FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2016050929001

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Two Sigma Securities, LLC, Respondent
Broker-Dealer
CRD No. 148960

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Two Sigma Securities, LLC ("Two Sigma Securities" or the "Firm") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against the Firm alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

A. The Firm hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

The Firm has been a FINRA member since June 25, 2009, and its registration remains in effect. The Firm's headquarters are in New York City and it employs more than 140 registered persons. The Firm engages in proprietary trading and market making, and receives order flow from an affiliate, broker-dealers, and institutional customers.

RELEVANT DISCIPLINARY HISTORY

The Firm has no relevant disciplinary history with the Securities and Exchange Commission ("SEC"), any state securities regulator or self-regulatory organization.

OVERVIEW

On July 11, 2016, the Firm self-reported to FINRA Market Regulation staff that it had discovered certain system issues impacting the Firm's calculation of available securities for purposes of complying with the requirements of Rule 203(b)(1) of Regulation SHO pursuant to the Securities Exchange Act of 1934 (also known as the "locate" requirement) for approximately two years. After discovering the issues on May 5, 2016, the Firm halted impacted trading on May 6, 2016. The Firm resumed trading on May 11, 2016 for all but Threshold Securities,[1] and then resumed trading in Threshold Securities in December 2016 upon respectively fixing the issues detailed below.

From March 21, 2014 to May 5, 2016 (the "review period"), the Firm effected certain short sale transactions detailed below without borrowing, or entering into a bona-fide arrangement to borrow the securities, or having reasonable grounds to believe they could be borrowed, by the delivery date of such securities contrary to the requirements of Rule 203(b)(1). The violations were attributable to issues related to the Firm's centralized system used to compute the amount of securities available for locate purposes (the "Locate System"). The Locate System issues, detailed further below, caused the Firm to incorrectly calculate its net position in one aggregation unit[2] and fail to distinguish between Threshold and non-Threshold Securities in two aggregation units for locate compliance purposes. Further, the Firm failed to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to achieve compliance with Rule 203(b)(1).

Based on the foregoing, the Firm violated Rule 203(b)(1) of Regulation SHO, NASD Rule 3010 and FINRA Rules 3110 and 2010.

FACTS AND VIOLATIVE CONDUCT

1. Rule 203(b)(1) of Regulation SHO Establishes Broker-Dealer Locate Requirements

The SEC adopted Regulation SHO in July 2004 to address concerns regarding persistent fails to deliver of securities from trading and potentially abusive "naked" short sales, *i.e.*, the sale of securities that an investor does not own or has not borrowed.

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[1] Threshold securities are equity securities that have an aggregate fail to deliver position for: (i) five consecutive settlement days at a registered clearing agency [*e.g.*, National Securities Clearing Corporation]; (ii) totaling 10,000 shares or more; and (iii) equaling at least 0.5% of the issue's total shares outstanding.

[2] Rule 200(f) of Regulation SHO requires a broker or dealer to aggregate all of its positions in a security unless the broker or dealer qualifies under the rule to trade in independent trading aggregation units, in which case each independent trading unit must aggregate all its positions in a security to determine its net position in the security.

Pursuant to Rule 203(b)(1), a broker-dealer, subject to certain exceptions not applicable to this matter, may not accept an equity short sale order from another person, or effect an equity short sale for its own account, without having borrowed the security, or entered into a bona-fide arrangement to borrow the security, or reasonable grounds to believe the security can be borrowed, so that it can be delivered when due. The rule also requires documentation of compliance with the above locate requirement.

2. *The Firm Did Not Comply with the Locate Requirement*

Between March 21, 2014 and May 5, 2016, the Firm did not comply with the locate requirement on 3,652,905 occasions, which involved the Firm's short selling in a non-market making capacity, and resulted in less than 20 fails to deliver of securities at the Firm's clearing firm. Almost all of the violations were associated with re-applying locates involving intra-day buy-to-cover trading in Threshold Securities, in a manner inconsistent with an FAQ issued by the SEC staff,[3] and the remainder were associated with inaccurate position computations within the Firm's market-making aggregation unit.

The Firm's locate violations occurred as a result of two different types of coding errors that started in 2014. The coding errors resulted from inadvertent failures to include the Firm's legacy market-making strategy in net position computations, and from failures to distinguish between Threshold and non-Threshold Securities for purposes of complying with the locate requirement. The Firm independently detected these errors in May 2016 when it was testing an updated surveillance report for calculating available locates for complying with the locate requirement.

The first system issue caused the short and long positions related to the Firm's legacy market-making strategy to be omitted from net position computations of the Firm's market-making aggregation unit between March 21, 2014 and May 5, 2016. As a result, in certain instances, the Firm miscalculated the market-making aggregation unit's overall net position as long in its Locate System. This caused the Firm to violate the locate requirement. Specifically, there were two primary trading strategies within the aggregation unit. In situations where the aggregation unit had an overall net short position, but one of the strategies had a long position, sales were properly marked as "short." However, the Locate System would determine that a locate was not required. For example, in certain situations the long positions of the one strategy had already been used to make delivery on sales by the other strategy, and were thus not available for delivery on non-market making short sales.

The second system issue resulted from inadvertent failures to distinguish between Threshold and non-Threshold Securities in certain trade strategies for locate compliance purposes from August 2014 to May 5, 2016. As a result of coding

[3] The restriction against re-applying locates for Threshold Securities is addressed in FAQ 4.4 from the SEC's FAQs relating to Regulation SHO.

errors, certain trade strategies re-applied locates from earlier short sales to subsequent intra-day short sales in Threshold Securities. This occurred when the trade strategy covered the earlier short sale with a purchase (*i.e.*, "buy-to-cover" trades). In these situations, it was unlikely that the Firm would have reasonable grounds to believe that the securities could be borrowed for delivery on settlement date, and at least 13 such short sales resulted in fails to deliver of securities at the Firm's clearing firm.

Based on the foregoing, the Firm violated Rule 203(b)(1) of Regulation SHO and FINRA Rule 2010.

3. The Firm Did Not Reasonably Supervise for Locate Compliance

NASD Rule 3010(a)[4] and FINRA Rule 3110(a) require each member to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules, including but not limited to, the establishment and maintenance of written procedures as prescribed by NASD Rule 3010(b) and FINRA Rule 3110(b), respectively.

NASD Rule 3010(b) and FINRA Rule 3110(b) require each member to establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules.

A violation of NASD Rule 3010 and FINRA Rule 3110 also constitutes a violation of FINRA Rule 2010.

During the review period, the Firm's supervisory system was not reasonably designed to achieve compliance with Rule 203(b)(1) of Regulation SHO.

a. <u>The Firm's Supervisory System Was Not Reasonably Designed to Achieve Compliance With the Locate Requirement</u>

The Firm failed to reasonably test the quality and accuracy of the systems that were the primary tool that the Firm relied on for achieving compliance with the locate requirement as described above. The Firm used two surveillance reports for locate compliance, however the reports relied upon data compiled in reliance on the system issues set forth above.

Starting in July 2015, one of the surveillance reports, known as the Borrow Exception Report, also was mapped to an aggregation unit that was no longer in existence, so it was not capturing any trading activity.

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[4] FINRA Rule 3110 replaced NASD Rule 3010 effective December 1, 2014.

In addition, the Firm lacked supervisory reviews that were reasonably designed to ensure that the data its surveillance reports relied upon for supervising locate compliance was accurate.

Further, from early 2013 when the Borrow Exception Report was created until March 14, 2017, the Borrow Exception Report incorrectly assumed that all the Firm's locates were obtained at the *beginning* of trading when that was not always the case. This assumption could result in potential failures to detect short selling in excess of available locates, by prematurely inflating the amount of locates the Firm had at market open when the Firm obtained locates on an intra-day basis.

Finally, the Borrow Exception Report erroneously relied upon execution times for purposes of triggering locate alerts. Rule 203(b)(1), however, requires a broker or dealer to comply with the locate requirement prior to effecting short sales, absent an applicable exception.[5]

b. The Firm's Written Supervisory Procedures Were Not Reasonable

Prior to February 2015, the Firm lacked written supervisory procedures concerning its system changes, updates and checks for regulatory compliance. While the Firm had a quality control process for systems updates, such review was not reflected in the Firm's written supervisory procedures until February 2015.

Prior to November 2015, the Firm's written supervisory procedures did not reflect reasonable supervisory reviews to validate whether the Firm's quality control process for reviewing and approving systems changes, including documentation of the approval process, was being followed. Further, the procedures did not make clear until September 2017 that the designated supervisor's responsibilities encompassed reviews designed to confirm whether systems changes were reasonable for achieving compliance with applicable securities laws and rules.

Finally, the Firm's written supervisory procedures did not provide complete descriptions of the nature, scope and use of the Firm's Rule 203(b)(1) surveillance reports.

Based on the foregoing, the Firm's supervisory system, including its written supervisory procedures, did not provide for supervision reasonably designed to achieve compliance with respect to Rule 203(b)(1) of Regulation SHO. The

[5] *See, e.g.,* Short Sales, Final Rule, Exchange Act Release No. 50103, 69 Fed Reg. 48008, at 48014(Aug. 6, 2004) ("[R]ule 203(b) creates a uniform Commission rule requiring a broker-dealer, prior to effecting a short sale in any equity security, to "locate" securities available for borrowing … Specifically, the rule prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer's own account unless the broker-dealer has (1) borrowed the security, or entered into an arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.")

conduct described violated NASD Rules 3010(a) and 3010(b) and FINRA Rules 3110(a) and 3110(b) and 2010.

B. The Firm also consents to the imposition of the following sanctions:

1. a censure; and

2. a fine in the amount of $225,000.

The Firm agrees to pay the monetary sanctions upon notice that this AWC has been accepted and that such payment is due and payable. It has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

The Firm specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanctions imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

The Firm specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

A. To have a Complaint issued specifying the allegations against the Firm;

B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council ("NAC") and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, the Firm specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

The Firm further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

The Firm understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against the Firm; and

C. If accepted:

1. this AWC will become part of the Firm's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against the Firm;

2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and

4. The Firm may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. The Firm may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects the Firm's: (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. The Firm may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The Firm understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of the Firm, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that the Firm has agreed to the AWC's provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce the Firm to submit it.

6/4/2020
Date

Two Sigma Securities, LLC

By: C. V. Vallese
Name: Carl Vallese
Title: Chief Compliance Officer

Reviewed by:

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Michael D. Wolk, Esq.
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Accepted by FINRA:

6/12/2020
Date

Signed on behalf of the
Director of ODA, by delegated authority

Dawn Faris

Dawn Faris
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