

**THE NASDAQ STOCK MARKET LLC  
NOTICE OF ACCEPTANCE OF AWC**

**Certified, Return Receipt Requested**

**TO: Wedbush Securities Inc.  
Mr. Gary L. Wedbush  
Executive Vice President  
1000 Wilshire Blvd., Suite 900  
Los Angeles, CA 90017**

**FROM: The NASDAQ Stock Market LLC ("Nasdaq")  
c/o Financial Industry Regulatory Authority ("FINRA")  
Department of Market Regulation  
9509 Key West Avenue  
Rockville, MD 20850**

**DATE: February 25, 2016**

**RE: Notice of Acceptance of Letter of Acceptance, Waiver and Consent No. 20100243866-02**

**Please be advised** that your above-referenced Letter of Acceptance, Waiver and Consent ("AWC") has been accepted on **February 25, 2016** by the Nasdaq Review Council's Review Subcommittee, or by the Office of Disciplinary Affairs on behalf of the Nasdaq Review Council, pursuant to Nasdaq Rule 9216. A copy of the AWC is enclosed herewith.

You are again reminded of your obligation, if currently registered, immediately to update your Uniform Application for Broker-Dealer Registration ("Form BD") to reflect the conclusion of this disciplinary action. Additionally, you must also notify FINRA (or NASDAQ if you are not a member of FINRA) in writing of any change of address or other changes required to be made to your Form BD.

You are reminded that Section I of the attached Letter of Acceptance, Waiver, and Consent includes an undertaking. In accordance with the terms of the AWC, a registered principal of the firm is required to notify the Compliance Assistant, Legal Section, Market Regulation Department, 9509 Key West Avenue, Rockville, MD 20850, of completion of the undertaking.

You will be notified by the Registration and Disclosure Department regarding sanctions if a suspension has been imposed and by NASDAQ's Finance Department regarding the payment of any fine if a fine has been imposed.

Wedbush Securities Inc.

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If you have any questions concerning this matter, please contact Dawn E. Faris, Senior Counsel, at (240) 386-6219.



David E. Rosenstein  
Senior Vice President, Legal Section  
Department of Market Regulation

Signed on behalf of NASDAQ

Enclosure

FINRA District 2 – Los Angeles  
Donald K. Lopezi  
Vice President and Regional Director  
(Via email)

John L. Erikson, Jr.  
Corporate Counsel, Legal Department  
Wedbush Securities Inc.  
1000 Wilshire Blvd., Suite 900  
Los Angeles, CA 90017

**THE NASDAQ STOCK MARKET LLC**  
**LETTER OF ACCEPTANCE, WAIVER AND CONSENT**  
NO. 20100243866-02

TO: The NASDAQ Stock Market LLC  
c/o Department of Market Regulation  
Financial Industry Regulatory Authority ("FINRA")

RE: Wedbush Securities Inc., Respondent  
Broker-Dealer  
CRD No. 877

Pursuant to Rule 9216 of The NASDAQ Stock Market LLC ("Nasdaq") Code of Procedure, Wedbush Securities Inc. ("Wedbush," the "firm," or "Respondent"), which was formerly known as Wedbush Morgan Securities Inc. prior to April 19, 2010, 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, Nasdaq 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 Nasdaq, or to which Nasdaq 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 Nasdaq:

**BACKGROUND**

The firm has been a member of FINRA since July 30, 1955, and a member of Nasdaq since July 12, 2006, and both those registrations remain in effect. Among other things, Wedbush provides both brokerage and advisory services to institutional and private clients, as well as clearing services.

During all applicable times of this action, Wedbush served as the clearing firm for Scout Trading, LLC, a correspondent broker-dealer that was engaged in the trading of various exchange-traded funds (“ETFs”)<sup>1</sup> (the “Client Broker-Dealer”).<sup>2</sup> Wedbush also was an Authorized Participant of various ETFs (which enabled Wedbush to submit redemption/creation orders on its behalf and on behalf of its clients).

Wedbush served as an Authorized Participant of the ETFs bearing on this action. As such, it cleared the Client Broker-Dealer’s trading of ETF shares in the secondary market and effectuated its orders to obtain and liquidate shares of such ETFs through the purchase and redemption of creation units on the primary market. In order to act as an Authorized Participant, Wedbush entered into Authorized Participant Agreements with the distributors for the ETFs that, among other things, set forth various contractual obligations of Wedbush in effectuating such redemption and creation orders.

### **RELEVANT PRIOR DISCIPLINARY HISTORY**

The firm has no relevant disciplinary history.

### **SUMMARY**

This matter originated from an investigation by FINRA’s Department of Market Regulation’s Short Sale staff (“staff”) of extensive fails to deliver on shares of 14 leveraged and inverse leveraged ETFs<sup>3</sup> by Wedbush resulting from the above Client Broker-Dealer’s redemption activity and trading of such ETF shares on the secondary market from January 1, 2010 through March 16, 2012 (the “review period”). The 14 ETFs included in the staff’s review period traded under the symbols EDC, EDZ, ERX, ERY, FAS, FAZ, SDS, SSO, TMF, TMV, TNA, TZA, ZSL, and AGQ.

During the review period, the Client Broker-Dealer repeatedly submitted orders to Wedbush to redeem ETF shares on the primary market, and it also repeatedly sold ETF shares in the open

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<sup>1</sup> ETFs are a type of exchange-traded investment product that are registered as open-end investment companies or unit investment trusts under the Investment Company Act of 1940. Unlike mutual funds, ETF shares trade throughout the trading day on national securities exchanges and at market prices that do not necessarily mirror the net asset value (“NAV”) of the underlying portfolio of assets in which the fund is invested. Additionally, unlike mutual funds, ETF issuers do not sell individual ETF shares directly to, or redeem individual ETF shares directly from, retail investors or other market participants. Instead, only certain qualifying entities designated as Authorized Participants can create and redeem shares directly with an ETF issuer.

<sup>2</sup> The Client Broker-Dealer was the subject of a separate formal Nasdaq disciplinary proceeding.

<sup>3</sup> Leveraged ETFs seek to deliver multiples of the performance of an index or benchmark they track (by, for example, seeking to replicate twice the daily return of the Dow Jones Industrial Average). Some leveraged ETFs are ‘inverse’ or ‘short’ funds in that they seek to deliver a return that is a multiple of the opposite of the performance of the index or benchmark they track. See FINRA Notice to Members 09-31 (June 2009); SEC Investor Bulletin: Exchange-Traded Funds (Aug. 10, 2012).

secondary market. These transactions resulted in failures to deliver substantial numbers of shares of ETFs by Wedbush, which allocated the fails to the Client Broker-Dealer. Although the Client Broker-Dealer took action to close out the fail on T+6, typically by creating ETF shares by submitting a creation order through Wedbush, the Client Broker-Dealer typically re-established the fail position by redeeming or selling shares of the ETF through or with the assistance of Wedbush the next trading day. The Client Broker-Dealer engaged in this cyclical pattern of fail to deliver activity to maximize the number of days the Client Broker-Dealer remained short in the securities so as to take advantage of the inherent financial benefits of being short versus long these ETF shares. As such, the Client Broker-Dealer was not entitled to utilize the T+6 close-out time frames for bona-fide market making activities under Rule 204 of Regulation SHO. Wedbush was aware, or should have been aware, that the Client Broker-Dealer was routinely submitting naked redemption orders (i.e., that is not long the requisite number of shares to cover its redemption order), contrary to Wedbush's obligations as an Authorized Participant of the subject ETFs.

As a result of the foregoing, Wedbush violated Nasdaq Rule 2110 as a result of its failure to sufficiently inquire into the Client Broker-Dealer's redemption orders and adequately follow-up to address the Client Broker-Dealer's recurring fails resulting from such redemption orders and short selling of ETF shares in the secondary market. In addition, Wedbush violated Nasdaq Rules 3010 and 2110 due to Wedbush's failure to establish, implement and enforce reasonable supervisory procedures, including written supervisory procedures, with respect to Rule 204 and its activities as an Authorized Participant, including its processing of ETF redemption and creation orders and ETF trades in the secondary market.

### **FACTS AND VIOLATIVE CONDUCT**

1. Throughout the review period, Wedbush's Client Broker-Dealer engaged in a systemic, recurring and cyclical pattern of 'naked' redemption and short sale trading activity in ETFs that resulted in substantial, repeated failures to deliver the ETFs by Wedbush within the Continuous Net Settlement System ("CNS"). More specifically, the Client Broker-Dealer routinely submitted orders to redeem ETFs to Wedbush, which also served as the Authorized Participant for such ETFs, even though the Client Broker-Dealer was insufficiently long the ETF shares comprising its redemption orders, and the Client Broker-Dealer also routinely executed short sales of the ETFs on the secondary market that cleared through Wedbush.
2. The Client Broker-Dealer repeatedly submitted such naked redemption orders and engaged in such open market short selling as a means to maintain a short position in the ETFs to take advantage of the natural economic decay associated with such funds as a result of certain asymmetric fee biases associated with the leveraged and inverse leveraged nature of the securities, whereby it was economically more advantageous to maintain a short position versus a long position in such ETFs. In sum, the Client

Broker-Dealer's naked redemption strategy was designed to maximize the number of days the Client Broker-Dealer remained in a short position for the Client Broker-Dealer's financial benefit.

3. Wedbush allocated the fails to deliver associated with the foregoing redemption and trading activity to the Client Broker-Dealer, which, upon receiving buy-in notices, the Client Broker-Dealer typically took action to close out the fail by submitting an order to create units in the ETFs on T+6, even though its redemption and short sale activities that resulted in the fails to deliver did not qualify as bona fide market making under Rule 204. In addition, the Client Broker-Dealer would typically re-establish the fail position by redeeming shares of the ETF through Wedbush, or executing sales of the ETF that cleared through Wedbush, the next trading day.
4. The extent and magnitude of the Client Broker-Dealer's naked redemption/short selling in the subject ETFs was significant. During the review period, the Client Broker-Dealer submitted at least 255 naked redemption orders through Wedbush in eleven of the above 14 ETFs included in the staff's review, totaling 295,950,000 shares for which the Client Broker-Dealer was not long the requisite number of shares of the ETF and otherwise did not have the full legal authority and legal and beneficial right to tender those shares at the time the Client Broker-Dealer submitted its redemption orders.<sup>4</sup> The amount of shares by which the Client Broker-Dealer was insufficiently long ranged from 19,638 shares to more than 9.8 million, and averaged more than 1.1 million shares. The market value of the subset of ETF shares comprising the redemption order in excess of the Client Broker-Dealer's position averaged almost \$23 million.
5. The Client Broker-Dealer's chronic fails to deliver in ETF shares resulting from its above naked redemption/trading strategy also constituted a significant factor in the 14 ETFs under review being classified as Threshold Securities under Regulation SHO for sustained timeframes during the review period. For example, the Client Broker-Dealer's ETF trading in FAZ accounted for approximately 95 percent of Wedbush's fails in FAZ, which, in turn accounted for about 59 percent of the aggregate total market fails to deliver in FAZ during the review period. Wedbush's fails in FAZ alone would have led to FAZ's inclusion on the Threshold List for more than 250 consecutive settlement dates during the review period from March 7, 2011 through March 16, 2012.
6. Wedbush, through its Correspondent Services Group, entered into the applicable Authorized Participant Agreements with the distributors for the above ETF issuers of

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<sup>4</sup> The applicable ETF symbols included AGQ, EDZ, ERX, ERY, FAS, FAZ, SDS, TMV, TNA, TZA and ZSL.

Direxion and ProShares funds in July and August 2009, respectively. Those agreements specified that Wedbush would not attempt to submit a redemption order for the purpose of redeeming any creation units unless it first ascertained that it or the customer/client on whose behalf it was acting “owns outright or has full legal authority and legal and beneficial right to tender for redemption the requisite number” of fund shares.

7. Wedbush, however, failed to ascertain whether the Client Broker-Dealer beneficially owned sufficient ETF shares to cover its redemption requests. In fact, Wedbush was aware, or should have been aware, that the Client Broker-Dealer routinely was placing ETF redemption orders with Wedbush when it was insufficiently long the ETF shares, resulting in repeated fails to deliver consistent with the Client Broker-Dealer’s strategy to maintain a short position in ETFs. In addition, Wedbush failed to adequately follow up on the Client Broker-Dealer’s repeated fails to deliver that resulted from its cyclical, repetitive pattern of naked redemption orders and short sales of ETFs in the secondary market to identify and take steps to address the misconduct.
8. Wedbush failed to observe high standards of commercial honor and just and equitable principles of trade by: (1) submitting the Client Broker-Dealer’s naked redemption orders without first ascertaining that the Client Broker-Dealer owned outright or had full legal authority and legal and beneficial right to tender for redemption the requisite number of ETF shares associated with its orders, contrary to certain contractual requirements pertaining to Wedbush’s activities as an Authorized Participant, and (2) taking insufficient follow-up actions concerning the Client Broker-Dealer’s systemic and cyclical fails.
9. In addition, Wedbush failed to establish, implement and enforce reasonable supervisory procedures, including written supervisory procedures, during the review period specific to compliance with Rule 204 of Regulation SHO, or specific to Wedbush’s activities as an Authorized Participant in certain ETFs, to reasonably ensure those activities complied with applicable securities laws, rules and regulations. While Wedbush maintained certain desk procedures and a corporate policy concerning close outs of fails to deliver and procedures regarding the processing of ETF creation/redemption orders during the review period, they were operational in nature. Wedbush’s written supervisory procedures did not address either Rule 204 or the firm’s activities as an Authorized Participant at all, let alone provide for supervisory reviews to ensure fails were being appropriately identified and addressed, close-out procedures were being followed and firm personnel tasked with carrying out the firm’s obligations and responsibilities as an Authorized Participant were both familiar with, and carrying out, such duties consistent with the firm’s Authorized Participant Agreements and applicable securities laws, rules and regulations.

10. As a result of the foregoing, Wedbush violated Nasdaq Rule 2110 by facilitating its Client Broker-Dealer's violations of Rule 204 of Regulation SHO in repeatedly effectuating, as an Authorized Participant and clearing firm, the Client Broker-Dealer's naked redemption orders and ETF short sell orders, without conducting adequate inquiry into whether the Client Broker-Dealer owned or had full legal authority and legal and beneficial right to redeem ETF shares and taking sufficient follow-up actions to address the Client Broker-Dealer's recurring, cyclical fails.
  11. In addition, Wedbush violated Nasdaq Rules 3010 and 2110 by failing to establish, maintain and enforce a supervisory system, including written supervisory procedures, reasonably designed to: (a) achieve compliance with Rule 204 of Regulation SHO and (b) ensure that its activities as an Authorized Participant, including its processing of ETF redemption and creation orders and ETF trades in the secondary market, complied with applicable securities laws and regulations.
- B. Wedbush also consents to the imposition of the following sanctions:

- a censure;
- a fine of \$675,000 to be paid jointly to Nasdaq and FINRA, of which \$337,500 shall be paid to Nasdaq; and
- an undertaking to revise Wedbush's written supervisory procedures with respect to the areas described in paragraph I.A.11. Within 60 business days of acceptance of this AWC by the Nasdaq Review Council, a registered principal of Wedbush shall submit to the **COMPLIANCE ASSISTANT, LEGAL SECTION, MARKET REGULATION DEPARTMENT, 9509 KEY WEST AVENUE, ROCKVILLE, MD 20850**, a signed, dated letter, or an e-mail from a work-related account of the registered principal to [MarketRegulationComp@finra.org](mailto:MarketRegulationComp@finra.org), providing the following information: (1) a reference to this matter; (2) a representation that the firm has revised its written supervisory procedures to address the deficiencies described in paragraph I.A.11; and, (3) the date the revised procedures were implemented.

## II.

Wedbush agrees to pay the monetary sanction(s) in accordance with its executed Election of Payment Form.

Wedbush specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.



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

### WAIVER OF PROCEDURAL RIGHTS

Wedbush specifically and voluntarily waives the following rights granted under Nasdaq's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against the firm;
- B. To be notified of the Formal 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 Nasdaq Review Council and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Wedbush specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Regulatory Officer, the Nasdaq Review Council, or any member of the Nasdaq Review Council, 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.

Wedbush further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of 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

Wedbush 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 FINRA's Department of Market Regulation and the Nasdaq Review Council, the Review Subcommittee, or the Office of Disciplinary Affairs ("ODA"), pursuant to Nasdaq Rule 9216;

- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
- C. If accepted:
1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by Nasdaq or any other regulator against them;
  2. Nasdaq may release this AWC or make a public announcement concerning this agreement and the subject matter thereof in accordance with Nasdaq Rule 8310 and IM-8310-3; and
  4. Respondent 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. Respondent may not take any position in any proceeding brought by or on behalf of Nasdaq, or to which Nasdaq is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent's right to take legal or factual positions in litigation or other legal proceedings in which Nasdaq is not a party.
- D. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent 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 Nasdaq, nor does it reflect the views of Nasdaq 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 it 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.

2/11/16  
Date

Wedbush Securities Inc.  
Respondent


By:   
Name: Gary L. Wedbush  
Title: Executive Vice President

Reviewed by:

  
John L. Erikson, Jr.  
Corporate Counsel, Legal Department  
Wedbush Securities Inc.  
1000 Wilshire Boulevard  
Los Angeles, CA 90017  
(213) 688-6665

Accepted by Nasdaq:

February 25, 2016  
Date

  
David E. Rosenstein  
Senior Vice President and Counsel  
Department of Market Regulation

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

**ELECTION OF PAYMENT FORM**


The firm intends to pay the fine proposed in the attached Letter of Acceptance, Waiver and Consent by the following method (check one):

- A firm check or bank check for the full amount;
- Wire transfer;
- The installment payment plan.<sup>5</sup>
  - Monthly
  - Quarterly

Respectfully submitted,

Respondent  
Wedbush Securities Inc.

2/12/16  
Date

By:   
Name: Gary L. Wedbush  
Title: Executive Vice President

<sup>5</sup> The installment payment plan is only available for a fine of \$50,000 or more. Certain requirements apply.