

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

**Certified, Return Receipt Requested**

TO: **Scout Trading, LLC  
Mr. Michael Bleich  
Managing Member  
120 West 45 Street  
Suite 3705  
New York, NY 10036**

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: April 7, 2015

RE: Notice of Acceptance of Letter of Acceptance, Waiver and Consent No. 20100243866-01

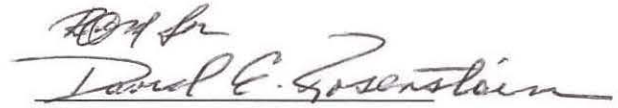
**Please be advised** that your above-referenced Letter of Acceptance, Waiver and Consent ("AWC") has been accepted on **April 7, 2015** by the Nasdaq Review Council's Review Subcommittee, or by the Office of Disciplinary Affairs on behalf of the Nasdaq Review Council, pursuant to Nasdaq Rule 9216. A 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 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.

Scout Trading, LLC  
Page 2

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 10 – New York  
Michael Solomon  
Senior Vice President and Regional Director  
(Via email)

Hal S. Shaftel  
Cadwalader, Wickersham & Taft LLP  
Counsel for Respondent  
One World Financial Center  
New York, NY 10281

FINRA

THE NASDAQ STOCK MARKET LLC 2015 APR -6 AM 11: 53  
LETTER OF ACCEPTANCE, WAIVER AND CONSENT  
NO. 20100243866-01

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

RE: Scout Trading, LLC, Respondent  
Broker-Dealer  
CRD No. 151990

Pursuant to Rule 9216 of The NASDAQ Stock Market LLC ("Nasdaq") Code of Procedure, Scout Trading, LLC ("Scout" or the "firm") ("Respondent") 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**

Scout became a member of Nasdaq on November 9, 2011. Scout's registration as a Nasdaq member was terminated on August 18, 2014, following the firm's filing on July 17, 2014 of a Form BDW seeking a complete withdrawal of its broker-dealer registrations through FINRA's Central Registration Depository.

Scout was founded in 2009 when Scout first registered as a broker-dealer with the Securities and Exchange Commission ("SEC") and CBOE Stock Exchange, LLC ("CBSX") that year. It was formed primarily to engage in the trading of exchange-traded

funds (“ETFs”).<sup>1</sup> At all relevant times of this action, Scout consisted of approximately a dozen or less personnel and was registered as a remote market maker on CBSX in various ETFs. During all applicable times of this action, Scout’s then clearing firm (the “clearing firm”) served as an Authorized Participant of the ETFs bearing on this action. Scout has no relevant disciplinary history.

### SUMMARY

This matter originated from an investigation by FINRA’s Market Regulation staff (“staff”) of extensive fails to deliver on shares of several ETFs by Scout’s then clearing firm resulting from Scout’s redemption activity and trading of such ETF shares on the secondary market within the staff’s investigative period of January 1, 2010 through March 16, 2012 (the “investigative period”). This action covers the portion of the investigative period since Scout became a Nasdaq member, from November 9, 2011 through March 16, 2012 (the “applicable period”). While this action only encompasses the portion of the timeframe of the above investigative period associated with Scout’s membership in Nasdaq, the common conduct of Scout occurring over the broader investigative period described below provides context and informs the present action.

The 14 leveraged and inverse leveraged ETFs<sup>2</sup> included in the staff’s reviews included Direxion and ProShares funds that traded under the symbols EDC, EDZ, ERX, ERY, FAS, FAZ, SDS, SSO, TMF, TMV, TNA, TZA, ZSL, and AGQ.

During the investigative period, Scout repeatedly engaged in transactions that resulted in a failure to timely deliver shares of ETFs associated with Scout’s orders to redeem ETF shares on the primary market and sell ETF shares in the open secondary market for Scout’s financial benefit. These transactions by Scout involved routinely and repeatedly waiting to close out the fails to deliver in ETFs associated with the above trading strategy until T+6 using close-out timeframes for bona fide market making under Rule 204 of Regulation SHO. Such trading activities by Scout, however, did not qualify as bona fide market making activities under Rule 204 of Regulation SHO. Instead, Scout’s trading involved the continual re-establishment of fail

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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> 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).

positions to maximize the number of days Scout remained short in the securities so as to take advantage of the inherent financial benefits of being short versus long the ETF shares.

As a result of the foregoing conduct, Scout violated Rule 204 of Regulation SHO and violated Nasdaq Rule 2110. Further, Scout violated Nasdaq Rules 3010 and 2110 due to Scout's lack of reasonable supervisory procedures to prevent misconduct of the type found in this matter.

### **FACTS AND VIOLATIVE CONDUCT**

During the applicable period (and the staff's investigative period more generally), Scout engaged in a systemic, recurring and cyclical 'naked' redemption and short sale trading strategy that resulted in its failure to timely deliver ETF shares associated with its orders to redeem creation unit(s) in those ETFs and its short sales of such ETF shares on the secondary market. In that connection, Scout routinely submitted redemption orders to the clearing firm, which also served as the Authorized Participant for such ETFs, when Scout was insufficiently long the ETF shares comprising its redemption order. The trading strategy generally followed a pattern that involved Scout's failure to timely deliver the ETF shares by regular-way (T+3) settlement deadlines contemplated for such transactions. Instead, Scout waited to close out the resulting fail until just before the beginning of regular trading hours on T+6 (frequently by the submission of an order to establish ETF creation units) using the T+6 close-out timeframes of Rule 204 of Regulation SHO for bona fide market making (when such trading activities did not qualify as bona fide market making activities under Rule 204 of Regulation SHO). Scout perpetuated the same pattern by submitting a naked redemption order (or, in some cases, an open market short sale) the next trading day following such a T+6 close out that was also not timely delivered, which resulted in another fail to deliver and T+6 close-out, followed by the same pattern for prolonged periods throughout the investigative period, including the applicable period.

Scout repeatedly submitted such naked redemption orders and engaged in such open market short selling as a means to maintain a short position in those ETFs, because it was financially more beneficial to do so due to the economic decay associated with such funds as a result of certain asymmetric fee biases associated with the ETF market whereby it was economically more advantageous to maintain a short position versus a long position. In sum, Scout's naked redemption strategy was designed to maximize the number of days Scout remained in a short position for the firm's financial benefit.

The extent and magnitude of Scout's naked redemption/short selling activity in the subject ETFs was significant. During the investigative period, Scout submitted at least 255 naked redemption orders through the clearing firm in eleven of the above 14 ETFs included in the staff's review, totaling 295,950,000 shares for which Scout was not long the requisite number of shares of the ETF at the time Scout submitted its redemption orders. The amount of shares by which Scout 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 Scout's position averaged almost \$23 million. Within the first two months of the applicable period, Scout submitted at least 38 naked redemption orders in nine of the above ETFs totaling 15,700,000 shares for which Scout was not long the requisite ETF shares when it submitted its redemption order.

Scout's naked redemption activity consistently resulted in fails by the clearing firm through the Continuous Net Settlement System. Scout typically received multiple buy-in notices weekly requiring close-out actions associated with the clearing firm's fails arising from Scout's ETF activity, which Scout consistently responded to by typically submitting an order to establish ETF creation units (or, in some cases, purchasing ETF shares on the secondary market) on the morning of T+6 (and engaging in naked redemption/short selling activity through the clearing firm to reset the short on T+7 and thereafter fail).

Scout's trading involving chronic fails to deliver in ETF shares resulting from its above naked trading strategy constituted a significant factor in the 14 ETFs under review being classified as Threshold Securities under Regulation SHO for sustained timeframes, both during the investigative and applicable periods. For example, Scout's ETF trading in FAZ accounted for approximately 95 percent of its clearing firm's fails in FAZ, which, in turn accounted for about 59 percent of the aggregate total market fails to deliver in FAZ, during the investigative period. The clearing firm'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 investigative period from March 7, 2011 through March 16, 2012.

In addition, Scout lacked any supervisory procedures, including written supervisory procedures, during the applicable period (and the investigative period more generally) specific to compliance with Rule 204 of Regulation SHO, or specific to Scout's ETF redemption/creation activities to reasonably ensure compliance of those activities with applicable securities laws and regulations more generally.

As a result of the foregoing:

1. Scout violated Rule 204 of Regulation SHO and violated Nasdaq Rule 2110.
2. Scout violated Nasdaq Rules 3010 and 2110 by failing to establish, maintain and enforce a supervisory system, including written supervisory procedures, reasonably designed to ensure: (a) compliance with Rule 204 of Regulation SHO, and (b) that its ETF redemption and creation activities and ETF trading in the secondary market complied with applicable securities laws and regulations.

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

- a censure, and
- a fine of \$3,000,000.

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

The firm 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.

## II.

### WAIVER OF PROCEDURAL RIGHTS

The firm 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, the firm 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.

The firm 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

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 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 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 Nasdaq or any other regulator against the firm;
  - 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
  - 3. 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 Nasdaq, or to which Nasdaq is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects the firm's right to take legal or factual positions in litigation or other legal proceedings in which Nasdaq is not a party.

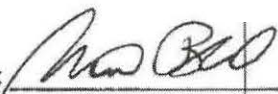


- D. The firm may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. The firm understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by 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.

4/1/15  
Date

Scout Trading, LLC  
Respondent

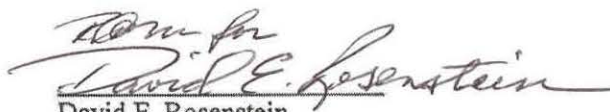
By:   
Name: MICHAEL BLEICH  
Title: MANAGING MEMBER

Reviewed by:

  
Hal S. Shaftel  
Cadwalader, Wickersham & Taft LLP  
Counsel for Respondent  
One World Financial Center  
New York, NY 10281  
(212) 504-6000

Accepted by Nasdaq:

4/7/15  
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>3</sup>
  - Monthly
  - Quarterly      OVER FOUR YEARS

Respectfully submitted,

Respondent  
Scout Trading, LLC

4/1/15  
Date

By:   
Name: MICHAEL BLEICH  
Title: MANAGING MEMBER

<sup>3</sup> The installment payment plan is only available for a fine of \$50,000 or more. Certain requirements apply.