FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION, Complainant, v. eBX LLC (CRD No. 138138), Respondent.	Disciplinary Proceeding No. 20100215720-01 Hearing Officer–MC **HEARING PANEL DECISION** October 22, 2015

Respondent eBX LLC inaccurately denoted itself as "principal" instead of "agent" when it reported transactions to FINRA, in violation of FINRA Rules 7230A(d)(7) and 2010. For these violations, eBX is censured and fined $15,000. Respondent failed to report other transactions with the required short sale indicator, in violation of FINRA Rules 6182, 7230(A)(d)(6), and 2010. For these violations, eBX is censured and fined $125,000. In addition, eBX failed to establish and maintain a supervisory system reasonably designed to achieve compliance with FINRA Rules 7230A and 6182, in violation of NASD Rule 3010 and FINRA Rule 2010. For these supervision violations, eBX is censured and fined $200,000. Respondent is also ordered to pay costs.

Appearances

For the Department of Market Regulation, Complainant: Michael W. Bautz, Esq., Lara M. Posner, Esq., and James J. Nixon, Esq.

For eBX LLC, Respondent: Craig S. Warkol, Esq., William J. Barbera, Esq. Kelly Koscuiszka, Esq., and David S. Sieradzki, Esq., Bracewell & Giuliani LLP.

DECISION

I. Introduction

This is a trade reporting case. The Department of Market Regulation believes it is egregious, one of the worst it has encountered in 25 years, requiring severe sanctions. In sharp contrast, Respondent believes the case is about a simple computer programming error and a good-faith legal dispute over FINRA's interpretation of complicated and unclear trade reporting

rules, and does not merit substantial sanctions. Respondent eBX LLC ("eBX" or the "Firm") has been a FINRA member broker-dealer since July 2006.[1] It operates an Alternative Trading System ("ATS") that performs the functions of a stock exchange for the broker-dealers that subscribe to eBX's services.[2] The Firm matches subscriber sell orders with subscriber buy orders.[3]

The relevant period in this case extends from November 2009 to March 2013, during which time eBX matched and reported more than one million agency cross transactions between broker-dealer subscribers who were not members of FINRA. In these, as in all trades it matches, eBX acted in a dual agency capacity, never in a single agency or principal capacity.[4] Nonetheless, because of a programming error, eBX incorrectly identified itself as "principal" rather than "agent" in trade reports it submitted to the FINRA/NASDAQ Trade Reporting Facility ("FN TRF").[5]

During the relevant period, eBX also matched more than 14 million buy orders from subscribers who are FINRA members with short sell orders from subscribers who are *not* FINRA members. In reporting these transactions, eBX did not use either a short sale or a short sale exempt indicator to reflect that the non-FINRA member leg of each match was a short sale.[6]

The Parties do not contest these facts, and eBX concedes that it reported its capacity incorrectly because of the programming error. However, the Parties strongly disagree over whether, under applicable FINRA rules and published guidance, eBX's failure to include short sale or short sale exempt indicators with the transaction reports of the matches involving non-member short sell orders was a violation of FINRA rules. The Department of Market Regulation argues that this constituted egregious misconduct calling for severe sanctions. The Firm insists that it acted reasonably and should not be sanctioned.

II. The Charges Against eBX

The Complaint contains three causes of action, all related to the Firm's trade reporting to the FN TRF.

The first cause of action charges that eBX violated FINRA Rules 7230A and 2010 by identifying itself as "principal" instead of "agent" in reporting the agency cross transactions between non-FINRA member subscribers.

[1] Joint Stipulation of Facts ("Stip.") ¶ 2.

[2] Stip. ¶¶ 4-5.

[3] Stip. ¶ 6.

[4] Stip. ¶¶ 7, 11.

[5] Stip. ¶¶ 11-12.

[6] Stip. ¶¶ 14-15.

The second cause of action alleges that eBX violated FINRA Rules 6182, 7230A, and 2010 by its failure to include short sale indicators in reporting the transactions in which it matched buy orders from FINRA member firm subscribers with short sell orders from non-FINRA member subscribers.

The third cause of action alleges that Respondent violated NASD Rule 3010 and FINRA Rule 2010 because it failed to establish and maintain a supervisory system reasonably designed to achieve compliance with its trade reporting obligations.

III. Summary of Findings

Prior to the hearing, both Parties filed motions for summary disposition. The Hearing Panel granted Market Regulation's motion for summary disposition for the first cause of action, finding no genuine issues of material fact regarding the charge that eBX incorrectly reported more than one million agency cross transactions as principal instead of as agent to the FN TRF. The Panel deferred consideration of sanctions until the hearing. The Panel denied the Parties' motions for summary judgment for the remaining two causes of action.

Based on the testimony and evidence presented at the hearing, and the briefs filed by the Parties, the Panel finds that Market Regulation established the violations alleged in the second and third causes of action by a preponderance of the evidence.

IV. Background

A. The Transactions and the Trade Reports

During the relevant period, eBX engaged FINRA member firm Lava Trading, Inc. ("Lava") to create and maintain the hardware and software systems necessary for eBX to operate its ATS and comply with its trade reporting obligations.[7]

The transactions at issue in the second cause of action had two "legs." The Firm describes the first as its "buy leg" and the second as its "sell leg." The first leg of each transaction was a short sale order for a security submitted to eBX by a non-FINRA member subscriber. The second leg was a buy order submitted to eBX by a FINRA member subscriber for the same security. When eBX matched the orders, the Firm acted as agent for each subscriber.

On eBX's behalf, Lava reported these matched transactions to the FN TRF. The Firm's reports to the FN TRF were "tape" reports. FINRA makes the details of tape reports public, as opposed to "non-tape" reports, which are monitored by FINRA for regulatory purposes or are used to clear trades, but whose details are not made public.[8]

[7] Tr. 159-60.

[8] Tr. 56-57; CX-3.

When there was a member firm on both sides of the matches, eBX has always reported both legs and, where appropriate, included a short sale indicator on the first leg—the buy leg.[9] However, in November 2009, eBX expanded its customer base and began allowing non-FINRA member broker-dealers to subscribe to its services.[10] Accordingly, eBX directed Lava to reprogram its trade reporting systems to properly report transactions involving non-FINRA member subscribers.[11] The Firm delegated the entire responsibility for the reprogramming to Lava. eBX did not review the changes or follow up after Lava completed reprogramming the reporting systems.[12]

As a result of the reprogramming, eBX did not report the first leg of the transactions – eBX's buy from a non-member firm. eBX therefore reported only the second leg – the sale from eBX to the FINRA member firm. During the relevant period, eBX matched over 14 million short sale orders from non-FINRA member subscribers with buy orders from FINRA member subscribers, and reported the transactions to the FN TRF with no short sale or short sale exempt indicator. However, in the reports of its order executions that eBX was required to make to FINRA's Order Audit Trail system ("OATS"), the Firm did include reports of its executions of the first leg of the matches, the non-FINRA member orders to sell short that were not reported to the FN TRF.[13]

B. Market Regulation's Initial Review

Market Regulation conducts routine trade reporting "sweeps" that monitor for discrepancies between the OATS reports of short sales and other trade reports relating to the same transactions. When such a sweep compared eBX's OATS trade reports with its FN TRF trade reports, it generated alerts (or "exceptions") that told Market Regulation of a discrepancy: the OATS reports indicated eBX had executed short sales, but the reports of the same trades submitted to the FN TRF had no short sale indicators, and therefore those trades would be considered long. The original sweep surveyed approximately 150,000 matched OATS and FN TRF reports and revealed discrepancies in 99 percent of the compared reports.[14]

On March 5, 2010, Market Regulation sent eBX a Rule 8210 request letter with a sample of the trades it had reviewed. Market Regulation pointed out that although the trades had been reported to OATS as short sales, the reports of the matches that eBX submitted to the FN TRF were "without a short sale modifier." Market Regulation directed eBX to provide detailed information about each trade, state whether it was short or long, and explain the "discrepancy

[9] Respondent's Post-Hr'g Submission, at 7.

[10] Stip. ¶ 8; Tr. 161.

[11] Stip. ¶ 9; Tr. 161.

[12] Tr. 162.

[13] Tr. 53; JX-24, at 1.

[14] Tr. 51-53; JX-1.

between how the order was reported to OATS and how the execution … was trade reported [to FN TRF]."[15]

After eBX responded, on June 22, 2010, Market Regulation staff and eBX and Lava personnel discussed the reports in a conference call to clarify how eBX facilitated and reported the matched trades.[16] eBX explained that it reported only the second leg of the transaction, reflecting the sale to a FINRA member.[17] Market Regulation's Short Sales Group Director informed eBX that, to be accurate, it needed to include a short sale indicator in the reports.[18]

C. FINRA's Trade Reporting Rules and Guidance

The Firm disagreed with Market Regulation, contending it was reporting correctly, based on guidance it gleaned from Frequently Asked Question ("FAQ") 308.2 and a Regulatory Notice.[19] eBX maintains that it reasonably believed that it would be "wrong to include a short sale indicator on the 'sell leg'" of the transactions it reported to the FN TRF.[20]

In 2009 FINRA amended its trade reporting rules. FINRA announced approval of the changes in Regulatory Notice 09-08, but the Notice does not mention short sales.[21] It states that a broker-dealer acting as agent matching orders of a non-member firm and a member firm has the responsibility to submit a tape report of the transaction between itself and the member firm, but under the amendments it is not required to make a non-tape report to indicate it acted as agent for the non-member firm.[22]

FINRA provides additional guidance on its website regarding its rules. Specifically focused on trade reporting rules, FINRA publishes "Trade Reporting Frequently Asked Questions."[23] One Frequently Asked Question ("FAQ"), Section 308, which refers to Regulatory Notice 09-08, addresses alternative trading systems like eBX. FAQ 308 concerns "Reporting Matches of Member Orders and Customer or Non-Member Orders by a Member."[24] FAQ 308.2 addresses the type of matched transactions eBX executes, stating:

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[15] JX-1.

[16] Tr. 127-28, 133.

[17] Tr. 134.

[18] Tr. 137.

[19] Tr. 134, 138.

[20] Respondent's Post-Hr'g Submission, at 7.

[21] Respondent's Post-Hr'g Submission, at 6.

[22] *Id.*; FINRA Regulatory Notice 09-08 (Jan. 2009), http://www.finra.org/industry/notices/09-08, or JX-47, at 3, 5 (Example 6).

[23] *See* http://finra.org/industry/guidance.

[24] *See* http://www.finra.org/sites/default/files/trade-reporting-faqs-pre-january-8-2015.pdf, at 31-32.

> Member BD1 matches as agent *a buy order from member* BD2 and *a sell order* for the same quantity of shares at the same price *from non-member* BD3. (Emphasis supplied.)

It then asks: "How should this transaction be reported?"

One answer it provides is Alternative #2:

> BD1 is the executing party and has the trade-reporting obligation.
>
> Tape report: BD1 (as agent) sells to BD2.
> Non-tape report: not required.[25]

Thus, according to Alternative #2, the executing agent, eBX, must provide a tape report to the FN TRF indicating that it sold to the FINRA member firm, BD2, but does not have to submit a non-tape regulatory report.

The reporting obligations imposed by Alternative #2 can be illustrated as follows, with eBX as BD1, acting as agent:

First ("Buy") Leg:	→	**eBX BD1 (agent)**	→	**Second ("Sell") Leg:**
Non-member subscriber, Seller BD3: *eBX makes no report to TRF*				Member subscriber, Buyer BD2: *eBX reports BD1 sale to BD2 to TRF*

D. eBX's Reliance on Lava

In November 2009, when it began accepting non-FINRA member subscribers, eBX directed Lava to program its systems to report the matched transactions to FN TRF according to Alternative #2. As eBX explained, Lava "programmed its systems so that the non-member leg of the Relevant Transactions was suppressed, but … made no change to the long/short status of the member leg."[26] Because Alternative #2 allowed it, eBX did not report the first leg.[27] And because the 2009 amendments did not explicitly state that a firm's report must reflect short sale orders from non-FINRA members on the buy side, eBX reported the second leg as it always had—with no short sale indicator.

When Market Regulation questioned eBX's omission of a short sale indicator in its initial March 2010 inquiry letter, eBX contacted Lava. Lava assured eBX that it had programmed the system properly, relying on guidance received previously from FINRA staff.[28] eBX informed

[25] *See id.* at 32.

[26] Respondent's Pre-Hr'g Submission, at 4.

[27] Tr. 161.

[28] Tr. 165.

Market Regulation that it, in turn, relied on guidance given to Lava by FINRA and the Firm's "many discussions" with Lava about how to report matched transactions involving a non-FINRA member subscriber to the FN TRF.[29]

E. Market Regulation Expands Its Inquiry

In August 2010, Market Regulation followed up with an expanded request for information, asking eBX to supply additional details to explain why it believed that it was not required to include a short sale indicator in its reports to the FN TRF.[30] eBX then again consulted with Lava. The person responsible for reprogramming the reporting system remained "adamant that the … nonmember leg should and could not be reported to the TRF."[31]

In September 2010, eBX sent Market Regulation its written response. eBX wrote that if a "match is between a FINRA member and a non-FINRA member [the Firm] will report to the TRF [only] on the FINRA member portion of the execution." eBX asserted that it was not required to report the first leg "because of guidance provided by FINRA" contained in Regulatory Notice 09-08, and FAQ 308.2. Relying on that guidance, eBX "does not believe that it has a short sale reporting obligation when it does not in the first place have a trade reporting obligation."[32]

The Parties did not discuss the matter again until July 20, 2011, almost a year later. In the interim, eBX made no changes to its reporting, taking the position that it was awaiting further guidance from Market Regulation. When they did finally speak, counsel for Market Regulation was unaware of eBX's previous conversations with other Market Regulation staff and informed eBX that Market Regulation does not provide "guidance" to member firms.[33]

On August 17, 2011, Market Regulation sent eBX a Wells letter, informing eBX that Market Regulation staff had made a preliminary determination to recommend disciplinary action against eBX for its failure to report short sale transactions with a short sale modifier in violation of FINRA Rule 6182.[34] That same day, eBX's counsel had a conference call with Market Regulation to discuss the Wells letter. According to Patrick Brake, then eBX's outside counsel, the Firm was surprised by the Wells letter because it had expected—but had not received—guidance as to how it should report the short sale leg to FN TRF. Furthermore, Brake testified that it made no sense to use a short sale indicator when reporting the sell leg to the member

[29] JX-24, at 1-2.

[30] JX-25.

[31] Tr. 168.

[32] JX-26, at 2.

[33] Tr. 194; RX-11, at 1.

[34] JX-27.

subscriber.[35] In that leg, eBX was not selling short to the member subscriber buyer.[36] Rather, in his words, eBX was "flat … acting as agent for both sides," not selling short.[37]

The Firm responded to the Wells letter with a reiteration of its position and requested that Market Regulation reconsider its determination to recommend disciplinary action.[38]

Approximately four and a half months later, on February 2, 2012, the Parties spoke again. The Firm asked why it should use a short sale indicator. When eBX asked for written guidance that showed the Firm's position was incorrect, Market Regulation staff referred to FINRA Rule 6182, which requires that the short sale modifier be reported.[39] eBX's Chief Operations Officer testified that during the call Market Regulation explained what eBX needed to do, but did not provide, in eBX's view, the "guidance" the Firm wanted: documentation of why it needed to change its reports.[40]

F. FINRA's FAQ 407.8

In the meantime, in January 2012, FINRA issued FAQ 407.8, which supplemented the previously issued guidance on the issue.[41] The new FAQ stated explicitly that when a broker-dealer acting in an agency capacity matches a non-member firm's short sale with a member firm's buy, it "should include the short sale (or short sale exempt) indicator in the tape report."[42] This new guidance echoed Market Regulation's instructions to eBX, and contradicted eBX's position.[43]

In the February 2, 2012 conference call, there was "much discussion" about why eBX needed to report short sales.[44] But in the call, and in the ensuing communications between the Parties, Market Regulation did not mention the new FAQ, although it was directly relevant to the issue under discussion and constituted "written guidance" supporting its position. Apparently,

[35] Tr. 223-25.

[36] Tr. 233.

[37] Tr. 238.

[38] JX-28.

[39] Tr. 142-43.

[40] Tr. 184-85.

[41] Stip. ¶ 18.

[42] CX-6.

[43] Tr. 119-20.

[44] Tr. 140.

there was no Regulatory Notice that announced the FAQ's issuance.[45] eBX missed the issuance of FAQ 407.8, and for more than a year the Firm was unaware that it existed.[46]

eBX argues that "it is astounding that the new FAQ directly addressing the dispute between the parties never came up in the numerous phone calls and written correspondence between Market Regulation and eBX" since "FINRA was clearly using [it] … to respond to the arguments raised by eBX."[47]

Market Regulation disputes this contention. Market Regulation's Yvonne Huber, vice president in charge of the Short Sales and Over the Counter Compliance Group, who participated in the development of FAQ 407.8, testified that it was issued because the original trade reporting FAQs did not address short sale reporting, and other members "called in with other questions about how to report short sales," so her group thought "it would make sense to add a section … related to short sale." However, when asked if she was aware of any other firms who posed the same questions as eBX, Huber stated that she could not recall any that did.[48]

Whatever prompted the issuance of FAQ 407.8, it is unfortunate that Market Regulation did not direct eBX's attention to it. Had Market Regulation done so in the February 2 call, eBX presumably would have corrected its reports a year earlier than it did.

G. Market Regulation's Second Inquiry

In September 2012, Market Regulation began a second short sale inquiry, and made additional requests for documents relating to eBX's supervisory procedures relating to reporting short sale or short sale exempt transactions. Noting that it had first "advised" eBX in June 2010 of the need to report the short sales in the matched transactions, Market Regulation asked eBX to describe any updates it had made to its trade reporting process to "to ensure that trades were reported with a short sale modifier, when applicable," and if it had made no changes, to explain why.[49]

The inquiry continued, and in January 2013, eBX's Chief Operating Officer came across the FAQ for the first time while reviewing the FINRA website.[50] It had been a year since FINRA released FAQ 407.8, Nevertheless, eBX did not immediately direct Lava to update its trade reports.

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[45] Tr. 124.

[46] Tr. 196.

[47] Respondent's Post-Hr'g Submission, at 8.

[48] Tr. 146-48, 197; Market Regulation's Post-Hr'g Br., at 6.

[49] Tr. 68-69; JX-31.

[50] Tr. 196.

In a February 2013 response to a Market Regulation information request, eBX reiterated its reporting rationale, insisting that it was reporting correctly.[51] It also argued that FAQ 407.8 was evidence of "the weakness of [Market Regulation's] long-held position that eBX was reporting these transactions incorrectly." The Firm argued that FAQ 407.8 did not change the existing guidance because it was, in essence, "a new rule" that was "not enforceable" because it was improperly promulgated; "not directly supported by any rule or interpretation"; and inconsistent with FAQ 308.2 and FINRA rules.[52]

H. eBX Updates Its Reports but They Are Rejected

Nonetheless, on the advice of its outside counsel, eBX finally directed Lava to change its programs to conform to FAQ 407.8 and add a short sale indicator.[53] The change was effective on February 26, 2013. The Firm began reporting the sell leg with a notation indicating "selling customer sold short." However, the FN TRF rejected the new reports.[54]

When they discussed the rejections, Market Regulation informed eBX that for the short sale indicator to be accepted by FINRA's system, it had to be coded with a tag that indicated eBX was a "dealer selling short." The Firm claimed that this was wrong because in these trades it did not take on a position, did not act as a dealer, and did not sell short.[55] The Firm continues to argue that it "should not be put in the position of having to misreport itself as 'dealer [sold] short'" because FINRA's systems "prevented it from reporting correctly."[56] Nonetheless, in March 2013, eBX made the change as Market Regulation directed, and the reports were accepted.

V. Discussion

A. The Trade Reports

FINRA Rule 6182 states unequivocally that, "[p]ursuant to applicable trade reporting rules, members must indicate on trade reports submitted to FINRA whether a transaction is a short sale or a short sale exempt transaction … . [A]ll short sale transactions … must carry a 'short sale' indicator (or a 'short sale exempt' indicator if it is a short sale transaction in a 'covered security' that may be marked 'short exempt' pursuant to SEC Regulation SHO)."

The rules under 7200A, pertaining to the "FINRA/NASDAQ Trade Reporting Facility," define the specific requirements of reporting trades to the FN TRF. Rule 7230A(a) states that

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[51] JX-32.

[52] JX-32, at 2-3.

[53] RX-11, at 2.

[54] Respondent's Post-Hr'g Submission, at 8-9.

[55] Tr. 87, 92, 198; RX-11, at 2.

[56] Respondent's Post-Hr'g Submission, at 9-10.

"Members shall comply with Rule 7200A series when reporting transactions to the System." Rule 7210A(j) explains that 'System" means the FN TRF. Rule 7230A(d)(6) requires that reports to the FN TRF must have a symbol "indicating whether the transaction is a buy, sell, or cross, and if applicable, a symbol indicating that the transaction is a sell short or sell short exempt trade."

Put simply, these rules require member firms reporting transactions to indicate in their trade reports whenever a short sale occurs. As Market Regulation points out, "[t]here are no exceptions to this requirement."[57]

eBX argues that the requirement is conditional. The Firm focuses on "qualifying language" in FINRA Rule 6182, which states that the requirement is "[p]ursuant to applicable trade reporting rules." According to eBX, "FINRA's trade reporting rules do not require a short sale indicator for the leg … that is required to be reported."[58] The Firm contends that FINRA Rule 7230A(d) requires short sale indicators to be reported only for transactions that must be reported to the FN TRF; that each leg of the trades at issue constitutes a separate transaction; and that Alternative #2 requires firms to make a tape report of only the second leg and does not require any report of the first leg—the leg consisting of the non-member sale—short or otherwise.[59]

The Firm insists that this case is "about … a complicated legal dispute" and that eBX "thoroughly researched the short sale issue and consulted with expert broker-dealer counsel and others in making a careful determination about how to report the relevant transactions."[60] The Firm also claims that Market Regulation "seeks to punish eBX for asking that Market Regulation provide support for its interpretation of applicable rules and guidance."[61]

However, Market Regulation's first inquiry in March 2010 alerted eBX to the possibility that its reporting might violate FINRA rules. The conference call in June 2010 ended with lines clearly drawn: eBX was adamant that it was reporting correctly, and Market Regulation insisted that eBX was not. eBX rejected Market Regulation's position outright. The Firm ended that call by essentially demanding that Market Regulation provide technical guidance to show Lava what it needed to do to change eBX's reporting system, and cite to a specific FINRA rule requiring eBX to change its reporting.[62]

Certainly by August 2011, after additional discussion and a second inquiry letter, Market Regulation had made it clear that eBX was reporting incorrectly. The Firm claims that it was still

[57] Market Regulation's Post-Hr'g Br., at 4.

[58] Respondent's Pre-Hr'g Submission, at 8.

[59] *Id.* at 8-9.

[60] Respondent's Post-Hr'g Br., at 1.

[61] *Id.* at 11.

[62] Tr. 179.

waiting to receive guidance from FINRA; but eBX was really waiting for Market Regulation to produce documentation sufficient to persuade eBX that its interpretation of the rules and guidance was wrong. Instead of heeding Market Regulation, the Firm chose to rely on the opinion of Lava personnel, who claimed to have relied generally on input from FINRA, but could point to nothing specific.[63] Market Regulation provided eBX with its rationale: FINRA rules require members to report short sale transactions by using a short sale modifier.[64] From that time forward, eBX knew that Market Regulation deemed it to be acting in violation of the reporting rules. eBX could no longer reasonably claim to have a good-faith basis for refusing to change its reporting. Had it made the change required, the total number of incorrect reports would have been significantly smaller.

The Firm's position is untenable. Regulatory Notice 09-08 and Alternative #2 of FAQ 308.2 do not relieve eBX of its obligation to report the short sale component of the matched transactions.

The Firm concedes that making the changes Market Regulation wanted was not complicated; the coding was done quickly.[65] On March 7, 2013, eBX finally directed Lava to modify the reports in the manner Market Regulation suggested, and by March 19, eBX began filing the corrected reports.[66]

Based on these facts, the Panel concludes that eBX violated FINRA Rules 6182, 7230A, and thereby 2010, by reporting over 14 million transactions in which it matched buy orders from FINRA member subscribers with short sell orders for the same quantity of shares at the same price from non-FINRA member subscribers without the required short sale indicator.

B. Supervision

NASD Rule 3010 requires each FINRA member to establish and maintain a system of supervision of its activities "that is reasonably designed to achieve compliance with applicable securities laws and regulations."[67]

As noted above, when eBX directed Lava to reprogram its reporting systems in November 2009, the Firm did not review the changes Lava made to determine whether they were correct or that they met the requirements of FINRA rules.[68]

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[63] Tr. 168.

[64] Tr. 176.

[65] Tr. 180.

[66] RX-11, at 2.

[67] During the relevant period NASD Rule 3010 was in effect. It was superseded on December 1, 2014, by FINRA Rule 3110. *See* Rule Conversion Chart: NASD to FINRA, http://www.finra.org/ruleconversionchart.

[68] Tr. 160-62.

eBX effected all of its matched transactions as a dual agent. However, through Lava's reprogramming error in November 2009, eBX reported more than one million agency cross transactions between non-FINRA member subscribers in reports that identified eBX as "principal" when it was acting in an agency capacity.[69] Daniel Ham, who served as eBX's vice president of operations from 2007 to 2011 and then as its Chief Operating Officer until 2014, testified at the hearing that he was unaware at the time that eBX had identified itself as principal in these trade reports.[70] The Firm did not detect the incorrect reports, but learned of the error from Market Regulation at the conclusion of an examination in 2013.[71]

eBX's written supervisory procedures contained several provisions calling for reviews of its trade reports. One provision called for the Firm's chief compliance officer ("CCO") to "review the accuracy of the OATS website for the OATS and ACT comparison percentage" and, if there was a discrepancy greater than three percent, to find out why and take corrective action.[72] Another provided that the CCO should review 50 transactions each week for accuracy and timeliness.[73] There is no evidence that eBX conducted these reviews. To the contrary, eBX was unaware of the near-100 percent discrepancy between the OATS reports of executions of short sales and the FN TRF reports with no short sale indicators for the same transactions. Finally, none of eBX's written supervisory procedures provided for a review of the accuracy of its trade reports.[74]

It is the case, as eBX argues, that not every violation of the trade reporting rules implicates a supervisory failure.[75] However, as the plain language of NASD Rule 3010 makes clear, a member is required to establish, maintain and enforce a supervisory system reasonably designed to achieve compliance with applicable securities laws and regulations,[76] tailored to its particular business activities.[77] eBX's business is devoted solely to matching orders entered by its member subscribers on an agency basis.[78] The Firm admits that it made no review to determine whether Lava's reprogramming in November 2009 produced reports that complied with FINRA rules. And eBX's procedures contained no reference to the need to monitor for compliance with short sale reporting requirements. The Panel therefore finds that eBX failed to

[69] Stip. ¶¶ 11-12.

[70] Tr. 158, 163.

[71] Tr. 163; JX-39.

[72] JX-29, at 16. ACT is the predecessor system to which firms reported trades prior to the creation of the FN TRF. A Market Regulation witness testified that ACT was "basically the same system" as the FN TRF and that the two terms "basically mean the same thing." Tr. 71-72.

[73] JX-29, at 13.

[74] Tr. 73.

[75] Respondent's Post-Hr'g Submission, at 3.

[76] NASD Rule 3010(a); NASD Notice to Members 98-96 (Dec. 1998).

[77] NASD Notice to Members 99-45 (June 1999).

[78] Stip. ¶¶ 4, 6-7.

establish, maintain, and enforce a supervisory system reasonably designed to achieve compliance with the applicable trade reporting rules, specifically FINRA Rules 6182 and 7230A, and thereby violated NASD Rule 3010 and FINRA Rule 2010.

VI. Sanctions

A. Trade Reporting Violations

FINRA's Sanction Guidelines recommend a fine of $5,000 to $15,000 for first-time violations of the trade reporting requirements of FINRA Rule 7230A.[79] The Parties' recommendations diverge widely.

1. Market Regulation's Recommendation

Citing the need to deter eBX and others from engaging in similar misconduct, and arguing that eBX's reporting violations in this case are egregious, Market Regulation seeks to impose fines substantially higher than those the Guidelines recommend. Market Regulation describes eBX's trade reporting violations as representing "one of the 'highest scenarios of misreporting'" to the FN TRF in the last 25 years.[80] Market Regulation argues that eBX's incorrect trade reporting reflects an "intentional and brazen refusal to accept responsibility for its conduct and comply with the instruction of its regulator for more than three years."[81] Market Regulation cites Principal Considerations in the Sanction Guidelines to underscore the egregiousness of eBX's violations: the Firm has not accepted responsibility for its conduct[82] and it continued to engage in incorrect trade reporting for over three years after being advised by Market Regulation of the impropriety of its trade reporting.[83] For these reasons, Market Regulation, aggregating the reporting violations charged in the first two causes of action, recommends imposing a censure and a fine of $250,000 for the trade reporting violations described in the first two causes of action.[84]

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[79] FINRA Sanction Guidelines at 63 (2015), http://www.finra.org/industry/sanction-guidelines ("Guidelines"). The current Guidelines, issued in March 2015, supersede prior versions. They apply to all disciplinary matters, including matters pending when the current Guidelines were issued, such as this one. *Id*. at 8. In its pre-hearing brief, Market Regulation argued that a Letter of Acceptance, Waiver and Consent ("AWC") filed after the conduct at issue should be considered aggravating because it included a finding that eBX made incorrect reports to the FN TRF and constitutes "another indication" of the Firm's "continued failure to sufficiently supervise its trade reporting obligations." However, as Market Regulation noted, because the AWC was filed after the conduct in this case occurred, it cannot be considered a prior instance of similar misconduct, and the Panel declines to consider it aggravating.

[80] Market Regulation's Post-Hr'g Br., at 1, quoting testimony at Tr. 85.

[81] *Id.*, at 11-12.

[82] Guidelines at 6 (Principal Consideration No. 2).

[83] *Id.* at 7 (Principal Consideration No. 15).

[84] Market Regulation's Post-Hr'g Br., at 14.

2. eBX's Recommendation

For its part, eBX argues $37,500 is a reasonable sanction for both the "single programming error" that caused it to report its capacity incorrectly, as well as the short sale reporting violations.[85] The Firm suggests that the incorrect reports were insignificant in number: it reported only one third of one percent of its trades with the incorrect capacity.[86] It argues that Market Regulation's recommended fine is unprecedented and inappropriately seeks to "punish" eBX for "engaging in a good-faith dispute" with Market Regulation "about what the rules require" and for "asking that Market Regulation provide support for its interpretation" of the reporting rules and guidance.[87] The Firm argues that it has simply attempted to defend itself, and should be allowed to disagree with FINRA's interpretation of the rules without being deemed to have committed egregious violations.[88]

3. Discussion

Although the trade reporting violations in both the first and second causes of action resulted from programming errors when eBX had its reporting systems reprogrammed in November 2009, we decline to aggregate them for the purpose of determining sanctions. We therefore consider the capacity reporting violations and the short sale reporting violations separately.

a. The Incorrect Capacity Reports

A programming error caused eBX to submit approximately 1.3 million trade reports incorrectly denoting its capacity. The Firm acknowledges this and has accepted responsibility.[89] The extended period of time over which the erroneous reporting occurred is an aggravating

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[85] Respondent's Post-Hr'g Submission, at 10.

[86] *Id.* at 2.

[87] *Id.* at 3, 11. The Firm also suggests that the Panel consider settlements in other cases for OATS violations, arguing that they "provide a good proxy for trade reporting violations," and attached a chart and an appendix to its post-hearing brief with a copy of each settlement. Respondent's Post-Hr'g Submission, at 11 n.25-26. Market Regulation filed a Motion to Strike all references to them because settlements in other cases are irrelevant as precedent. Market Regulation's Motion to Strike, at 3. It is well settled that the appropriateness of sanctions depends on the particular facts and circumstances of each case, and that settlements of other cases are inappropriate to consider because, as the Securities and Exchange Commission has stated, "[P]ragmatic considerations may justify lesser sanctions in negotiated settlements." *Raghavan Sathianathan*, Exchange Act Release No. 54722, 2006 SEC LEXIS 2572, at *44-45 (Nov. 8, 2006). We therefore decline to consider any references to settled cases in determining the sanctions here. *Dep't of Enforcement v. McCune*, No. 2011027993301, 2015 FINRA Discip. LEXIS 22, at *25 (NAC July 27, 2015), *appeal docketed*, No. 3-16768 (SEC Aug. 25, 2015).

[88] Tr. 274.

[89] The Guidelines direct us to consider acceptance of responsibility and deem it a mitigating factor when a respondent acknowledges the misconduct to a regulator prior to detection. Guidelines at 6 (Principal Consideration No. 2). In this case, eBX did not discover the programming error. However, eBX accepted responsibility as soon as FINRA informed it of the incorrect reports, in sharp contrast to the Firm's refusal to accept responsibility for the short sale reporting errors.

factor. However, although there were over a million incorrect reports, the number was a small percentage of eBX's trading volume.[90] It is an aggravating factor that eBX had not developed and implemented reasonable supervisory procedures to monitor the reprogramming of its reports by Lava that caused eBX's capacity to be incorrectly reported.[91] However, when informed of the problem, as noted above, eBX promptly accepted responsibility and corrected it. Under these circumstances, we conclude that a censure and a fine of $15,000 are appropriate sanctions for the incorrect reporting described in the first cause of action.

b. The Failure to Report Short Sales

The second cause of action presents distinctly different factors to consider in assessing sanctions. As noted, the Parties are in strong disagreement. eBX believes it was justified in reporting as it did, and places blame on Market Regulation for not providing better guidance and for recommending changes that placed it in the "impossible situation" of having to submit reports that are inaccurate. Market Regulation argues that the number of incorrect reports, the length of time eBX reported incorrectly, and eBX's refusal to correct the reports after being instructed to do so, make this an egregious case.

The Panel finds that eBX's failure to use short sale indicators appropriately in the more than 14 million trade reports at issue requires us to impose serious sanctions to achieve the remedial and deterrent purposes set forth in the Sanction Guidelines. We do not accept eBX's justifications of its conduct, or its effort to place blame on Market Regulation. Neither do we agree with Market Regulation's assessment of the degree of egregiousness. For the reasons given below, therefore, we reject the Parties' recommendations and conclude that the appropriate sanctions are censure and a fine of $125,000.

i. eBX's Persistent Misreporting Was Unreasonable

The Panel does not accept eBX's argument that imposing sanctions here will punish it for merely expressing its good-faith disagreement over the correct interpretation of applicable rules and published guidance concerning reports. The Firm persisted in refusing to modify its reporting program to meet Market Regulation's objections for an unreasonably long period. Thus, there is some merit to Market Regulation's assertion that eBX intentionally elected not to "comply with the instruction of its regulator for … years."[92]

That does not mean that we entirely reject eBX's argument that there was room for confusion and disagreement over how the applicable rules and guidance required the Firm to report the transactions at issue. As Market Regulation concedes, Alternative #2 of FAQ 308.2 permitted eBX to elect to report the sell side and not report the buy side of the transactions, and did not mention the separate requirement to report a short sale from a non-member firm.

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[90] Guidelines at 7 (Principal Consideration No. 18).

[91] Guidelines at 6 (Principal Consideration No. 5).

[92] Market Regulation's Post-Hr'g Br., at 11-12.

But Market Regulation put eBX on notice in June 2010 that its reliance on Alternative #2 did not relieve it of its responsibility to report short transactions, as Rules 7230A and 6182 clearly require. At the very latest, by August 17, 2011, when Market Regulation sent its Wells notice, eBX reasonably should have concluded that it needed to reassess its reliance on Lava's interpretation of the applicable guidance and comply with the short sales reporting requirements. Doing so would not, as eBX claims, have compelled it to relinquish its belief that Lava's interpretation of the applicable rules and guidance was correct or to abandon its ability to pursue its "good-faith dispute about rules." The Firm could have made the necessary changes and brought its concerns to the attention of higher level Market Regulation and FINRA officials. Instead, in its September 2011 Wells response, eBX simply restated its rationale, urged Market Regulation to reverse its position, and continued to report as it had.

ii. Market Regulation Was Not at Fault

The Firm posits that Market Regulation should have told it "specifically what programming change we should make and what fields we need to populate in what way and based on what rule."[93] As noted above, Market Regulation informed eBX that it does not provide "guidance." To the Panel, it seems unfortunate that Market Regulation did not, in the course of the numerous communications between the Parties, offer to refer eBX to persons with technical background to discuss the details of program changes that might have led the Firm to change its reporting systems sooner than it did.

When Market Regulation did not provide the written guidance eBX wanted, the Firm assumed that Market Regulation's inquiry had ended, inferred that the matter had been resolved, "that this matter was done," and continued to submit reports with no short sale indicator.[94] The Firm's inference was not reasonable. It is well established that, just as a respondent cannot shift responsibility for compliance with FINRA rules to a third party, a respondent, "cannot blame FINRA," even if it "has asked FINRA multiple times for guidance" that is not forthcoming.[95] It is "unreasonable for [a firm] to equate NASD/FINRA … staff 'inaction' with tacit approval." This is because a member "cannot shift responsibility for compliance to FINRA,"[96] which is essentially what eBX seeks to do here.

The Firm also argues that Market Regulation's insistence that it report the short sale leg of its matches put eBX into an "impossible situation," because FINRA's system rejected eBX's attempt to report it as "selling customer sold short" and required eBX to report it inaccurately as

[93] Tr. 183-84.

[94] Tr. 34-35, 38, 141-42, 179, 268.

[95] *Dep't of Enforcement v. The Dratel Group, Inc.*, No. 2009016317701, 2015 FINRA Discip. LEXIS 10, at *43 (NAC May 6, 2015).

[96] *J.P. Turner & Company, LLC*, Initial Decisions Release No. 395, 2010 SEC LEXIS 1656, at *44-45 (May 19, 2010).

"dealer sold short."[97] The Firm insists that this reinforces its position that "it was incorrect to report the 'sell leg' short where eBX was acting as agent" and complains that it "should not be put in the position of having to misreport itself."[98] However, Market Regulation explained that using the required code to report the short sale leg did not cause eBX to misrepresent its capacity: the system offers a separate field in which eBX could clarify its capacity as principal, and Market Regulation, reviewing the combined entries, would understand accurately that eBX acted as agent, not as dealer, in the short sale transactions.[99]

iii. Aggravating Factors

Throughout the investigation and at the hearing, eBX has refused to accept responsibility for its short sales reporting violations, an aggravating factor in determining sanctions.[100]

But the Panel does not find eBX's short sale reporting violations to be as egregious as Market Regulation argues. There is no evidence that when eBX began submitting incorrect reports it acted in bad faith, or that it set out to submit incorrect reports to gain an economic or other advantage. The Firm, unfortunately, relied on Lava's determination of how to reprogram the reporting systems when it began accepting non-FINRA member subscribers. The Firm assumed, apparently without question, that the guidance it received from Lava was correct because Lava had experience operating another ATS and would program eBX's system just as it did for the other firm.[101]

However, eBX's reliance on Lava does not relieve it of its responsibility for the incorrect reporting. A member cannot delegate its responsibility to comply with securities laws and FINRA rules.[102]

The Panel recognizes, as Market Regulation stresses,[103] that the number of incorrect reports—more than 14 million—is a large number. And the incorrect reporting occurred over an extended period. The length of time and number of transactions constitute aggravating factors.[104]

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[97] Respondent's Post-Hr'g Submission, at 8-9.

[98] *Id.* at 9-10.

[99] Tr. 100-02.

[100] Guidelines at 6 (Principal Consideration No. 2).

[101] Tr. 204.

[102] *Dep't of Enforcement v. Zaragoza*, No. E8A2002109804, 2008 FINRA Discip. LEXIS 28, at *28 (NAC Aug. 20, 2008) (a respondent may not shift responsibility for complying with rules to a third party), citing *Michael David Borth*, 51 S.E.C. 178, 181 (1992) (finding that a respondent may not "shift his responsibility to others").

[103] The Firm "committed approximately 14,042,017 separate and distinct violations" affecting "more than 15 million trade reports over more than three years" and "millions of reports to the FN TRF." Market Regulation's Post-Hr'g Br., at 5, 11, 13.

[104] Guidelines at 6-7 (Principal Considerations Nos. 8, 18).

The number of reports must be taken in context, however. The Firm points out that during the relevant period it executed an average of almost half a million trades monthly.[105] Thus, any deficiency in its report programming that lasted for months would inevitably result in a high number of incorrect reports.

The Panel also recognizes that eBX's incorrect reports adversely impacted Market Regulation's ability to perform its market surveillance functions properly.[106] Failures to report short sales frustrate Market Regulation's ability to monitor for compliance with Reg SHO. In addition, Market Regulation often receives complaints about questionable short selling activity, and needs accurate reporting data to investigate such complaints. Market Regulation relies on volume concentration reports to identify suspiciously heavy concentrations of short selling, but those reports are unreliable if short selling activity is not accurately reported.[107] Furthermore, the SEC requires FINRA to report daily every trade in every stock reported to the FN TRF, including short sales. Market Regulation needs accurate short sales data to fulfill this responsibility. OATS reports, like those which eBX accurately submitted, do not suffice because OATS reports are order-based, while the FN TRF reports are execution-based, and provide more information than OATS reports.[108]

After considering all of the relevant factors, the Panel finds neither Party's recommended sanctions to be appropriate in this case. The Firm's recommended fine of $37,500 is inadequate to serve the requisite remedial and deterrent purposes of FINRA sanctions, and Market Regulation's recommended fine of $250,000 is excessive and unnecessarily punitive. The Panel concludes that a censure and a fine of $125,000 will serve to remediate eBX's failure to report more than 14 million transactions with the required short sale indicator, and will serve as a deterrent to such failures by eBX and other similarly situated member firms.

B. Supervision Violations

The Guidelines recommend a fine of $5,000 to $73,000 for failure to supervise. The three Principal Considerations are (i) whether a respondent ignored red flags; (ii) the nature, extent, size, and character of the supervision failure; and (iii) the quality and degree of supervisory implementation of the respondent's procedures and controls.[109]

[105] Respondent's Post-Hr'g Submission, at 5.

[106] A Market Regulation witness testified, uncontradicted, that failure to report short sales properly renders the "backbone" of Market Regulation's trade surveillance inaccurate. Tr. 77-78.

[107] Tr. 79-80.

[108] Tr. 80-81.

[109] Guidelines at 103.

1. The Parties' Positions

The Firm makes no recommendation for a sanction for failing to supervise because, in its view, there is no evidence to support the supervision charge.[110]

Market Regulation argues that "there was no implementation of [eBX's] supervisory controls or procedures" as evidenced by its misreporting of its capacity as principal in agency crosses, despite its written procedures clearly stating that it always acts as agent; the extended period of its misreporting; and its continued misreporting after Market Regulation notified it of the short sales reporting failure in June 2011.[111] Market Regulation recommends imposing a fine of $500,000 for what it describes as eBX's egregious supervision failures.[112]

2. Discussion

The Panel agrees with Market Regulation that eBX's supervision of its reporting systems was sorely deficient, and that eBX was derelict in not exercising any supervisory review of Lava's November 2009 changes to its reporting system. The consequence was that for over three years it misreported its capacity in over one million agency cross transaction reports, and only learned of the problem when informed by Market Regulation. In addition, eBX exercised no supervisory review of the reports of the more numerous matched transactions. It thus failed to establish, maintain, and implement a supervisory system reasonably designed to achieve compliance with its trade reporting obligations. However, we do not agree that eBX's failure to include short sale indicators after September 2011 resulted from its flawed supervisory system; rather, it resulted from its refusal to change its reporting system as instructed by Market Regulation.

As with the reporting violations, the Panel concludes that eBX's supervisory failures, although very serious, were not as egregious as Market Regulation argues, and that therefore Market Regulation's recommended sanctions are unnecessarily severe and punitive. Had eBX implemented reasonably designed supervision, and had it tested for compliance with its reporting obligations, its significant reporting deficiencies would have been, if not avoided, at least significantly minimized. For these reasons, the Panel concludes that a censure and a fine of $200,000 are appropriate sanctions to achieve the objectives of remediating eBX's misconduct and deterring similar misconduct by it and similarly situated member firms in the future.

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[110] Respondent's Post-Hr'g Submission, at 2.

[111] Market Regulation's Post-Hr'g Br., at 15.

[112] *Id.*, at 15.

VII. Order

For violating FINRA Rules 7230A(d)(7) and 2010 by inaccurately denoting itself as "principal" instead of "agent" when it reported transactions to FINRA, eBX is censured and fined $15,000. For violating FINRA Rules 6182, 7230A(d)(6), and 2010 by failing to report other transactions with the required short sale indicator, eBX is censured and fined $125,000. For violating NASD Rule 3010 and FINRA Rule 2010 by failing to establish and maintain a supervisory system reasonably designed to achieve compliance with FINRA Rules 7230A and 6182, eBX is censured and fined $200,000. The Firm is also ordered to pay hearing costs of $2,855.74, which includes an administrative fee of $750. The costs shall be due on a date set by FINRA, but not sooner than 30 days after this decision becomes FINRA's final disciplinary action in this proceeding.[113]

HEARING PANEL

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By: Matthew Campbell
Hearing Officer

[113] The Hearing Panel considered and rejected without discussion all other arguments of the parties.