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**UNITED STATES OF AMERICA**
**BEFORE THE**
**SECURITIES AND EXCHANGE COMMISSION**
**AUGUST 1, 2019**



SECURITIES EXCHANGE ACT OF 1934
Release No. 86287 / July 2, 2019

Admin. Proc.File No. 3-19182

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| In the Matter of the Application of | ) |
| EQUITEC PROPRIETARY MARKETS, LLC | ) |
| For Review of Disciplinary Action Taken by | ) |
| CBOE | ) |

**BRIEF IN SUPPORT OF APPLICATION FOR REVIEW FILED BY EQUITEC PROPRIETARY MARKETS, LLC**

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On behalf of Equitec Proprietary Markets, LLC

## I. Introduction

Equitec Proprietary Markets, LLC, ("Equitec" or the "Firm") by its Counsel, David Barclay, hereby submits this brief in support of its application for review by the Securties and Exchange Commission (the "Commission").

## II. Procedural Background

The Business Conduct Committee ("BCC") of the Cboe Exchange, Inc. ("Cboe" or "Exchange") instituted this proceeding under Chapter 17 of the Exchange's Rules ("Exchange Rules"). On June 2, 2015, under authorization of the BCC, FINRA Market Regulation / Legal issued a Statement of Charges in STAR No. 20150456213 ("SOC" or "Charges") against Equitec.

The SOC alleged violations of Exchange Rule 4.2 - Adherence to Law ("Exchange Rule 4.2") and 17 C.F.R. 240.15c-3-5 - Risk Management Controls for Brokers or Dealers with Market Access, (the "Rule" or "15c3-5") promulgated under the Securities Exchange Act of 1934, as amended ("Rule 15c3-5" or "Market Access Rule"). Equitec filed a timely Answer on July 10,2015, denying all charges.

Pursuant to Exchange Rule 17.6, a two-day hearing was held in Chicago, Illinois on January 23-24, 2017 ("Hearing") before the Hearing Panel consisting of three public members of the BCC. The BCC issued its Decision and Order (the "Decision") on June 14, 2017.

On July 14, 2017 Equitec submitted a petition for review by the (the "Board") of the Cboe Exchange, Inc. ("Cboe" or the "Exchange") for review of the June 14, 2017 Decision and Order that resulted from the Business Conduct Committee ("BCC") disciplinary hearing before the BCC Hearing Panel (the "Panel") for STAR NO. 20150456213.

On April 23, 2019 the Board issued its Decision in this matter, Decision No. 19BD 01 (the "Board Decision"). The Board Decision upheld the findings of the BCC and found that CBOE Regulation has proven by a preponderance of evidence that Equitec had violated the Market Access Rule and CBOE Rule 4.2. It is from this Decision that Equitec is appealing.

## III. Summary of Argument

The Exchange erred in misreading the market access rule to require the inclusion of executions as well as orders, in a reasonably designed system of controls. The Exchange inferred a method of decrementation for executed orders that was also nowhere in the Rule. Further, the Exchange erred in stating that the Exchange's interpretation of the rule and its method for implementing the Rule could be reasonably implied by the Rule or its legislative history. Finally, the Exchange erred in finding that Equitec had been given adequate notice of its interpretation of the Rule.

## IV. The Exchange's Incorrect Interpretation of the Market Access Rule

First, we address the Exchange's incorrect interpretation of the Market Access Rule. The one substantive allegation in this matter was that the Firm was required to include executions as well as orders in implementing its preset credit thresholds. This is based on a fundamental misreading of Rule 15c3-5. In relevant part the Rule states:

§240.15c3-5 Risk management controls for brokers or dealers with market access.

> (b) A broker or dealer with market access, or that provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier or otherwise, shall establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity. Such broker or dealer shall preserve a copy of its supervisory procedures and a written description of its risk management controls as part of its books and records in a manner consistent with §240.17a-4(e)(7).
>
> (c) The risk management controls and supervisory procedures required by paragraph (b) of this section shall include the following elements:

> (1) *Financial risk management controls and supervisory procedures.* The risk management controls and supervisory procedures shall be reasonably designed to systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, including being reasonably designed to:
>
> (i) Prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer and, where appropriate, more finely-tuned by sector, security, or otherwise by rejecting orders if such orders would exceed the applicable credit or capital thresholds; ....
>
> (2) *Regulatory risk management controls and supervisory procedures.* The risk management controls and supervisory procedures shall be reasonably designed to ensure compliance with all regulatory requirements, including being reasonably designed to:
>
> (i) Prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis;
>
> (ii) Prevent the entry of orders for securities for a broker or dealer, customer, or other person if such person is restricted from trading those securities;
>
> (iii) Restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer....
>
> 17 C.F.R. § 240.15c3-5.

Nowhere is the term "executions" used. That is not due to oversight. The Rule is designed to prevent the entry of orders. It is designed to protect the market and firms from the effects of orders that are entered into the market. As such, executed orders are not at issue. Executed orders are no longer orders, but are trades. Firms have positions or economic results based on trades, but executed trades, whether they were executed two seconds ago, two minutes ago or two weeks ago, do not have the capacity to harm the market. Only orders pending in the system can cause harm. It was not intended to be an overall risk requirement or a substitute for the net capital rule and was not intended to change the way firm's do business.

The November 15, 2010 Federal Register Release which implemented SEC Rule 15c3-5 (the "Adopting Release"), including the background and purpose of the Rule. In the Adopting Release the SEC noted "The recent proliferation of sophisticated, high speed trading technology has changed the way broker-dealers trade for their own accounts and as agents for their customers." The SEC was rightfully concerned that computer or human error could trigger extreme market disruptions such as the May 6, 2010 Flash Crash and chose to impose a requirement for "reasonably designed" financial and regulatory risk management controls. Among the requirements under the Rule were controls designed to "Prevent the entry of orders (emphasis added) that exceed appropriate pre-set credit or capital thresholds..." Nowhere is there any mention of "executions". In fact, the Adopting Release states that "...controls should measure compliance with appropriate credit or capital thresholds on the basis of orders entered rather than executions obtained". The Exchange's interpretation is fundamentally in conflict with this SEC guidance.

Understanding of the Rule evolved over time. On April 15, 2014 the SEC did issue a Response to Frequently Asked Questions (FAQ) to provide additional guidance on the Rule. For example, quotes were not originally considered orders under the Rule, but over time, and with the issuance of the FAQ, firms came to know to include them. (Shimanek tr. p. 20) No such FAQ was issued on executions The FAQ stated that "Division staff notes that under the Rule these risk management controls are required for all orders, whether generated manually by a trader or generated automatically by a computer..." Consistent with the Rule and the Release, the FAQ contains no mention of executions. Surely if the SEC meant to include executions as well as orders it could have and would have.

## V. Decrementation

While having to concede that the Rule and Release do not require specific procedures, the Exchange insisted that somehow this meant that a particular procedure, a simplistic method of decrementation of executed, not pending, orders was the only and somehow best way to achieve effective credit threshold control. ".. nothing in the Adopting or Proposing Release states or suggests the value of executed orders should be ignored or added back to the threshold." (Decision p. 13). However, it is also true that nothing in the Adopting Release or Proposing Release states or suggests the value of executed orders should not be ignored or added back to the threshold. Both Releases are simply silent on the matter.

Further, the Exchange tries to assert that because the FAQ doesn't "address decrementation practices per se" (Decision p. 15) that somehow means the SEC is endorsing something (decrementation) that it flatly doesn't discuss.

The Board somehow seemed to accept this non-proof as proof. The Board Decision states the Rule "requires a broker-dealer to implement a control that accounts for all orders, including executed orders, in determining an appropriate credit or capital threshold. " Board Decision at p. 11. This does not refute Equitec's position, since the Board is conflating the establishment of a threshold with rather that the implementation of the control. Executions, i.e., the firm's positions, as well as its capital, are relevant in setting the threshold. However, once a threshold is set, it is how it is implemented that is at issue here. Citing Mr. Markovic's testimony, the Board states that even after an order has been executed, a firm still has risk from that position (Board Decision p. 11). That is simplistic and not actually true. For example, an execution that closes out a position cannot still pose any risk to the firm. A firm such as Equitec has a sophisticated risk system that takes into account hedges, offsets and related positions, none of which are accounted for in the Exchange's view. Essentially they make a conclusion based on nothing in the legislative history and no support other than the Exchange's self-serving statements.

### VI. Exchange Interpretation of Rule cannot be fairly or reasonably implied

The Exchange Act and SEC Rule 19b-4 require SROs to provide a "fair procedure" for the discipline of members or associated persons. Although the formal "requirements of constitutional due process do not apply to [SRO] proceedings," the statutory fair-procedure mandate gives rise to certain "'due-process-like'" requirements. For the Exchange to come up with this novel interpretation of the Rule and expect Equitec to have read its mind can hardly be said to be reasonably or fairly implied by the Rule, as required by SEC Rule 19b-4. Moreover, because the interpretation was never published (formally or otherwise) or even revealed until the close of the firm's examination in the spring of 2015, it simply cannot be considered sufficiently determinate to avoid running afoul of the due process clause. *Rooms v. Securities and Exchange Commission*, 444 F.3d 1208, 1214 (10th Cir. 2006) (explaining that due process requires an exchange "rule give fair warning of the prohibited conduct before a person may be disciplined for that conduct."); *General Bond & Share Co. v. Securities and Exchange Commission*, 39 F.3d 1451, 1455 (10th Cir. 1994) same); *Timpiano v. Securities and Exchange Commission*, 2 F.3d 453 (D.C. Cir. 1993) a vague rule is unconstitutional because it imposes "standards of conduct so indeterminate that it is impossible to ascertain just what will result in sanctions.").

## VII. Notice of Interpretation of the Rule

The Exchange's interpretation of the Rule was never communicated to Equitec in any way and was never set forth in any document or communication available to Equitec until the examination that led to these charges. As stated above, this is in blatant violation of the requirements of SEC Rule 19b-4. The Decision states that the Firm had ample notice and that "There were plenty of resources available to Respondent prior to 2015 that indicated that executed orders should be decremented against credit or capital threshold" (Decision p. 16) The Board Decision agrees with that (Board Decision p. 14) However, none of the so-called ample resources (Decision pages 16-19),provide that notice. It is instructive to review all six in order.

1. The Proposing Release that says firms "must assess compliance with the applicable threshold on the basis of exposure for orders entered on an exchange or ATS, *rather than waiting for executions to make that determination*." (emphasis added by Exchange). The BCC in its Decision goes on to state that the SEC is saying you cannot count only executed orders against the threshold and that "Instead, all orders, including those that are executed, must be decremented against the capital thresholds." (Decision p. 16). The Proposing Release simply does not say that, and it cannot be reasonably inferred therefrom. It literally says look at orders, not executions.

2. With regard to the Davis Polk Memorandum dated November 5, 2010, which discusses only orders, not executions, the Decision stated: "nothing in the memorandum suggests that executed orders are not to be counted against the capital threshold" (Decision p. 17). Davis Polk's Guidance that you must do one thing (include orders) and not specifically prohibiting the inclusion of executions can in no way be seen as giving advice to do that. It certainly doesn't provide adequate notice to do so.

3 The Decision discusses the Goldman Sachs comment in the Adopting Release and again tries to prove its position by virtue of the rejection of a different position. The Decision states that "the SEC is stating in the Adopting Release that broker-dealers must decrement all orders entered, rather than waiting for executions to take place." (Decision p. 17) This is true and goes back to the purpose of the Rule. The BCC then goes on to state: "The SEC is not stating or implying that executed orders are to be altogether ignored with respect to the threshold." (Decision p. 17). This is also true. The SEC here is saying nothing either way about how executed orders are to be handled. It is unfair and incorrect to imply that it means they are saying they need to be decremented—or not. It is simply not addressed.

4. Next the Decision cites SEC in the matter Knight Capital America, October 16, 2013 (the "Knight case"). The case does not discuss the need to decrement. The Panel says there was no need to discuss that: "It was not necessary for the SEC to specifically discuss decrementation practices in Knight because the number of orders that were sent to the market and executed far exceeded the capital threshold." (Decision p. 18). Directly after that the Decision states "The Knight case supports the Exchange's position that executed orders are to be counted against the threshold." This is simply not true and is not a logical conclusion from what has just gone before. Knight does not support the Exchange's position and again cannot possibly be seen as giving anyone notice of that position.

5. The FAQ's issued by the SEC on April 15, 2014 (the "FAQ's") are cited. The FAQs do not mention executions and in fact say the opposite. "Nothing in the FAQ's indicates that once an order is executed, the value can be added back to the capital or credit threshold." (Decision p. 18) Nor does it say it cannot be added back. There is no reason to infer from this that the executions should not be added back, and in fact the discussion of orders without reference to execution would imply, if anything, the opposite. In any event this cannot be seen as giving firms notice that they should decrement executed orders. The Board Decision states the Rule does not draw a distinction between orders that are entered and orders that are executed. (p. 11 quoting of Mr. Markovic). The Board cites the testimony of William Shimanek in support of this position. (Board Decision, p. 12) This a blatant mischaracterization of what Mr. Shimanek said. When asked if orders entered are still orders after they are executed, he said no, they are trades, executions. (Shimanek at p. 66). Upon execution they cease to be orders.

After an order is executed it no longer poses a risk to the market. It is a bullet spent, no longer a bullet but a shell. The Exchange, including the Board, have throughout this matter betrayed a fundamental misunderstanding of what an order is and what an execution is. It is this fundamental misunderstanding that has led to the decisions made at every step of the way by the Exchange.

6. The BCC's last argument that the firm should have had notice of the Exchange's position on executed orders is the testimony of Milan Markovic. Mr. Markovic claims that every other firm is doing it. (Markovic p. 199) That is based on nothing but bare assertion. He had been working in 15c3-5 only since December 2014 (Markovic cross p.243) and had only been in this area for four months at the time Equitec received its Wells letter in this matter in April 2015. As was stated in the Hearing, Equitec first was told of the Exchange's view that executions should be decremented from its 15c3-5 threshold by the Exchange in the spring of 2015. It should be noted that Equitec received the Wells letter in this matter the very next day. If the purpose of exams is in part to inform firms of the Exchange's interpretation of rules and assist them in compliance with them, then how is it served by announcing a novel (at least to Equitec) interpretation and allowing no time for the firm to in any way try to comply. In fact, it appears the Wells had already been prepared when the telephone conversation occurred. Most of Mr. Markovic's experience has come long after this and thus his testimony as to what other firms do today is irrelevant to what Equitec knew during the relevant time period. Mr. Markovic testified he did not know of any other firms that took a similar view to Equitec's with respect to this issue. In fact, we are aware of several that do. Mr. Markovic's limited experience cannot and should not have the weight of some sort of industry-wide survey. But more importantly, what Mr. Markovic did or didn't know has nothing to do with providing "ample notice" to Equitec. Neither he nor anyone else at the Cboe ever communicated prior to the Spring of 2015 that this is how the Rule should be applied. Thus Mr. Markovic's understanding of industry practice cannot

be a source of notice to Equitec. Nor should his lack of imagination as to how a threshold could otherwise work be dispositive.

In sum, not one of their six grounds for determining the Firm had "ample notice" constitute notice at all. The cited instances either don't address the issue or appear to say the opposite of what the Decision says they do.

In conclusion we ask that the SEC reverse the decision of the Board and the BCC and order the dismissal of the charges against Equitec in this matter. Applying the *de novo* review standard it is clear that any review of the law, in this case Rule 15c3-5 as interpreted through SEC Releases and FAQ's, would lead to the inescapable conclusion that nowhere is there a requirement that execution be included in the application of the required market access filters. Moreover, no notice, as required by Rule 19b-4, of such a non-intuitive interpretation was given, and the various attempts by the Exchange to claim that notice was given fall laughably short.

Respectfully submitted,

Equitec Proprietary Markets, LLC

By:____________________

David J. Barclay, Esq.

Attorney for, Equitec Proprietary Markets, LLC

## CERTIFICATE OF SERVICE

I, David J. Barclay, an attorney, do hereby certify that on August 1, 2019, I caused a copy of the foregoing document, BRIEF IN SUPPORT OF APPLICATION FOR REVIEW FILED BY EQUITEC PROPRIETARY MARKETS, LLC, to be served on the following persons through electronic mail, and US mail:

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A copy of the same was also filed with the Secretary of the Securities and Exchange Commission.

David J. Barclay

## STATEMENT OF SERVICE

I, David J. Barclay, an attorney, do hereby certify that on August 1, 2019, I caused a copy of the foregoing document, BRIEF IN SUPPORT OF APPLICATION FOR REVIEW FILED BY EQUITEC PROPRIETARY MARKETS, LLC, to be served on the following persons through Fax and FedEx:

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