 31, 2010 is consistent with the requirements of the rule. The certification tracks the language recommended by FINRA and the report: (1) successfully identifies the officer responsible for the report (Mr. Delaney); (2) identifies which department is responsible for the testing (internal compliance department); (3) identifies the amount of time spent executing the testing plan (1760 hours); (4) identifies additional testing (by AML consultants); (5) identifies factors considered for determining which areas would be tested; and (6) states that the tests in some instances resulted in remedial measures.

Nor was there an omission from the 3012 Summary Report that would have made a reasonable CEO of a large broker-dealer aware of purported "systemic" and "intentional" violations of Rule 204T/204(a) with respect to long sales of loaned securities. First, the 3012 Summary Report was a ***summary report***. By definition, it would not have included all issues or the results from every 3012 audit that the firm performed throughout the year. Second, the results of the December 3012 Rule 204 audit were discussed at the March 31, 2010 3130 meeting. As the Division concedes, Mr. Yancey was again assured at this meeting that remediation measures were underway.[71] As Eric Alaniz testified, Mr. Yancey's operations managers, John Kenny (COO) and Brian Gover (V.P. of Operations), also discussed with Mr. Yancey at this meeting their Reg SHO and Rule 204 remediation and compliance efforts. Third, the 3012 Summary Report was prepared by Mr. Delaney. To the extent that Penson's WSPs required the Summary Report to include a review of "key compliance issues," it was Mr. Delaney's responsibility as CCO to determine whether an issue rose to the level of a "key compliance issue." It is both reasonable and customary for the CEO of a broker-dealer to rely on the recommendations and conclusions of his or her Chief Compliance Officer.

Further, it is my opinion, based on the facts and circumstances, that the results of the December audit did not rise to the level of a "key compliance issue." Put in context, Penson was clearing approximately one million equity transactions per day. The December audit revealed an extraordinarily small subset of trades that the Buy-Ins department failed to close out before market open via a buy in. The issue was brought to Mr. Yancey's attention, a plan was developed to remediate the issue, and the Compliance, Buy-Ins, and Stock Loan departments began executing that plan. Given the number of regulatory inquiries that Penson received, by virtue of the volume of transactions that it was clearing, it is both logical and understandable that

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[68] *See* FINRA Rule 3130, Supplemental Material 3130.10 (emphasis added).

[69] *Id.*

[70] *Id.*

[71] *See* OIP at 12-13.

the technical violations identified in the December audit would not warrant inclusion on a list of "key compliance issues."

d. Penson's November 2010 OCIE response was not a red flag.

Lastly, the Division asserts that Penson made misrepresentations in its November 2010 response to OCIE's deficiency findings. Specifically, the Division alleges that Penson's statement to OCIE that Penson's Rule 204T/204(a) processes were "reasonable," "effective," and "performed as designed" was "false in light of the December 2009 audit results."[72] I do not believe that Penson's response would have alerted a reasonable CEO that individuals in the firm's Stock Loan department were systematically and intentionally violating Rule 204T/204(a).

First, it was repeatedly communicated to Mr. Yancey that the issues identified in the December 3012 audit were the focus of prompt remediation efforts. This fact is confirmed by the follow up test that the Compliance department conducted in June 2010. Thus, Penson's testing procedures were, in fact, effective and performed as designed, particularly given the highly technical nature of Rule 204T/204(a).

Second, the record reflects that Mr. Yancey was not involved in the drafting of the OCIE response. Penson's OCIE response was drafted by members of the Compliance and Operations departments. Mr. Yancey was entitled to rely on the conclusions reached by these qualified individuals, especially when Mr. Yancey had independently confirmed that the issues identified in the December 3012 audit had been the focus of prompt remediation efforts.

C. The policy underlying Rule 204T/204(a) did not contemplate the conduct by Yancey that is alleged to have violated the securities laws.

Regulation SHO does not contain a duty to ferret out possible violations without cause. Rule 204T/204(a) is concerned with a participant's fail to deliver position at a registered clearing agency. Rule 204's concern with individuals directly involves the requirement that the "participants [i.e., the broker-dealer] should consider having in place policies and procedures to help ensure that delivery is being made by settlement date."[73]

In Rule 204T/204(a), the SEC did not impose enhanced supervision requirements on broker-dealers or their associated persons. Rather, the SEC reminded broker-dealers that they must comply with any applicable SRO policies and procedures requirements (noting specifically, NASD Rule 3010). Neither Rule 204T/204(a), nor any case of which I am aware, imposes liability of a president/CEO of a broker dealer not involved in operations, based on "red flags by omission."

The Division concedes that Mr. Yancey was not informed of "systemic" and "intentional" violations but argues that omissions should have prompted Mr. Yancey to inquire further. The record reflects that Mr. Yancey did just that.

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[72] *See* OIP at 16.

[73] Release 34-60388 (July 27, 2009), 74 FR 38266.

Penson had reasonable policies and procedures related to Rule 204T/204(a) of Regulation SHO. The record reflects that Mr. Yancey understood that Penson's Rule 204T/204(a) policies and procedures were reasonably designed and implemented in compliance with, or that responsible Penson staff were taking steps to address, Rule 204T/204(a) of Regulation SHO.

As the SEC Staff has stated, "[m]ost enforcement actions against individuals for failure to supervise have involved business line personnel."[74] That is particularly applicable in the context of highly technical short selling/stock lending/clearing. In the cases implicating senior level executives in the context of short selling, such individuals have been at smaller firms and/or have themselves been involved in the actual day-to-day short selling operations.[75]

It is my opinion that to hold Mr. Yancey responsible for failing to supervise Mr. Delaney and Mr. Johnson based on purported violations of a highly technical rule and of which the SEC concedes Mr. Yancey was not made aware would result in a significant extension of Rule 204T/204(a) and would cause uncertainty and confusion among senior-level managers at broker-dealers as to their supervisory responsibilities.

Executed this 5th of November, 2014

Marlon Q. Paz

[74] *See* Division of Trading and Markets, Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers Under Sections 15(b)(4) and 15(b)(6) of the Exchange Act (September 30, 2013), available at http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm.

[75] *Cf., In The Matter Of OptionsXpress, Inc. And Jonathan I. Feldman*, Administrative Proceeding File No. 3-14848, November 5, 2013 (noting that Stern "was very much involved in buy-ins for a couple of weeks when Rules 204T and 204 took effect September 18, 2008, and July 31, 2009, respectively, and that he worked on responsive buy-in procedures with David Fisher, CEO of optionsXpress Holdings, Bennett, and Hoeh.").

EXHIBIT A – Curriculum Vitae

MARLON Q. PAZ

EXPERIENCE

Locke Lord LLP, Washington, DC — October 2012-present
Partner

Partner concentrating on securities matters, business litigation, white collar defense and internal investigations. Handle a wide range of complex securities issues (in the regulatory and litigation context), internal investigations and compliance (including the Foreign Corrupt Practices Act), and global anti-corruption matters.

Georgetown University Law Center, Washington, DC — August 2008 - present
Adjunct Professor of Law

- Teach courses on U.S. regulation of financial institutions and the securities markets, and international litigation and investigations.
- Serve as faculty advisor to students conducting graduate independent study.

Inter-American Development Bank, Washington, DC — June 2010 – October 2012
Principal Integrity Officer

Managed team of lawyers and investigators in Office of Institutional Integrity, the office that investigates fraud and corruption in all bank-financed activities, carries out prevention and compliance activities designed to improve the bank's integrity policies and mechanisms, and engages in outreach on integrity-related issues. Responsible for managing OII budget, hiring and work plan. Work extended to 26 countries in Latin America and the Caribbean.

U.S. Securities and Exchange Commission, Washington, DC — August 2004 - June 2010
Senior Special Counsel to the Director, GS-16, Division of Trading and Markets

- Advisor to Director of Division of Trading and Markets and liaison to Division of Enforcement.
- Central role developing the SEC's positions on many important regulatory and enforcement matters, including initiatives to address financial stress in the markets. Significant responsibility for developing rule to require disclosure of short sales by hedge funds and other large investors; formulating options to revise regulation of investment advisers and broker-dealers; devising recommendations to improve the regulatory framework to facilitate global market access; and proposing rule to streamline the processing of rule filings submitted by self-regulatory organizations.
- Coordinated with Commissioners and senior officials from other Divisions and offices throughout the SEC on matters of interest to the Division of Trading and Markets. Performed wide range of senior management functions for Director.
- Counseled attorneys in the Division of Enforcement conducting investigations involving novel and complex issues under the federal securities laws, particularly in matters involving broker-dealers, hedge funds, prime brokers, research analysts and the securities markets. Areas of substantive expertise include fraud, short sales, manipulation, trading practices, supervision, insider trading, information barriers, conflicts of interest, net capital, books and

records, and registration.
- Formulated recommendations to the Commission for regulatory improvement of trading practices, including release on client commission practices (soft dollars) and recommendations related to Reg. M (manipulation) and Reg. SHO (short sales).

Grant & Eisenhofer, P.A., Wilmington, DE October 2002 - August 2004
Associate
- Represented financial institutions and pension funds in complex corporate and securities litigation.
- Successfully defended motions in several high profile securities litigation matters, including *WorldCom Securities Litig.*, *Global Crossing Securities Litig.*, and *Parmalat Securities Litig.*
- Represented investors in proxy contests. Drafted requests for SEC no-action letters.

Morris, James, Hitchens & Williams LLP, Wilmington, DE November 2001 - September 2002
Associate
- Represented corporations or directors in litigation involving governance, control, and fiduciary duty.
- Drafted pleadings, motions, affidavits, briefs, and memoranda on securities and corporate law.
- Served as Delaware counsel to investors, lenders, and trustees.

Paul, Hastings, Janofsky & Walker LLP, Los Angeles, CA August 1999 - October 2001
Associate
- Represented financial institutions and corporations in corporate finance matters.
- Assisted clients with arbitration before FINRA. Drafted requests for SEC no-action letters.

EDUCATION

Georgetown University Law Center, Washington, DC
Master of Laws, with distinction, Securities and Financial Regulation, May 2008

University of Pennsylvania Law School, Philadelphia, PA
Juris Doctor, May 1999
Activities: Small Business Clinic (competitively selected); *Co-Chair*, International Law Society.

Wesleyan University, Middletown, CT
Master of Arts, Liberal Studies, May 1996

Trinity College, Hartford, CT
Bachelor of Arts, Philosophy, May 1994
Activities: *President*, Student Government; *Student Trustee*, Board of Trustees; *Teaching Assistant.*

HONORS

- Named to Washington, D.C. Super Lawyers (2013, 2014)
- Graduate, 2013 DC Bar Leadership Academy (competitively selected)
- Recognized as one of the *Top 20 Latino Leaders Under 40, Latino Leaders* Magazine (1/10).
- *Leadership Award*, Hispanic National Bar Foundation (7/09).
- Named one of the *100 Most Influential U.S. Hispanics, Hispanic Business* Magazine (10/08).
- *Rising Legal Star,* Hispanic Bar Association of the District of Columbia (11/06).
- *Ambassador,* American Bar Association, Section of Business Law (10/06).

- *Regional President of the Year Award*, Hispanic National Bar Association (9/06).

PROFESSIONAL ACTIVITIES

- American Bar Association, Business Law Section, International Business Law Committee (*Chair, International Banking and Finance Subcommittee*); Federal Securities Regulation Committee, (*Vice-Chair, Trading and Markets Subcommittee*).
- Hispanic Bar Association of the District of Columbia (*Past President).*
- Delaware Bar Foundation (*Former Director*); Multicultural Judges and Lawyers, Delaware Bar Association (*Former Vice-Chair and Special Advisor).*
- Hispanic National Bar Association (*Former National Vice-President).*

PRIOR EXPERT TESTIMONY

- *None*

SELECT SPEAKING ENGAGEMENTS

- *Minimizing Marketing and Promotional "Slush" Fund Pitfalls: How to Implement Effective Controls to Minimize FCPA Exposure*, Global Forum on Anti-Corruption Compliance in High Risk Markets, Washington, DC (7/14)
- *Responding to Crisis: Key Steps in Managing Internal Investigations*, Ethics & Compliance Officer Association Sponsoring Partner Forum 2013, San Diego, CA (5/13)
- *Getting the Right Compliance Infrastructure*, MCCA's 12th Annual CLE Expo 2013 (3/13)
- *Who Guards the Guardians? Public Accountability, Transparency and Oversight in Anti-Corruption Initiatives*, 2013 ILR Annual Symposium (2/13)
- *Managing an Internal Investigations Office*, 13th Conference of International Investigators, Luxembourg (9/12)
- *Determining How to Manage an Internal Investigation*, 8th Annual FCPA and Anti-Corruption Compliance Conference, Washington, D.C. (6/12)
- *Detecting Bribery Schemes and Questionable Transac*tions: Practical Steps to Avoid FCPA Investigations, Minority Corporate Counsel Association, Chicago, IL (3/12)
- *Cross-Border Practice in a Shrinking Global Economy*, ABA Annual Meeting, Toronto, Canada (8/11).
- *Forensic Auditing and its Role in Investigations*, 12th Conference of International Investigators, Washington, DC (5/11).
- *Institutional Integrity and Anti-Corruption Efforts*, Conference on Optimizing Accountability of Public Funds in a Transparent and Efficient Environment, Santo Domingo, Dominican Republic (5/11).
- *Global Anti-Corruption Enforcement*, Minority Corporate Counsel Association, Chicago, IL (3/11).
- *Promoting Integrity: Tools of Investigation and Prevention in the Fight Against Corruption*, International Anti-Corruption Day Conference, San Jose, Costa Rica (12/10).
- *The SEC Speaks in 2009*, Practicing Law Institute, Washington, DC (2/09).
- *Financial Market Meltdown & Its Impact on Litigation, Regulation, and Corporate America,* ABA Section of Litigation, Orlando, FL (2/09).
- *Keynote Address, Impact of the Economic Crisis on the Changing Landscape of the Financial Sector,* ALPFA Finance Summit, New York, NY (1/09).
- *Hedge Funds: Derivatives, Liquidity and Valuation Issues,* ABA, Washington, DC (11/08).

- *Live From the SEC*, ABA Section of International Law, Washington, DC (10/08).
- *Lessons to be Learned from the Financial Crisis*, ABA Section of International Law, Brussels, Belgium (9/08).
- *Hot Topics in Securities Laws,* ABA Annual Meeting, New York, NY (8/08).
- *U.S./E.U. Mutual Recognition in Securities Markets*, Global Business Law Conference, Frankfurt, Germany (5/08).
- *Stock Exchange Competition and International Listings,* Hofstra University, Hempstead, NY (5/08).
- *A Forum on the Future of Financial Regulation,* Brooklyn Law School, New York, NY (5/08).
- *Investment Advisers, Broker-Dealers & Market Turmoil,* ABA Section of Business Law, Dallas, TX (4/08).
- *The SEC Speaks in 2008*, Practicing Law Institute, Washington, DC (2/08).
- *Broker-Dealer Enforcement*, Broker-Dealer Regulation, ALI | ABA, Washington, DC (01/08).

PUBLICATIONS

- *Secondary Markets*, Research Handbook On Securities Regulation In The United States (Jerry Markham and Rigers Gjyshi, Elgar Press (2014).

BAR ADMISSIONS AND OTHER CERTIFICATIONS

- California, Delaware, New York, District of Columbia.
- *Certified Fraud Examiner*, Association of Certified Fraud Examiners.

LANGUAGES

- Spanish (Read, write, and speak fluently).

EXHIBIT B – Facts and Data Reviewed

In preparation of this report I reviewed the OIP and a variety of documents provided to me by Haynes and Boone, including:

- A copy of the Formal Order, dated July 6, 2011.
- A copy of the Wells Notice to Charles W. Yancey, dated April 3, 2011.
- A copy of the Wells Submission from Yancey dated June 7, 2013, July 24, 2013, September 18, 2013, and March 10, 2014.
- A copy of a letter from the SEC's Office of Compliance Inspections and Examinations, dated October 27, 2010.
- A copy of Penson's response to the October 27, 2010 deficiency letter, dated November 24, 2010.
- A copy of a letter from Penson to the SEC, dated September 21, 2009.
- A copy of a letter from Penson to the SEC, dated November 24, 2010.
- A copy of Penson's Execution Services WSPs, 2010.
- A copy of Penson's Execution Services WSPs, dated December 30, 2010.
- A copy of Penson's WSPs, dated January 2010 through December 2010.
- A copy of Penson's WSPs, dated "December 30, 2010 to present."
- Organization Charts for Penson's Buy-Ins, Compliance, Operations, and Stock Loan departments.
- Letter from Michael MacPhail to Jonathan Warner, dated February 11, 2011, and attachments.
- Letter from Michael MacPhail to Jonathan Warner, dated March 13, 2012, and attachments.
- Registered Representative Supervisory Matrices, dated February 26, 2009, May 5, 2009, September 1, 2010, November 1, 2010, April 2011.
- FINRA Exit Meeting report dated October 22, 2010.
- Excerpts of Apex trade data.
- PowerPoint presentations from Penson's 2011 meetings in Washington, D.C.
- Copies of the investigative testimony of the following:
    - Eric Alaniz (4/13/2013)
    - Thomas Delaney (4/4/2012, 8/28/2012, 7/31/2013)
    - Rudy DeLaSierra (4/3/2012, 1/10/2013)
    - Scott Fertig (9/10/2012)
    - Brian Gover (8/16/2011)
    - Brian Hall (7/7/2011)
    - Holly Hasty (4/4/2012, 8/31/2012)
    - Michael Johnson (1/11/2013)
    - Bart McCain (1/23/2013)
    - Marc McCain (8/17/2011)
    - Kimberly Miller (4/3/2012, 8/31/2012)
    - Phil Pendergraft (9/26/2013)
    - Summer Poldrack (8/10/2011)
    - Angel Shofner (8/17/2011)
    - Lindsey Wetzig (8/18/2011)

    - Bill Yancey (1/23/2013)
- Copies of the Division's investigative exhibits (Exs. 1-175).
- A copy of the Declaration of Brian Gover dated January 7, 2014.
- A copy of the cooperation agreement of Brian Hall dated September 13, 2013.
- A copy of the cooperation agreement of Rudy DeLaSierra dated September 17, 2013.
- Copies of Brady Statements provided by the Division on June 30, 2014 and October 6, 2014.
- Expert Report of Larry Harris.
- Expert Report of David Paulukaitis.
- Respondent Charles W. Yancey's Motion for More Definite Statement.
- Answer and Affirmative Defenses of Charles W. Yancey.