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BEFORE THE
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC

In the Matter of the Application of

Equitec Proprietary Markets, LLC

For Review of

Cboe Exchange, Inc. Disciplinary Action

Admin. Proc. No. 3-19182

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CBOE EXCHANGE, INC.'S BRIEF IN OPPOSITION TO APPLICATION FOR REVIEW

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I. INTRODUCTION

The Board of Directors of the Cboe Exchange, Inc. (f/k/a Chicago Board Options Exchange, Incorporated) (the "Exchange") found that Equitec Proprietary Markets, LLC (the "Firm"), a broker-dealer with market access, violated Rule 15c3-5 under the Securities Exchange Act of 1934 (the "Market Access Rule" or the "Rule") by failing to implement and maintain reasonably designed risk management controls and written supervisory procedures ("WSPs"). For these violations, the Exchange's Board of Directors (the "Board") censured the Firm and ordered it to pay a monetary fine of $50,000.

The Firm does not challenge the Board's findings that it maintained unreasonable WSPs. Thus, this appeal only involves the Firm's risk management controls. Specifically, the primary issue on appeal is whether the Firm violated the Market Access Rule because its capital threshold did not account for executed orders and their accompanying financial risks.

The Board correctly held that pursuant to the Market Access Rule, the Firm's system of controls should have accounted for both open *and* executed orders to properly limit its overall financial exposure, reduce risk to other market participants, and maintain the integrity of trading on the Exchange. (RP 1423.)[1] In reaching this conclusion, the Board considered the Rule's overall purpose, the plain language of the Market Access Rule and the Rule's proposing release and adopting release, and Commission precedent.

The Firm has presented nothing on appeal to reverse the Board's well-reasoned decision. Instead, it continues to base its arguments on an overly narrow reading of the Market Access Rule and its purpose, as well as selective language taken out of context from the Commission's proposing and adopting releases. Similarly, the Firm has not shown that it lacked notice of the Rule's requirements or that the sanctions imposed for the Firm's violations—a censure and $50,000 fine—are excessive or oppressive. The record thoroughly supports that the Board carefully considered numerous factors in assessing these sanctions, which are appropriately remedial and consistent with sanctions imposed in similar cases. Consequently, the Commission should dismiss the Firm's appeal and sustain the Board's findings and sanctions in their entirety.

II. BACKGROUND

A. The Firm

During the relevant periods, the Firm was an Exchange Trading Permit Holder registered to conduct a market making and proprietary trading business, and was subject to the Exchange's

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[1] "RP __" refers to the page number in the certified record. "Firm Br. __" refers to the Firm's August 1, 2019 brief in support of its application for review.

jurisdiction. (RP 19, 28.)[2] The Firm had direct access to trade on market centers, including the Exchange as a market-maker/floor broker. (RP 0026, 0051, 0123-24.)

B. The Market Access Rule

The Commission enacted the Market Access Rule in July 2011. The Rule provides that

> (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 . . . 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. . . .
>
> (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[3] in the aggregate for each customer and the broker or dealer . . . and (ii) Prevent the entry of erroneous orders, by rejecting orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.

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[2] A Trading Permit Holder is a firm that holds a license that grants it the right to access the facilities of the Exchange to effect securities transactions and to otherwise access the Exchange to trade, report, or transmit orders or quotations. *See* Eleventh Amended and Restated Bylaws of Cboe Exchange, Inc., Section 1.1(f), http://www.cboe.com/framed/pdfframed?content=/publish/cboe-rules/11th-amended-and-restated-bylaws-of-cboe-exchange-inc.pdf§ion=SEC_ABOUT_CBOE&title=Eleventh%20Amended%20and%20Restated%20Bylaws%20of%20Cboe%20Exchange,%20Inc.; Exchange Rule 1.1, http://cdn.cboe.com/resources/regulation/rule_book/C1_Exchange_Rule_Book-Currently-Effective.pdf.

[3] A credit threshold is one that must be set by a broker-dealer for each of its customers with market access. *See* 75 Fed. Reg. 69792, 69802 (the "Adopting Release"). A capital threshold is a threshold that a broker-dealer must set for its proprietary trading. *Id.* Because the Firm engaged in proprietary trading and did not provide direct market access to customers, the risk control at issue will be referred to as a "capital threshold control" throughout this brief.

17 C.F.R. § 240.15c3-5(b), (c).

The Commission adopted the Market Access Rule in part, to address concerns that financial and regulatory risks arising in connection with access to trading securities directly on an exchange or an alternative trading system ("ATS") "may not be appropriately and effectively controlled by all broker-dealers." Adopting Release, at 69792. The Commission emphasized that

> New Rule 15c3-5 is designed to ensure that broker-dealers appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system.

Id.

The Market Access Rule provides "flexibility" to broker-dealers for exactly how to design their controls and procedures, "so long as they are reasonably designed to achieve the goals articulated in the proposed rule." *Id.* at 69798.

C. The Firm's Flawed Control Under the Market Access Rule

During the relevant period, the Firm's capital threshold control—a key component of the protective measures required by the Market Access Rule—did not account for executed orders. The impact of the Firm's flawed control is illustrated using a straight-forward example.[4] If a broker-dealer establishes a $100 million capital threshold control under the Market Access Rule, the total value of orders that the firm enters should not exceed $100 million. Any order entered by the firm that exceeds the $100 million threshold must be rejected. If the firm enters a $10 million order, the firm should decrement that order from the $100 million threshold (which

[4] Both the Board and the Exchange's Business Conduct Committee ("BCC") used similar examples in their decisions. *See* RP 1190-91, 1421. This brief addresses the Firm's criticism of this example below. *See infra* Part III.A.

would reduce to $90 million the total amount of outstanding orders that the firm could enter). If that $10 million order is then canceled, the firm may add the value of the canceled order back to its threshold (which would return to $100 million).

Here, however, it is an undisputed fact that the Firm's controls operated in such a way to add back to its capital threshold the value of executed orders, similar to how the value of a canceled order would be added back to the capital threshold as reflected in the above example. Thus, if the Firm had entered a $10 million order and that order was executed, the Firm would add the value of the executed order back to its threshold (returning it to the hypothetical $100 million limit). Under the Firm's capital threshold control, it would have been possible for the Firm to enter and execute 20 orders, valued at $10 million each, and not exceed its $100 million capital threshold if each order was executed before the next order was entered. This could result in the Firm establishing a $200 million position, despite having adopted a $100 million capital threshold. Consequently, even though the Market Access Rule requires broker-dealers to design controls to limit risks to their financial conditions and the marketplace as a whole, the Firm's capital threshold control ignored these risks. Indeed, the operation of the Firm's control rendered its capital threshold virtually meaningless.

D. The Statement of Charges

In June 2015, the BCC issued a Statement of Charges against the Firm.[5] (RP 0015-17.) The Statement of Charges alleged that the Firm violated the Market Access Rule and Exchange

[5] Under the Exchange's rules in effect during the relevant period, Exchange staff would investigate potential misconduct and, if appropriate, issue a report to the BCC requesting that it authorize a statement of charges. The BCC would then determine whether probable cause existed for finding a violation; if the BCC found probable cause, it would then direct staff to prepare a statement of charges. *See* SR-CBOE-2019-025, https://cdn.cboe.com/resources/regulation/rule_filings/approved/2019/SR-CBOE-2019-025.pdf

Rule 4.2[6] by: (1) failing to establish a reasonable credit or capital threshold control that limited the overall financial exposures of the Firm and its customers by considering both pending orders and executions; and (2) failing in myriad ways to maintain reasonably designed WSPs related to the Market Access Rule. Specifically, the BCC alleged that the Firm's WSPs were unreasonable because they failed to specify the processes through which: (a) the Firm's systems prevent the entry of orders that exceed the appropriate credit or capital thresholds in the aggregate; (b) the Firm's on-floor market makers are made aware of the Firm's capital thresholds and appetites for risk so that the on-floor market makers do not disseminate quotes or orders that exceed those thresholds; (c) the Firm prevents the entry of orders unless it has complied with all regulatory requirements that must be satisfied on a pre-order entry basis; (d) the Firm's on-floor market makers are restricted from disseminating quotes or orders in securities if a market maker is restricted from trading in those securities; and (e) the Firm restricts access to the Exchange's trading floor.[7] (RP 0016.)

(explaining existing procedural rules concerning issuing a statement of Charges and proposed changes to the rules); *see also* RP 0015.

[6] Exchange Rule 4.2 provides that, among other things, Trading Permit Holders such as the Firm shall not engage in conduct that violates the Exchange Act or Exchange Act rules and shall supervise associated persons to ensure that they comply with the Exchange Act and Exchange Act rules.

[7] The relevant period for the charge relating to the Firm's unreasonable threshold control was from November 30, 2011, through April 8, 2015. (RP 0015.) The relevant period for the charges relating to the Firm's unreasonable WSPs was from October 18, 2012, through April 8, 2015. (RP 0016.)

E. The BCC Found that the Firm Failed to Establish Reasonable Risk Management Controls and WSPs

A BCC Hearing Panel conducted a two-day hearing in January 2017, during which four witnesses testified. (RP 0593-1182.) In a June 14, 2017 decision, the BCC found that the Firm engaged in the alleged misconduct. (RP 1183-1214.) Specifically, it found that the Firm failed to establish a credit or capital threshold control reasonably designed to limit the overall financial exposure of the Firm, in violation of the Market Access Rule and Exchange Rule 4.2. The BCC based this finding on the fact that the Firm's risk control at issue did not decrement executed orders against its threshold, and thus "failed to mitigate against the financial risk broker-dealers, and their clients and the markets could face as a result of the rapid execution of trades on electronic marketplaces." (RP 1190-1202.) The BCC also found that the Firm failed to maintain reasonably designed WSPs, as alleged in the Statement of Charges. (RP 1202-11.) For these findings of misconduct, the BCC censured the Firm and ordered it to pay a monetary fine of $50,000. (RP 1211-12.)

F. The Board Also Found that the Firm Violated the Market Access Rule

The Firm appealed the BCC's decision to the Board. (RP 1265.) After a de novo review of the BCC's decision, the Board affirmed the BCC's findings and sanctions.[8] (RP 1413-31.) The Board found that the Firm violated the Market Access Rule by failing to establish reasonable controls that limited the Firm's overall financial exposure. (RP 1418-27.) The Board agreed

[8] In its application for review, the Firm states that the Board improperly conducted a de novo review of the BCC's decision. *See* RP 1435. The Board, however, followed the Commission's recent directive that it apply a de novo standard of review to a disciplinary decision issued by the BCC. *See ABN AMRO Clearing Chicago, LLC*, Exchange Act Release No. 83849, 2018 SEC LEXIS 2004, at *6 (Aug. 15, 2018) (holding that the Board must conduct a de novo review of BCC decisions).

with the BCC that the Firm's controls should have accounted for both open and executed orders—and not just open orders—in calculating its credit or capital thresholds. The Board held that the Firm's system of controls did not take into account the risk exposure from the position resulting from the executed order. (RP 1423.) The Board also found that the Firm failed to establish and maintain reasonably designed WSPs, as alleged in the Statement of Charges. (RP 1418.) The Board noted that the Firm did not provide any arguments regarding how the charges related to its deficient WSPs were incorrect, except to assert broadly, without support, that a reversal of the BCC's findings on the first charge would "essentially moot[] the remainder of the Exchange's case." The Board thus found that the Firm waived any challenge to those findings and affirmed the BCC's findings that the Firm maintained unreasonable WSPs. (*Id.*)

The Board rejected all of the Firm's arguments that claimed the Firm did not have to decrement executed orders against its thresholds. (RP 1419-27.) For example, the Firm argued the Market Access Rule is silent regarding executed orders and therefore the Firm could ignore executed orders in its capital threshold control. The Board rejected this argument. The Board found that the Rule's language and its overall purpose to systematically limit broker-dealers' financial exposure arising from market access undercut the Firm's arguments. (RP 1423.) It also found that the release proposing the Market Access Rule,[9] the Adopting Release, and Commission precedent further supported the Market Access Rule's broad requirement that broker-dealers implement controls that account for both open and executed orders to limit financial risks to broker-dealers themselves and to the marketplace as a whole. (RP 1423-24.)

[9] *See* 75 Fed. Reg. 4007 (Jan. 26, 2010) (the "Proposing Release").

The Board correctly concluded that the Firm's approach, where executed orders are not considered in determining its credit or capital thresholds, "would not yield a 'true risk measurement,' as it would not account for the risk relating to a firm's executed orders." (RP 1423.) As the Board found, "[e]ven after an order has been executed, a firm still has risk exposure from that position." *See id.* (citing testimony of Exchange witness Milan Markovic, RP 0789-90.)

The Board further held that the Commission's intent that both open and executed orders be accounted for in a firm's risk controls under the Market Access Rule is supported by the text of the Market Access Rule's Proposing Release and Adopting Release. (RP 1424.) The Board found that the Firm relied selectively, and thus improperly, upon snippets of the Commission's language in the Proposing Release and the Adopting Release which led to the Firm's inability to understand the broader concept being advanced by the Commission in the Proposing Release and the Adopting Release. (RP 1422, 1424.)

The Board also rejected the Firm's argument that it did not have notice that the Market Access Rule required it to account for open orders as well as executed orders, and found that the Firm was afforded a fair procedure. (RP 1425-27.) In so holding, the Board found that the Market Access Rule, especially when viewed in the context of the Proposing Release, the Adopting Release, and Commission precedent, gave adequate notice that executed orders, like open orders, must be decremented against a credit or capital threshold so that a broker-dealer's risks are limited. (RP 1426.)

The Board affirmed the censure and $50,000 fine imposed by the BCC. (RP 1427-31.) In reviewing the BCC's sanctions, the Board considered the factors set forth in Exchange Rule 17.11. (RP 1428.) It also considered the sanctions imposed in relevant precedent, as well as the

Firm's prior rule violations involving deficient WSPs. (RP 1429-30.) The Board concluded that the Firm's misconduct warranted the sanctions imposed by the BCC, and it rejected several arguments raised by the Firm in support of its claim that the BCC's sanctions were excessive and out of line with relevant precedent.

G. The Firm's Appeal

The Firm appealed the Board's decision to the Commission. (RP 1434.) On appeal, the Firm does not dispute that its WSPs were unreasonably designed, as alleged in the Statement of Charges and found by the BCC and the Board.[10]

Moreover, the Firm does not dispute that during the relevant period, its procedures concerning thresholds only took into account "the maximum value of open orders that may exist for each client at any time." The Firm also does not dispute that it failed to have any controls in place that decremented executed orders from its thresholds. (RP 0147, 0682, 0986-92.) As set forth below, the Board correctly found that the Firm's capital threshold control was not reasonably designed and therefore, violated the Market Access Rule.

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[10] The Exchange urges the Commission to affirm the Board's findings that the Firm has waived its challenge to these findings (both before the Board and now before the Commission). *See* Commission Rule of Practice 420(c) ("Any exception to a determination not supported in an opening brief that complies with Rule 450(b) may, at the discretion of the Commission, be deemed to have been waived by the applicant): Exchange Rule 17.10(a) (providing that in an appeal of a BCC decision to the Board, "[a]ny objections to a decision not specified by written exception shall be considered to have been abandoned"); *see also Merrimac Corp. Sec., Inc.*, Exchange Act Release No. 86404, 2019 SEC LEXIS 1771, at *99 n.158 (July 17, 2019); *United States v. Feinberg* , 89 F.3d 333, 340 (7th Cir. 1996) (holding that issues or arguments not addressed in appellate brief are forfeited). Regardless, the record amply shows that the Firm's WSPs were inadequate, as alleged by the Exchange. *See* RP 1202-11 (BCC's analysis of the Firm's deficient WSPs). The Commission should therefore affirm these findings of violations.

III. ARGUMENT

The central issue in this appeal is whether a broker-dealer that has market access and has an obligation to systematically manage financial, regulatory and other risks can use a capital threshold control that applies to open orders but does not apply to executed orders. The Commission should affirm the Board's finding that the Firm's systematically designed capital threshold control must apply to both open and executed orders.

A. The Firm Violated the Market Access Rule

The Commission should affirm the Board's findings that the Firm violated the Market Access Rule. The Market Access Rule required the Firm, as a broker-dealer with access to an exchange or ATS, to establish and maintain a system of risk management controls reasonably designed to manage financial, regulatory, and other risks of its business activities. *See* 17 C.F.R. § 240.15c3-5(b). It specifically required the Firm to limit, in a systematic fashion, its financial exposure that could arise as a result of its market access by preventing the entry of orders "that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer . . . by rejecting orders if such orders would exceed the applicable credit or capital thresholds." *See* 17 C.F.R. § 240.15c3-5(c). The Board's decision is fully supported by the overall purpose and express language of the Market Access Rule, the Commission's discussions in the Market Access Rule's Proposing Release and Adopting Release, and Commission precedent involving the Rule.

The Commission should find, as the Board did, that the Firm's failure to consider executed orders in calculating its capital threshold was an unreasonably designed control, in that it did not adequately account for the Firm's risks, and did not limit the Firm's financial exposure, as required by the Market Access Rule. The purpose of the Market Access Rule's controls and

procedures framework is to limit risk, including, but not limited to, financial risk. For a capital threshold to be a reasonable control and thus systematically limit a broker-dealer's financial exposure, a firm must account for both open orders and executed orders. As the Board correctly observed, executed orders, and the resulting positions from those executed orders, expose the Firm to risks. (RP 1423.) Ignoring executed orders could cause a firm to exceed its capital threshold, and would be the antithesis of a control "reasonably designed to systematically limit the financial exposure of the broker or dealer that could arise as a result of market access."[11] *See* 17 C.F.R. § 240.15c3-5(e); *see also supra* Part II.C.

Moreover, nothing in the Proposing Release or the Adopting Release supports the Firm's view that executed orders need not be considered in calculating its thresholds to systematically limit its financial risks. To the contrary, language in these materials demonstrates that the Board correctly concluded that executed orders must be considered in designing a reasonable capital threshold control. For example, the Proposing Release emphasized that the Market Access Rule is designed to ensure that broker-dealers "appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system." Proposing Release, at 4007. Executed orders and resulting positions expose broker-dealers to risk and must be considered in setting a capital threshold control under the Market Access Rule.

[11] The Firm continues to argue that executed orders "do not have the capacity to harm the market. Only orders pending in the system can cause harm." *See* Firm's Br., at 3, 9. The Firm's argument is contrary to the evidence presented at the hearing that executed orders do present financial risks to a firm in the form of open positions. *See* RP 789-90. The Firm's argument is also at odds with its claim, for which it did not provide any evidence in support, that the Firm did account for the risk of executed orders through its supervisory systems in other ways (e.g., through hedging).

If they were not considered, a capital threshold could essentially become limitless, and therefore, meaningless. And while the Firm is correct that the Market Access Rule is concerned with preventing the entry of orders that exceed a firm's thresholds, the Firm's position—that broker-dealers may add back to the threshold the value of executed orders when calculating whether subsequent orders may be entered—would undermine the Rule's purpose to control risks so that broker-dealers do not jeopardize their financial positions and harm the markets.

The Adopting Release also establishes that the Commission intended that broker-dealers take into account both open and executed orders when decrementing against thresholds under the Market Access Rule, and not completely ignore executed orders under the Rule as argued by the Firm. Indeed, in adopting the Market Access Rule, the Commission stated that "broker-dealers should monitor compliance with applicable credit or capital thresholds based on orders entered, *including* the potential financial exposure resulting from open orders not yet executed." Adopting Release, at 69801 (emphasis added). The Board correctly found that this language demonstrated that the "risks attendant to open orders" were not the only risks that the Commission was concerned about in adopting the Market Access Rule. (RP 1424.)

The Firm, as it did before the BCC and the Board, points to language in the Adopting Release that a firm's "controls should measure compliance with appropriate credit or capital thresholds on the basis of orders entered rather than executions obtained" to support its position that executed orders can be ignored in calculating a capital threshold. *See* Firm's Br., at 4. The Firm is mistaken and takes this language out of context. The snippet of language continuously cited by the Firm relates to the Commission's consideration, and ultimate rejection of an approach advanced by Goldman, Sachs & Co. (the "Goldman Sachs Proposal") to decrement from a credit or capital threshold only upon execution of an order and not upon an order's entry.

Specifically, Goldman suggested that broker-dealers be permitted to decrement an order from their thresholds at the time of the order's execution, rather than at the time of the order's entry. Goldman was not seeking approval of a rule that would permit broker-dealers to exclude executed orders from their capital or credit thresholds.

The Commission's response to the Goldman Sachs Proposal is the brief snippet of language the Firm has repeatedly cited in support of its argument. The Commission's response rejected the Goldman Sachs Proposal because of its proposed timing as to *when* a firm would decrement. The rejection had nothing to do with whether a firm would and should decrement executed orders. Therefore, the language cited by the Firm only refers to the Commission's rejection of the Goldman Sachs Proposal's timing of *when* orders would be decremented from the capital threshold. Read in full context, the Firm's view that it did not have to decrement executed orders against its capital threshold does not withstand scrutiny. *See* Proposing Release, at 4013 (stating that broker-dealers must assess compliance with applicable thresholds "on the basis of exposure from orders entered on an exchange or ATS, rather than waiting for executions to make that determination"); Adopting Release, at 69802 (stating that controls and procedures should be designed so that orders are rejected if they exceed thresholds prior to execution "rather than relying on a post-execution, after-the-fact determination" that an order exceeded a threshold).[12]

[12] This is especially true in light of the Commission's statements that "broker-dealers should monitor compliance with applicable credit or capital thresholds based on orders entered, including the potential financial exposure resulting from open orders not yet executed. . . . [B]ecause the controls and procedures must be reasonably designed to prevent the entry of orders that exceed the applicable credit or capital thresholds by rejecting them, the broker-dealer's controls must be applied on an automated, pre-trade basis, before orders are routed to the exchange or ATS . . . rather than relying on a post-execution, after-the-fact determination." *Id.* at 69801-02.

The Commission's 2013 order in *Knight Capital Americas, LLC* further bolsters the Board's finding that the Market Access Rule required the Firm to consider open and executed orders in calculating its thresholds. In *Knight Capital*, the Commission found that the firm violated the Market Access Rule because it did not implement financial controls to prevent orders from being entered that exceeded its capital thresholds. *See* Exchange Act Release No. 70694, 2013 SEC LEXIS 3253 (Oct. 16, 2013). While processing 212 small retail orders from Knight Capital's customers, the firm's automated order routing system erroneously routed millions of orders into the market during a 45-minute window. *Id.* at *2. By the time the firm stopped sending the orders, the firm had established a net long position in 80 stocks of approximately $3.5 billion and a net short position in 74 stocks of approximately $3.15 billion. Knight Capital lost more than $460 million from these positions. *Id.*

The cause of the erroneous orders was a flaw in the firm's automated routing technology, which did not take into account the number of share executions the firm had already received. *Id.* at *13-14. The Commission found that the firm's capital thresholds failed to account for its exposure from executed orders and the firm did not link its post-execution monitoring system to "its entry of orders so that the entry of orders in the market would automatically stop when Knight exceeded pre-set capital thresholds or its gross position limits."[13] *Id.* at *19. The Commission concluded that the firm violated the Market Access Rule because it lacked adequate controls for its order router. *Id.* at *31. *Knight Capital* supports the Board's conclusion that executed orders must be accounted for in a firm's thresholds under the Market Access Rule.

[13] Until it switched to the problematic automatic trading system at issue, the firm's system had a function that would count, on a cumulative basis, the number of shares executed and would stop routing orders after an order had been completely filled. *Id.* at *12.

The Firm argues that *Knight Capital* did "not discuss the need to decrement" executed orders from the firm's thresholds. *See* Firm's Br., at 8. This argument is not correct. The Commission found that Knight Capital violated the Market Access Rule when executed orders were inadvertently excluded from the firm's threshold calculations. That conclusion is directly relevant to this matter and supports the Board's findings.

The Firm also criticizes the Board's discussion, by way of an example, of how the Firm's method of decrementing only open orders against its capital threshold would work, calling it "simplistic" and "not actually true," because it fails to consider whether an execution opens or closes a position or whether the Firm has hedges in place. *See* Firm's Br., at 5. Contrary to the Firm's assertion, the Board noted that its example was not how "decrementation must work in all instances." Indeed, the Board stated that whether an execution opens or closes a position or whether a firm has hedges in place were not irrelevant to determining whether the Firm's controls were adequate under the Market Access Rule. (RP 1425.) The Board found, however, that the Firm did not present any evidence that its controls accounted for whether orders opened or closed positions or whether it had hedges in place when adding an executed order back to the Firm's thresholds. (RP 1425.) Thus, the example used by the Board, while perhaps simplistic, aligned with the Firm's evidence of the controls it had in place concerning executed orders and thresholds. And more importantly, the example used by the Board is consistent with what the Market Access Rule requires as a baseline requirement of what should be decremented from a capital threshold control.

Finally, the Firm argues that the Commission could have issued a "Response to Frequently Asked Questions (FAQ)" to provide guidance that executed orders should be included when calculating thresholds under the Market Access Rule, or should have included

guidance to this effect when it issued FAQs on the rule in 2014. *See* Firm's Br., at 4. The fact that the Commission did not do so cannot be read to mean that executed orders could be ignored. Nor does it necessarily suggest that it was unclear that the Market Access Rule required firms to include executed orders when calculating thresholds. In fact, the lack of additional guidance from the Commission indicates that the Rule's requirements were clear. The weight of the evidence, including the purpose and language of the Rule itself, the Proposing and Adopting Releases, and *Knight Capital*, cut against the Firm's position.

B. The Firm Had Notice of the Market Access Rule's Requirements

On appeal, the Firm argues that it was not afforded fair notice that the Market Access Rule required that it consider both open and executed orders when calculating its capital threshold. The Commission should reject the Firm's arguments—many of which overlap its claim that its controls did not violate the Market Access Rule—as they are without factual or legal support.

The Commission has stated that a proscription that "mark[s] out the rough area of prohibited conduct, allowing law-abiding individuals to conform their conduct by steering clear of the prohibition" provides parties with adequate notice. *See James M. Schneider*, Exchange Act Release No. 69922, 2013 SEC LEXIS 1932, at *20 (July 2, 2013). A regulation "need not achieve 'meticulous specificity' and may instead embody 'flexibility and reasonable breadth.'" *Rock of Ages Corp. v. Sec'y of Labor*, 170 F.3d 148, 156 (2d Cir. 1999).

A regulation satisfies due process requirements "as long as a reasonably prudent person, familiar with the conditions the regulation[] [is] meant to address and the objective the regulation[] [is] meant to achieve, has fair warning of what the regulation[] require[s]." *Id.; accord Edward John McCarthy*, 56 S.E.C. 1138, 1157 (2003) ("Due process requires that the

laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited.").

The Market Access Rule easily meets these requirements. The Commission promulgated the Market Access Rule through its rulemaking process under the Exchange Act, pursuant to which it issued the Proposing Release giving parties notice of the proposed Rule, solicited and reviewed comments concerning the Rule, and then notified the public of the Rule's adoption. If the Firm read the relevant Proposing Release and Adopting Release in the correct and full context, the Firm should have had fair warning that the Market Access Rule required it to consider executed orders when establishing its capital threshold control. Further, a reasonably prudent individual, familiar with the Market Access Rule's purpose to systematically limit broker-dealers' financial risks, should have understood that executed orders must be accounted for in determining the thresholds of a broker-dealer with market access.

As described above, the language of the Rule expressly refers to controls reasonably designed to limit a firm's systematic risk, including controls to "[p]revent the entry of orders that exceed appropriate pre-set credit or capital thresholds." *See* 17 C.F.R. § 240.15c3-5(c). Such risks include the risks posed by executed orders vis-à-vis the existing positions held by a firm, and ignoring executed orders is contrary to the Rule's directive and could cause a broker-dealer to exceed its thresholds. Similarly, the Proposing Release and the Adopting Release emphasized that the Market Access Rule "is designed to ensure that broker-dealers appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading the securities markets, and the stability of the financial system." Adopting Release, at 69792; *see also* Proposing Release, at 4007. As the

evidence showed, executed orders pose risks and must be considered when establishing a capital threshold in order for that capital threshold to serve an actual purpose.

Moreover, the Commission's order in *Knight Capital*—which found that the firm violated the Market Access Rule because its capital thresholds failed to account for its exposure from executed orders—should have further alerted the Firm that the Market Access Rule requires consideration of executed orders when establishing controls and calculating its capital threshold. In fact, the Firm's chief compliance officer through the end of 2013 testified that he examined relevant disciplinary actions against other firms in connection with the Market Access Rule and likely reviewed the *Knight Capital* order. (RP 0993-94.) The Firm's arguments that it did not have adequate notice that the Market Access Rule required it to account for executed orders do not withstand scrutiny.[14]

The Firm also suggests that the Exchange deprived it of a fair procedure based upon its "novel interpretation" of the Market Access Rule and the Exchange's failure to inform the Firm of this interpretation until the spring of 2015. *See* Firm's Br., at 6. The Commission should reject the Firm's process arguments, as it received the "fair procedure" that the Exchange Act

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[14] The Firm argues that the testimony of Milan Markovic, a director in FINRA's Trading Financial Compliance Examination Program who has, among other things, been involved with numerous market access examinations on a wide array of firms since late 2014, is irrelevant to whether the Market Access Rule put broker-dealers on notice that executed orders should be considered. *See* Firm's Br., at 9-10. Markovic testified that in his experience, no other firms interpret the Market Access Rule to exclude executed orders such that they do not need to be decremented against a firm's thresholds. *See* RP 776-79, 791. The Board, however, did not rely upon Markovic's testimony that is objectionable to the Firm in determining that the Firm had notice of the Market Access Rule's requirements. *See* RP 1426; *cf. also David Evansen*, Exchange Act Release No. 75531, 2015 SEC LEXIS 3080, at *51 (July 27, 2015) (stating that it is the opinion of FINRA's National Adjudicatory Council, and not the hearing panel, that is the final action of FINRA reviewable by the Commission). Nor did the Board rely upon the November 2010 law firm memorandum or the Commission's April 2014 FAQs discussed by the Firm. *See* Firm's Br., at 7-8.

requires. *See* 15 U.S.C. § 78f(b)(7), (d) (requiring that exchanges provide fair procedures); *cf. Sundra Escott-Russell*, 54 S.E.C. 867, 873-74 (2000) (finding requirements of the Exchange Act met when self-regulatory organization brought specific charges, respondent had notice of charges and an opportunity to defend himself, and kept a record of proceedings). The Firm received notice of the specific charges against it; a hearing panel conducted a hearing for two days where the Firm, through counsel, presented witnesses and evidence; and the Firm had an opportunity to appeal the BCC's decision to the Board. *See David C. Ho*, Exchange Act Release No. 54481, 2006 SEC LEXIS 2100, at *19 (Sept. 22, 2006) (finding no evidence of unfairness where Exchange conducted proceedings against respondent in full accordance with its procedures).

Further, the Exchange was not obligated to proactively tell the Firm how it should design its controls to satisfy the Market Access Rule. This is particularly true where the Rule gave broker-dealers flexibility to design controls, and the Exchange's disciplinary action against the Firm for its violations of the Market Access Rule was consistent with the purpose of the Rule, the Rule's express language, the Proposing Release and Adopting Release, and Commission precedent. The Firm's argument that the Exchange violated Exchange Act Rule 19b-4 because it brought a disciplinary action against it without informing the Firm of its interpretation of the Market Access Rule's requirements is incorrect. *See* Firm's Br., at 5-6. Exchange Act Rule 19b-4(d) provides that an SRO's interpretation of an existing SRO rule is deemed a proposed rule change if it is not reasonably and fairly implied by the rule itself. *See* 17 C.F.R. § 240.19b-4(d). As noted by the Board, however, the Market Access Rule is not a rule of the Exchange. (RP 1427.) The Exchange's disciplinary action against the Firm is therefore not measured by the standard for the Exchange proposing a new rule pursuant to Rule 19b-4. Regardless, as

described above, the Exchange's interpretation of the Market Access Rule is reasonably and fairly implied from the Rule itself and the Proposing Release and the Adopting Release.

C. The Sanctions Are Neither Excessive Nor Oppressive

Exchange Act Section 19(e)(2) governs the Commission's review of the Exchange's sanctions, and provides that the Commission may eliminate, reduce, or alter a sanction if it finds that the sanction is excessive, oppressive, or imposes a burden on competition not necessary or appropriate to further the purposes of the Exchange Act. *See* 15 U.S.C. § 78s(e)(2); *see also Ho*, 2006 SEC LEXIS 2100, at *20.[15] The Commission has affirmed sanctions imposed by the Exchange where the Exchange has considered the factors articulated in Exchange Rule 17.11 and the sanctions are consistent with those imposed in similar cases. *Id.* at *20-22; *cf. also Arthur James Niebauer*, Exchange Act Release No. 54384, 2006 SEC LEXIS 1937, at *27-28 n.46 (Aug. 30, 2006) (noting that sanctions imposed by the NYSE fell within the range of sanctions imposed in similar cases).

The Board determined that a censure and $50,000 fine were appropriately remedial to address the Firm's violation of the Market Access Rule and its failure to maintain adequate WSPs in five distinct areas. (RP 1428-31.) The Firm has not shown that the sanctions imposed for its misconduct are excessive or oppressive. Rather, the record shows that the Board, in sanctioning the Firm, carefully considered numerous factors. The Commission should therefore affirm the Board's sanctions.

[15] The Firm does not make any specific arguments with respect to sanctions. It also does not argue, and the record does not show, that the Board's sanctions impose an unnecessary burden on competition.

The Board considered the relevant Principal Considerations in Determining Sanctions set forth in Exchange Rule 17.11, and other relevant factors, in determining that a censure and $50,000 fine were appropriately remedial, including:

- That sanctions should be remedial and should prevent and deter future misconduct, discourage others from engaging in similar misconduct, and improve overall business standards;
- That sanctions should consider relevant disciplinary history;
- That sanctions should be tailored to the misconduct; and
- The seriousness of the offense.

The Market Access Rule is an important tool designed to "reduc[e] the risks faced by broker-dealers and other market participants as a result of various market access arrangements;" without the Rule's "systemic risk protection, erroneous trades . . . could potentially expose a broker or dealer to enormous financial burdens and disrupt the markets." Adopting Release, at 69817. The Board also determined that, notwithstanding the Firm's characterization of its violations related to its WSPs as "procedural," the Firm's violations were significant and that its WSPs "were deficient in a number of ways." (RP 1430.)

The Board also carefully considered relevant precedent in imposing its sanctions. It weighed two settled disciplinary matters (*Consolidated Trading* and *Citadel Securities*), which involved charges of unreasonably designed risk management controls under the Market Access Rule and imposed fines of $50,000 and $100,000, respectively. The Board cited to well-established Commission precedent that sanctions in settled matters are often lower than those resulting from a contested hearing where findings are made, and rejected the Firm's efforts to compare its case to the fines imposed in numerous other settled cases and a Cautionary Action issued to a different, but affiliated broker-dealer by a different exchange. The Board further

rejected the Firm's efforts to characterize the settled cases it used to urge lower sanctions as involving firms with controls "completely absent;" rather, these settlements "are cases where the basis for the finding of a violation of the Market Access Rule was not specified." (RP 1430.) The Board also properly considered a disciplinary matter in which the BCC imposed a $90,000 fine for similar deficiencies with a firm's WSPs after a contested hearing (*Essex Radez*). These matters all support the Board's order of a censure and $50,000 fine.

Finally, the Board considered that the Firm has a relevant regulatory history. (RP 1430.) In September 2005, the Pacific Stock Exchange fined the Firm $2,000 for failing to have adequate WSPs. (RP 0081-83.) And in April 2007, the Firm and an affiliated entity agreed to a Letter of Acceptance, Waiver and Consent with the American Stock Exchange for, among other things, failing to have adequate supervisory systems and WSPs. For this misconduct, the Firm was censured, fined $90,000 and agreed to certain undertakings. (RP 008587.) Finally, in September 2012, the Exchange issued the Firm a Cautionary Action Letter related to allegations that its WSPs did not comply with the Market Access Rule. (RP 0417-19.)

In sum, the Board carefully considered all relevant factors in imposing a $50,000 fine and censure upon the Firm. On appeal, the Firm has not demonstrated that the sanctions imposed for its violations are either excessive or oppressive, and the record demonstrates that they are appropriately remedial, relevant and tailored to the specific misconduct. The Commission should therefore sustain these sanctions.

IV. CONCLUSION

The Commission should sustain the Exchange's action in all respects and dismiss the Firm's application for review. The Firm, by excluding executed orders from its capital threshold, failed to implement reasonable risk controls to systematically limit its financial exposure as required by the Market Access Rule. It also failed to establish and maintain reasonable WSPs with respect to five distinct issues addressed under the Market Access Rule. The Firm's arguments on appeal seeking to avoid liability for these violations are conclusory and without factual or legal support. Similarly, the Firm has not demonstrated that the censure and $50,000 fine are excessive or oppressive. For all of these reasons, the Exchange respectfully requests the Commission dismiss the Firm's application for review.

Respectfully submitted,

Andrew J. Love / JS

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Counsel for the CBOE Exchange, Inc.

September 3, 2019

CERTIFICATE OF SERVICE

I, Andrew Love, certify that on this 3rd day of September 2019, I caused a copy of the foregoing Brief in Opposition to Application for Review, in the matter of the Application for Review of Equitec Proprietary Markets, LLC, Administrative Proceeding File No. 3-19182, to be served by messenger on:

Vanessa A. Countryman
Acting Secretary
Securities and Exchange Commission
100 F St., NE
Room 10915
Washington, DC 20549-1090

and via FedEx (with a courtesy copy via email) on:

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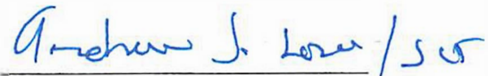
Service was made on the Commission by messenger and on applicant's counsel by overnight delivery service due to the distance between FINRA's offices and applicant's counsel.



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CERTIFICATE OF COMPLIANCE

I, Andrew Love, certify that this brief complies with the Commission's Rules of Practice by filing a brief in opposition not to exceed 14,000 words. I have relied on the word count feature of Microsoft Word in verifying that this brief contains 7,294 words.

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VIA MESSENGER

Vanessa A. Countryman, Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E., Room 10915
Washington, DC 20549-1090

Re: In the Matter of the Application of Equitec Proprietary Markets, LLC
Administrative Proceeding No. 3-19182

Dear Ms. Countryman:

Enclosed please find the original and three copies of the CBOE Exchange, Inc.'s Brief in Opposition to Application for Review in the above-captioned matter. FINRA's Office of General Counsel is handling this appeal under a Regulatory Services Agreement between the Exchange, C2 Options Exchange, Inc., and FINRA, which became effective December 19, 2014.

Please contact me at (202) 728-8281 if you have any questions.

Very truly yours,

Andrew J. Love /JG

Andrew Love

Enclosures

cc: David J. Barclay, Esq.
Sarah McDowell, Esq. (via electronic mail)
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