

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 78093 / June 16, 2016

Admin. Proc. File No. 3-16285

In the Matter of the Application of

ELECTRONIC TRANSACTION
CLEARING, INC., KEVIN MURPHY, and
HARVEY C. CLOYD, JR.

for Review of Disciplinary Action Taken by

CBOE

OPINION OF THE COMMISSION

NATIONAL SECURITIES EXCHANGE—REVIEW OF DISCIPLINARY
PROCEEDING

Grounds for Remedial Action

Failure to Conduct an Independent Anti-Money Laundering Audit

Failure to Close Out an Open Short Position

**Conduct Inconsistent with Just and Equitable Principles of Trade and
Adherence to Law**

Broker-dealer and two of its officers appeal from a CBOE action finding that the firm failed to apply customer identification procedures to individuals trading in certain customer accounts, failed to apply the exchange's margin rules to these traders, failed to implement effective surveillance tools for detecting suspicious trading activities of customers, failed to close out a fail-to-deliver, and failed to conduct an independent audit of member firm's anti-money laundering program; and that one of the broker-dealer's officers failed to adhere to applicable laws related to the firm's audit violation. *Held*, CBOE's findings of violations are set aside in part and sustained in part and CBOE's assessment of sanctions are set aside and remanded.

APPEARANCES:

Ivan P Harris, Allyson N. Ho, and Megan Braden, of Morgan, Lewis & Bockius LLP, for applicants.

Andrew D. Spiwak and Kerry Ann P. Adler, of the Financial Industry Regulatory Authority, Inc., and Paul E. Greenwalt, of Schiff Hardin LLP, for CBOE.

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Last brief received: March 3, 2015

Electronic Transaction Clearing, Inc. (“ETC”), a registered broker-dealer, Kevin Murphy (“Murphy”), ETC’s President and Chief Operations Officer, and Harvey C. Cloyd, Jr. (“Cloyd,” and, collectively with ETC and Murphy, “Applicants”), ETC’s Chief Executive Officer, appeal from a Chicago Board Options Exchange, Inc. (“CBOE”) disciplinary action.¹ CBOE’s findings against Applicants center largely around the fact that ETC did not apply the Customer Identification Program (“CIP”) rule² and CBOE’s margin requirements to individuals who entered trades in the accounts of two of ETC’s institutional customers—Esurge Trading Group, Ltd. (“Esurge”) and Vantage Point Securities, LLC (“Vantage Point”).³ The record, however, does not provide sufficient evidence to conclude that the individual traders were “customers” for purposes of those rules and thus subject to their terms. The record also provides insufficient evidence to find that, because ETC took part of its electronic monitoring system offline for several months in 2010, ETC’s overall approach for detecting suspicious trades was unreasonable and thus violated CBOE rules. We find, however, that ETC failed to close out a “fail-to-deliver” and to conduct an independent audit of its AML program. Because CBOE based its sanctions determination on Applicants’ aggregate violations, we set aside those sanctions and remand for reconsideration in light of the dismissed charges. Our findings are based on an independent review of the record.

¹ ETC was a CBOE member between 2008 and 2013 and has been a FINRA member since 2009.

² The CIP rule generally requires a broker-dealer to establish, document, and maintain procedures for identifying customers and verifying their identities. 31 C.F.R. § 1023.220.

³ CBOE found that ETC violated its rules by failing to (1) verify the identities of individuals who were entering trades in the accounts of certain institutional customers, (2) apply CBOE’s margin rules to those individual traders, (3) implement effective surveillance tools for detecting suspicious trading activities, (4) close out a “fail-to-deliver,” and (5) conduct an independent audit of ETC’s anti-money laundering (“AML”) program. CBOE further held that Murphy and Cloyd violated certain CBOE rules because of their role in ETC’s violations. For these violations, CBOE censured Applicants; jointly and severally fined Applicants \$1,000,000; and barred Cloyd and Murphy for six months, in all capacities, from acting as CBOE Trading Permit Holder (“TPH”) and associating with any TPH or TPH organization.

I. Facts

ETC provides high-volume equity execution and clearing services to other broker-dealers and non-broker-dealer proprietary trading firms. Cloyd, the firm's CEO, has worked in the securities industry for almost 30 years. Before founding ETC in November 2007, Cloyd served in senior roles at various broker-dealers and as the chairman of the Ethics, Business, and Conduct Committee at the Pacific Stock Exchange. Murphy, the firm's COO, also has worked in the securities industry for almost 30 years. Before joining ETC in December 2007, Murphy worked as a compliance consultant and as a national sales manager for a compliance firm. At ETC, Murphy first served as the President, Chief Operations Officer, Chief Compliance Officer, and the AML Compliance Officer. Those duties changed after the firm hired David DiCenso ("DiCenso") to be the firm's Chief Compliance Officer in December 2009 and, later, as the firm's AML Compliance Officer.

During the relevant time here in 2009 and 2010, ETC's customers consisted of two main categories of firms. The first category was what Cloyd described at the hearing as "black boxes," which were firms that use computer algorithms to generate trading orders. The second category consisted of proprietary trading firms – in this case, Esurge and Vantage Point. Esurge and Vantage Point held omnibus accounts with ETC and were the intermediaries between ETC and Esurge's and Vantage Point's multiple individual traders. The traders would enter trades on behalf of their respective firms through the firms' Market Participant Identifiers ("MPIDs").⁴ The individual traders could enter trades, but had no control over the omnibus accounts.⁵ The record contains insufficient evidence to establish that the traders were trading on their own behalf and *not* proprietary traders acting on behalf of Esurge or Vantage Point, *i.e.*, whether the traders were trading for their own accounts or those of Esurge or Vantage Point. This inquiry, and the lack of evidence on this point, is at the heart of our analysis below.

II. Procedural History

In June 2011, CBOE charged Applicants and DiCenso with multiple violations that allegedly occurred between December 2009 and July 2010. After holding a seven-day hearing, CBOE's Business Conduct Committee (the "BCC") issued an 81-page Amended Decision and Order on March 4, 2015. The BCC found, in part, that ETC had not applied the Commission's CIP rule and margin requirements to individual traders who were executing trades on behalf of Esurge and Vantage Point. Because of this, the BCC found that ETC violated CBOE Rules 4.1 (which requires compliance with just and equitable principles of trade),⁶ 4.2 (which requires

⁴ MPIDs are codes that are used to report a market participant's trades.

⁵ CBOE introduced documents to support that the traders may have been assigned buying power, but the record provides insufficient information to make that finding. The record also fails to establish that ETC was aware of the purported assignments.

⁶ CBOE Rule 4.1 states that "[n]o Trading Permit Holder shall engage in acts or practices inconsistent with just and equitable principles of trade."

compliance with applicable laws),⁷ 4.20 (which requires TPH organizations to develop and implement an AML compliance program), 12.3(j) (which imposes margin requirements for pattern day traders), and 12.4(i) (which imposes additional margin requirements for portfolio margin account customers when margin deficiencies arise). The BCC further found that, in violating CBOE Rule 4.2, Murphy failed to adequately supervise the conduct related to ETC's CIP rule violation and that Murphy and Cloyd failed to adequately supervise by allowing the conduct related to ETC's margin rule violations.

The BCC also found that ETC violated CBOE Rules 4.1 and 4.2 for failing to maintain effective surveillance tools in 2010; CBOE Rules 4.1, 4.2, and 4.20⁸ for failing to conduct an independent AML audit in 2009; and CBOE Rules 4.2 and Exchange Act Rule 204 of Regulation SHO⁹ for failing to timely close out a "fail-to-deliver." Based on its findings of misconduct, the BCC censured Applicants; imposed a \$1,000,000 joint and several fine against them; and imposed a six-month bar against both Cloyd and Murphy, in all capacities.¹⁰

Applicants appealed that decision to CBOE's Board of Directors (the "Board"), which affirmed the BCC Decision in its entirety by finding that the Board "could not conclude that any of the findings and conclusions of the BCC in this matter were clearly erroneous or that any of the sanction determinations by the BCC in this matter were arbitrary, capricious, or a clear abuse of discretion." This appeal followed.

⁷ CBOE Rule 4.2 states that "[n]o Trading Permit Holder shall engage in conduct in violation of the Securities Exchange Act of 1934, as amended, rules or regulations thereunder, the Bylaws or the Rules of [CBOE] . . . insofar as they relate to the reporting or clearance of any [CBOE] transaction, or any written interpretation thereto." Rule 4.2 adds that "[e]very Trading Permit Holder shall so supervise persons associated with the Trading Permit Holder as to assure compliance therewith."

⁸ Rule 4.20 requires firms to provide for annual independent testing for AML compliance. CBOE's Interpretation .01 to Rule 4.20 provides that such independent testing "may not be conducted by: (1) a person who performs the functions being tested, or (2) the designated [AML] compliance person, or (3) a person who reports to a person described in either (1) or (2) above."

⁹ Rule 204 of Reg. SHO governs when a clearing broker-dealer (such as ETC) must deliver securities to a registered clearing agency for clearance and settlement. 17 C.F.R. § 242.204.

¹⁰ In reaching these conclusions, the BCC found that CBOE had not established that ETC, Cloyd, and Murphy committed other alleged violations and dismissed those charges against them. The BCC further found that CBOE had not established that DiCenso committed any of the violations alleged against him and dismissed those charges entirely.

III. Analysis

We base our findings on an independent review of the record and apply the preponderance of the evidence standard for self-regulatory organization disciplinary actions.¹¹ Pursuant to Exchange Act Section 19(e)(1), we determine whether Applicants engaged in the conduct found by CBOE, whether that conduct violated the relevant provisions, and whether those provisions are, and were applied in a manner, consistent with the purposes of the Exchange Act.¹²

A. Insufficient evidence of a CIP rule violation

We first turn to CBOE's finding that ETC violated the CIP rule by verifying the identities of only Esurge and Vantage Point, and not the identities of those firms' underlying traders. In light of the lack of evidence in the record, we set CBOE's finding aside.

The CIP rule requires that a broker-dealer's CIP "include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable," and that such procedures "enable the broker-dealer to form a reasonable belief that it knows the true identity of each customer."¹³ For purposes of the CIP rule, a "customer" is defined as "a person that opens a new account"¹⁴ and an "account" is defined as "a formal relationship with a broker-dealer established to effect transactions in securities, including, but not limited to, the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral."¹⁵ In adopting the CIP rule, the Commission and the Department of the Treasury ("Treasury") stated that "customer" means "the person identified as the accountholder."¹⁶ Therefore, under the CIP rule, "a broker-dealer is not required to look through

¹¹ See *Richard G. Cody*, Exchange Act Release No. 64565, 2011 WL 2098202, at *9 (May 27, 2011) (citing *Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in self-regulatory organization disciplinary proceeding)), *aff'd*, 693 F.3d 251 (1st Cir. 2012).

¹² 15 U.S.C. § 78s(e)(1).

¹³ 31 C.F.R. § 1023.220(a)(2).

¹⁴ *Id.* § 1023.100(d)(1).

¹⁵ *Id.* § 1023.100(a)(1).

¹⁶ *Customer Identification Programs For Broker-Dealers*, Exchange Act Release No. 47752, 68 Fed. Reg. 25,113, 25,116 (May 9, 2003) ("CIP Release"). Section 326 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA Patriot Act") required the Secretary of the Treasury to jointly prescribe with the Commission a regulation that, at a minimum, required brokers or dealers to implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable; to maintain records of the information used to verify the person's identity; and to determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to brokers or dealers by any government agency. See 31 U.S.C. § 5318(l).

a trust, or similar account to its beneficiaries, and is required only to verify the identity of the named accountholder.”¹⁷ And, “[s]imilarly, with respect to an omnibus account established by an intermediary, a broker-dealer is not required to look through the intermediary to the underlying beneficial owners, if the intermediary is identified as the account holder.”¹⁸

The two ETC institutional customers at issue here, Esurge and Vantage Point, fit squarely within this definition of customer: both Esurge and Vantage Point established a formal relationship with ETC by opening new accounts to effect securities transactions. By comparison, the record does not provide sufficient evidence to find that Esurge’s and Vantage Point’s traders were “customers” for purposes of the CIP rule.

CBOE puts forth a number of arguments for why ETC’s actions with regard to the traders violated the CIP rule. Although the traders were not listed as accountholders for the Esurge and Vantage Point accounts, CBOE argues that the traders effectively controlled Esurge’s and Vantage Point’s accounts by virtue of the traders’ ability to place trades in those accounts. The Commission and Treasury, however, rejected the idea that traders be treated as “customers” for purposes of the CIP rule simply because they can place trades in an account. In adopting the CIP rule, the Commission and Treasury explained that they initially considered defining “customer” to include persons who are “granted authority to effect transactions in an account” with a broker dealer.¹⁹ The Commission and Treasury did not, however, include that language in the final rule. As they explained, “requiring limited resources to be expended on verifying the identities of persons with authority over accounts could interfere with a broker-dealer’s ability to focus on identifying customers and accounts that present a higher risk of not being properly identified.”²⁰

CBOE nevertheless argues that ETC, in light of certain “red flags” suggesting that the traders may have had a beneficial ownership interest in the account, had a duty under the CIP rule to investigate further into the true nature of the relationship between Esurge and Vantage Point and their traders. Specifically, CBOE points to Esurge’s and Vantage Point’s large number

¹⁷ *CIP Release* at 25116.

¹⁸ *Id.* Nevertheless, and as discussed *infra* notes 24 & 26 and accompanying text, the Commission and Treasury noted a broker-dealer may be required to obtain information about persons with control over an account under a limited provision of the CIP rule or other provisions of the Bank Secrecy Act (the “BSA”), 31 U.S.C. §§ 5311–5314 & 5316–5332, or the securities laws. *CIP Release* at 25116, n. 30. In addition, a firm may be required to treat as customers the sub-account holders of an omnibus account where (1) the sub-account holders effect securities transactions directly and without the intermediation of the omnibus account holder; and (2) the sub-account holders effect transactions for their own accounts, do not act on behalf of the omnibus account holder, and the sub-accounts are not proprietary accounts of the omnibus account holders. As discussed, there is insufficient evidence to establish that those conditions were met here.

¹⁹ *CIP Release* at 25116.

²⁰ *Id.* (explaining why “the final rule does not include persons with authority over accounts in the definition of ‘customer,’” as was proposed).

of traders, the traders' location overseas, the Esurge's and Vantage Point's relatively small trading deposits, and Esurge's and Vantage Point's high expected trading volume.²¹ CBOE also cites to evidence that some of the traders ended the day flat²² and that ETC monitored the individual traders for compliance purposes. This evidence, CBOE found, "should have indicated to ETC that it was extremely unlikely that [Esurge and Vantage Point] were actually proprietary trading firms" and that ETC should have suspected that the firms were, instead, "facilitating day trading." CBOE concluded that, under the CIP rule, ETC should have undertaken additional steps to determine whether the traders may have had a beneficial ownership interest in the customers' accounts, and were not engaging in proprietary trading on behalf of Esurge and Vantage Point.²³

We disagree. There is insufficient evidence on the record to conclude that the traders were anything other than authorized traders on Esurge's and Vantage Point's proprietary accounts, and therefore, insufficient evidence to conclude that ETC had any further obligation with respect to the traders under the CIP rule.

Although, as CBOE points out, the CIP rule requires broker-dealers to "address situations where, based on the broker-dealer's risk assessment of a new account . . . the broker-dealer will obtain information about individuals with authority or control over such account," the rule specifies that this additional verification method "applies *only* when the broker-dealer cannot verify the customer's true identity using [documentary and non-documentary] verification

²¹ According to ETC's new customer approval forms, Vantage Point had 1,400 traders, who were expected to trade more than a billion shares a month, and Esurge had 500 traders, who were expected to trade 4.1 million shares per month.

²² A CBOE examiner testified at the hearing that, at least on select days, three Vantage Point traders were not carrying their trading positions over to the next day and testified that this suggested that the traders were day trading.

²³ CBOE also cited an email DiCenso sent to ETC's outside counsel asking about the extent to which ETC needed to investigate its customers' foreign traders for AML purposes. CBOE contends that the email is evidence that ETC knew, or should have known, that the traders could have been customers. The record, however, does not contain the outside counsel's response to the email, any evidence that DiCenso was asking specifically about ETC's CIP obligations, nor any evidence that DiCenso was told that ETC needed to verify the identity of the individual traders for purposes of the CIP rule. Instead, the evidence suggests that DiCenso was endeavoring to ensure that ETC was complying with its regulatory obligations—a conclusion supported by CBOE's dismissal of charges against DiCenso for his role in ETC's CIP rule compliance. Additionally, we note that DiCenso's question regarding the extent to which ETC needed to investigate its customers' foreign traders for AML purposes is a broader question than whether or not the CIP rule applies to the foreign traders. As discussed below, ETC may have had obligations under other provisions of the BSA, such as the broader AML program rule or the requirement to report suspicious activity, but those issues are not before us.

methods.”²⁴ Here, the record does not suggest that ETC failed to adequately verify the identities of its customers: Esurge and Vantage Point.

Accordingly, based on the record before us, the preponderance of the evidence does not support a finding that ETC was obligated under the CIP rule to look through Esurge and Vantage Point to identify or verify the identity of the traders.²⁵ Rather, the red flags which CBOE cites may raise questions about whether ETC met its obligations under other provisions of the BSA or the securities laws, as discussed further below.²⁶ For example, the red flags suggest that ETC may not have understood the *nature* of and *risks* posed by Esurge’s and Vantage Point’s businesses or their *relationship* with their traders, and accordingly, that ETC may have had an obligation to determine whether the activity required a suspicious activity report (“SAR”).²⁷ However, CBOE did not charge ETC with such violations so those obligations are not at issue here.

For similar reasons, we find that the record does not support CBOE’s alternate finding that, “irrespective” of whether the traders were customers for purposes of the CIP rule, there was still substantial evidence to support a finding that ETC violated just and equitable principles of trade (Rule 4.1). CBOE does not explain how ETC violated just and equitable principles of trade independently without an underlying CIP rule violation, and the record is not sufficiently developed to support that conclusion. There are some facts—such as Esurge’s and Vantage Point’s large number of foreign, high-volume traders that used personal (rather than firm) email accounts—that may have triggered other regulatory obligations for ETC, such as, but not limited to, filing SARs²⁸ or determining whether the Office of Foreign Assets Control (“OFAC”) had

²⁴ 31 C.F.R. § 1023.220(a)(2)(ii)(C) (emphasis added).

²⁵ We note that the legal analysis may have been different if the preponderance of the evidence in the record established that the traders were not proprietary traders trading for their firms, and were instead individual traders trading for themselves. *See supra* note 18 (discussing a broker-dealer’s CIP obligations with respect to certain intermediated accounts).

²⁶ In adopting the CIP rule, the Commission and Treasury explained that while there is no general obligation under the CIP rule to look through the accountholder to identify and verify the underlying beneficial owners of the account, “the due diligence procedures required under other provisions of the BSA or the securities laws may require broker-dealers to look through to owners of certain types of accounts.” *CIP Release* at 25116, n.30. We note, however, that on May 11, 2016, FinCEN published a final rule under the BSA that includes “a new requirement to identify and verify the identity of beneficial owners of legal entity customers, subject to certain exclusions and exemptions.” *Customer Due Diligence Requirements for Financial Institutions*, 81 Fed. Reg. 29397, 29398 (May 11, 2016).

²⁷ *See, e.g., Oppenheimer & Co. Inc.*, Exchange Act Release No. 74141, 2015 WL 331117, at *8 (Jan. 27, 2015) (settled order).

²⁸ The BSA requires broker-dealers to file a SAR with FinCEN about a financial transaction that the broker-dealer knows, suspects or has reason to suspect involves funds derived from illegal activity as part of a plan to violate or evade Federal law, is designed, whether through structuring or other means, to evade BSA regulations, has no business or apparent lawful purpose

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subjected the traders to sanctions or restrictions on business activity.²⁹ But CBOE does not allege that ETC violated those provisions, and the record contains insufficient evidence to conclude what steps ETC may or may not have taken to comply with these or other regulatory requirements.

We thus set aside CBOE's finding that ETC violated CBOE Rules 4.1, Rule 4.2, and 4.20 for its alleged failure to verify the identities of the individual traders. For the same reasons, we set aside CBOE's finding that Kevin Murphy (ETC's president and COO) violated CBOE Rule 4.2 for his role in ETC's CIP rule compliance.

B. Insufficient evidence of margin requirement violations

We next turn to whether ETC violated CBOE rules by not imposing margin requirements on Esurge's and Vantage Point's individual traders. As with the CIP rule, the applicability of CBOE's margin rules turn on whether the individual traders were "customers." CBOE found that the individual traders were customers for margin purposes, but for reasons similar to those discussed above, we find that the record does not contain sufficient evidence to sustain this finding.³⁰

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or is not the sort in which the particular customer would normally be expected to engage, or involves the use of the broker-dealer to facilitate criminal activity. *See* 31 C.F.R. § 1023.320(a)(2); *Amendment to the Bank Secrecy Act Regulations—Requirement that Brokers or Dealers in Securities Report Suspicious Transactions*, 67 Fed. Reg. 44,048, 44,051 (July 1, 2002). Exchange Act Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping, and record retention rules adopted under the BSA. 17 C.F.R. § 240.17a-8.

²⁹ OFAC is an office within Treasury that administers economic and trade sanctions based on U.S. foreign policy and national security goals. It publishes lists of countries and persons whose property is subject to blocking and with whom U.S. persons cannot conduct business. Although a strong OFAC compliance program consists of procedures similar to those contained in the CIP rule, OFAC's programs are separate and distinct from a broker-dealer's AML obligations under the BSA. *See, e.g., Opening Securities and Futures Accounts from an OFAC Perspective* (Nov. 5, 2008), available at <https://www.sec.gov/about/offices/ocie/aml/ofacaccounts110508.pdf>.

³⁰ While CBOE's margin rules do not define the term customer, it is a defined term under the Board of Governors of the Federal Reserve System's Regulation T, which regulates extensions of credit by broker-dealers. 12 CFR 220.2. A customer under Regulation T includes "(1) [a]ny person or persons acting jointly: (i) [t]o or for whom a creditor extends, arranges, or maintains any credit; or (ii) [w]ho would be considered a customer of the creditor according to the ordinary usage of the trade..." *Id.* *See also* FINRA Rule 4210(a)(3) (defining the term "customer" to include "any person for whom securities are purchased or sold or to whom securities are purchased or sold whether on a regular way, when issued, delayed or future delivery basis. It will also include any person for whom securities are held or carried and to or for whom a member extends, arranges or maintains any credit."). Under the definition of customer under Regulation T, there was not sufficient evidence to conclude that ETC should

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CBOE Rule 12.3(j) requires member firms to impose a \$25,000 minimum margin requirement on “pattern day traders,” which the rule defines as “any *customer* who executes four (4) or more day trades within five (5) business days” (emphasis added).³¹ CBOE rules do not define the term “customer,” but CBOE found that ETC should have treated the individual traders as customers because the firm was on notice that Esurge and Vantage Point were facilitating day trading by the individual traders. CBOE concedes it was unable to establish that the traders were engaged in their own independent day trading. Instead, CBOE points to the same red flags that CBOE found existed as to the alleged CIP rule violations, including evidence that some of the traders ended the day flat and that ETC monitored the individual traders for compliance purposes. This additional evidence does not establish by a preponderance of the evidence that the trader were day traders—closing out positions could be equally true of firm proprietary traders.

We accordingly set aside CBOE’s finding that ETC violated CBOE Rules 4.1, 4.2, 12.3(j), and 12.4(i) for its failure to impose margin requirements on the individual traders.³² For the same reasons, we also set aside CBOE’s finding that Murphy and Cloyd violated CBOE Rule 4.2 by allegedly failing to supervise ETC’s compliance with CBOE’s margin requirements.

C. Insufficient evidence that ETC acted unreasonably in implementing surveillance tools

We also set aside CBOE’s finding that ETC inadequately surveilled for wash trades in 2010. CBOE Rule 4.20(1) requires firms to “establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of” suspicious activity and transactions. CBOE guidance further recommends that its members implement procedures to review trading activity for potentially manipulative trading practices and advises that “[t]hese procedures may be implemented on a post-trade basis,” including “via exception reports and other post-trade reviews of documents showing trade activity.”³³ Although ETC took part of its electronic monitoring system down for part of the year to update it, the record does not provide

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have treated the individual traders as customers for margin purposes under CBOE’s margin rule, rather than ETC and Vantage Point.

³¹ The rule also states that “[t]he minimum equity required for the accounts of *customers* deemed to be pattern day traders shall be \$25,000” (emphasis added).

³² CBOE further found violations related to CBOE’s portfolio margining rules, which provide an alternative margining methodology based on the net risk of eligible instruments in a customer’s account. *See generally* CBOE Rule 12.4. Because CBOE concedes that these violations also turn on the same analysis concerning whether the individual traders were “customers,” we set them aside for the reasons discussed above.

³³ Supervisory Obligations of Members Providing Access to Exchange Systems, CBOE Regulatory Circular RG09-118 (Oct. 26, 2009).

sufficient evidence to establish that ETC violated CBOE's rules in its overall approach to detecting wash sales and other potentially manipulative trades during the relevant time.³⁴

Before 2010, ETC monitored for manipulative trades by having certain ETC employees look at trading data in real time. This changed after DiCenso was hired as the firm's chief compliance officer in late 2009. DiCenso designed and implemented two online monitoring tools. The first was a Wash Sale Report ("WSR"), which generated exception reports of when individual traders traded with him or herself. The second was a Trade Participation Report ("TPR"), which monitored for wash trades at the customer level (and thus generated exception reports of trading activity between different traders for the same ETC customer, different customers, and different MPIDs used by the same customer).

ETC initially ran its TPR in an Excel-based format once every two weeks to check for wash trades at the customer level, but the system required extensive computer resources to run. As one ETC employee who helped DiCenso design the firm's exception reports explained at the hearing, ETC's server was "choking on that amount of data that needed to be processed" for the server to both run the TPR and handle all of the firm's other daily functions. By late May 2010, ETC decided to fix this problem by making the TPR web-based, which would also give it more functionality.

To implement the change, ETC stopped running the TPR in approximately June 2010. While the system was down, ETC used several other tools designed to prevent wash and manipulative trading, including implementing a self-trade prevention setting that removed traders' ability to enter into two-sided markets (*i.e.*, the ability to have a buy and sell order outstanding at the same time) and activating anti-wash or self-trade prevention modifiers that prevented customers from trading with themselves at exchanges that offered those features.

On September 9, 2010, ETC implemented the newly designed TPR. Once the new system was online, ETC ran it regularly and used it to review all trades that occurred while the old system had been down. That review found no evidence of violative or manipulative activity.³⁵

³⁴ Wash sales are generally defined as fictitious trades where a trader sells securities contemporaneous with a purchase of the same securities, thus resulting in no change of beneficial ownership. *See Cohen v. Stevanovich*, 722 F. Supp. 2d 416, 426 (S.D.N.Y. 2010) (citing BLACK'S LAW DICTIONARY 1456 (9th ed. 2009)). Such trades may be effected for manipulative purposes and are prohibited by the federal securities laws' anti-fraud provisions when they are intended to create a false or misleading appearance of trading activity. *See* 15 U.S.C. § 78i(a)(1) (forbidding matched orders or wash sales conducted "[f]or the purpose of creating a false or misleading appearance of active trading" of a registered security on a national exchange); *see also* § 15 U.S.C. § 78j(b) (prohibiting the use of "manipulative or deceptive device[s] or contrivance[s] in contravention of" Commission rules); 17 C.F.R. § 240.10b-5(a) (prohibiting the use of fraudulent devices in securities transactions).

³⁵ Although a firm's compliance with its monitoring obligations does not turn on whether improper trading actually occurred, we note that CBOE produced no evidence here that ETC
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CBOE nevertheless found that, because the original TPR was down for three months, ETC failed to have effective risk procedures and surveillance tools in place. CBOE based this finding, in part, on DiCenso's statement in his Wells Response that "the first generation of the pre-arranged trading report did not prove to be an effective tool, and required massive system resources to evaluate trading data." During the hearing, DiCenso clarified that the TPR *was* an effective tool for monitoring for potentially manipulative activity, but that it had been inefficient, and thus taken offline, because of the computing resources that it required. In fact, the BCC itself cleared DiCenso of liability for his role in ETC's monitoring of potentially manipulative trades—expressly finding that CBOE had not shown that DiCenso had failed to monitor for suspicious trading or had failed to allocate adequate resources to ETC's risk monitoring program.

Under all the circumstances, we do not find ETC's procedures regarding wash sale surveillance unreasonable during the relevant period.³⁶ Although the TPR was taken down for three months, ETC attempted to account for this lapse by running a "look-back" at the missed trades once the TPR was back up. During the time the TPR was down, ETC also implemented other anti-manipulation tools. This limited record does not contain sufficient evidence to find that ETC's surveillance measures were unreasonable in 2010. We accordingly set aside CBOE's finding that ETC violated CBOE Rules 4.1 and 4.2 for allegedly failing to implement effective risk procedures and surveillance tools for detecting suspicious trading activity.

D. ETC's 2009 AML audit violated CBOE rules

We affirm CBOE's finding that ETC failed to conduct an independent audit of its AML program in 2009. CBOE Rule 4.20 requires member firms to perform annual independent audits of their AML programs, but prohibits having the audit performed by anyone who reports to the firm's designated AML compliance person. That was what happened here: DiCenso audited ETC's AML program in December 2009, when he reported to Murphy, who was ETC's designated AML compliance person.

Applicants do not dispute that ETC's audit violated CBOE's rules. They instead argue that the firm conducted its audit in good faith and that it would be unduly punitive to impose liability because ETC's audit complied with *FINRA's* audit rules (which, Applicants claim, are unlike CBOE's rules because they do not expressly prohibit auditing by someone who reports to a designated anti-money laundering compliance person). Applicants argue that CBOE's determination was also unfair because ETC provided CBOE with its AML audit results, but

(...continued)

failed to detect any suspicious transactions. Nor does CBOE allege that improper trading occurred.

³⁶ In its brief, CBOE makes various allegations about ETC's use of real-time surveillance to detect potential wash sales and other suspicious trading activity in 2009, but because CBOE's findings of violations are limited to what ETC did in 2010, the effectiveness of ETC's surveillance in 2009 is not before us. And regarding ETC's alleged activities in 2010, CBOE did not challenge, and the limited evidence in the record does not support an adverse finding regarding, the substance of ETC's trading surveillance measures, such as how the WSR and TPR were designed or what kinds of potentially improper trades they monitored.

CBOE did not respond or object until CBOE filed this disciplinary action against them.³⁷ ETC's various fairness arguments could be relevant to a sanctions analysis, but they do not change the fact that ETC had DiCenso audit the company's AML program at the time that DiCenso reported to ETC's designated AML compliance person.

We accordingly find that ETC violated CBOE Rule 4.20 and, in doing so, violated CBOE Rules 4.1 and 4.2.³⁸ Because Murphy caused ETC to engage DiCenso to perform the 2009 AML audit, and thus failed to ensure that the audit was conducted in accordance with CBOE rules, we also find that Murphy violated CBOE Rule 4.2.³⁹

E. ETC violated Rule 204 of Reg. SHO by failing timely to close out an open short position.

We also affirm CBOE's finding that ETC violated Rule 204 of Reg. SHO by failing to purchase or borrow securities within the necessary time to close out an open short position. Rule 204 requires participants in a registered clearing agency to deliver equity securities to the registered clearing agency when delivery is due; in the case of a short sale, delivery is due within three settlement days (*i.e.*, T+3). Failing to deliver a security to the relevant registered clearing agency on T+3 does not, by itself, violate Rule 204. Rather, absent an applicable exception, Rule 204 requires the participant with a fail-to-deliver position to "immediately close out its fail-to-deliver position by borrowing or purchasing securities" by "no later than the beginning of regular trading hours" on the following settlement day (*i.e.*, T+4).⁴⁰ ETC, a participant in National Securities Clearing Corporation ("NSCC"), a registered clearing agency, did not do that here.

On May 25, 2010, an ETC customer sold short 300 shares of China North East Petroleum Holdings Limited ("NEP"). Later that day, NYSE Amex LLC halted trading in NEP because of that company's failure to file an annual and quarterly report. ETC failed to deliver the 300 NEP shares to NSCC on T+3 and neither purchased nor borrowed NEP shares before the beginning of regular trading hours on T+4. Murphy testified that, despite the firm's best efforts, the trading halt prevented ETC from purchasing or borrowing NEP stock within the required time frame.

³⁷ We can find no evidence, however, that ETC informed CBOE of the key, disqualifying fact that DiCenso reported to Murphy at the time of the audit or that ETC requested permission from CBOE to depart from its rule.

³⁸ As relevant to CBOE Rule 4.1, the Commission's "long-standing and judicially-recognized policy" is that "a violation of another Commission or self-regulatory organization rule or regulation constitutes a violation of the rule prohibiting conduct inconsistent with just and equitable principles of trade." *Edward S. Brokaw*, Exchange Act Release No. 70883, 2013 WL 6044123, at *1 n.2 (Nov. 15, 2003) (quoting *Stephen G. Gluckman*, Exchange Act Release No. 41628, 1999 WL 507864, at *6 (July 20, 1999)). Rule 4.2 specifically requires that member firms comply with other CBOE rules.

³⁹ CBOE Rule 4.2 prohibits TPHs from violating CBOE rules and further requires TPHs to supervise persons to ensure compliance with those rules. *See supra* note 7.

⁴⁰ 17 C.F.R. § 242.204.

The firm did not close out its fail-to-deliver position in NEP for more than a month, ultimately closing it on July 6, 2010.

ETC does not dispute that it failed to purchase or borrow securities to close out its fail-to-deliver position as required by Rule 204. Instead, the firm argues that it would be “unduly punitive” to affirm CBOE’s disciplinary action based on ETC’s “inability to close out a single short sale for 300 shares in a halted security—in a year where ETC successfully cleared and closed out almost 60 million short sales involving over 20 billion shares.” Although ETC’s arguments could be relevant to a sanctions analysis, they do not negate ETC’s failure to meet its obligations under Rule 204 of Reg. SHO. Because ETC violated Reg. SHO, we find that the firm also violated CBOE Rule 4.2.⁴¹

F. Applicants have not demonstrated that CBOE’s proceedings were unfair.

On appeal, Applicants argue that CBOE’s disciplinary proceedings were unfair and, as a result, its decision should be set aside. We do not find these arguments to be persuasive. Although Applicants allege various deficiencies, they fail to establish how those alleged deficiencies rendered the proceedings unfair.

Applicants first argue that CBOE lacks certain procedural safeguards used by other regulators, such as employing professional hearing officers and requiring BCC members or its staff to rotate—the lack of which, Applicants argue, has resulted in the same BCC chairman serving in that role and participating in cases with the same CBOE staff for more than ten years. This, Applicants claim, has led to a “remarkable” success rate in disciplinary proceedings, which Applicants contend shows that CBOE has prevailed in every BCC decision (twenty-six decisions) and in every CBOE published decision (five decisions) since 1986. But generalized statistical evidence alone does not demonstrate that CBOE rendered an unfair judgment in this matter.⁴²

⁴¹ CBOE additionally found that ETC’s violation of Rule 204 of Reg. SHO led to a violation of CBOE Rule 15.1, which requires TPHs to maintain accurate books and records. In neither its decision below nor in its brief to the Commission does CBOE support its findings. Notably, CBOE dismissed the other books and records-related charges (brought under Exchange Act Rules 17a-3 and 17a-4, 17 C.F.R. §§ 240.17a-3, 240.17a-4.) because the CBOE Office of Enforcement failed to present evidence of those alleged violations. We accordingly set aside CBOE’s finding that ETC violated Rule 15.1.

⁴² See, e.g., *NLRB v. Pittsburg S.S. Co.*, 337 U.S. 656, 659–60 (1949) (rejecting claim that trial examiner was biased where the examiner consistently found the company’s witnesses to be untrustworthy and the union’s witnesses to be reliable by holding that “total rejection of an opposed view cannot of itself impugn the integrity of competence of a trier of fact”); *S. Pac. Comm’n Co. v. AT&T*, 740 F.2d 980, 995 (D.C. Cir. 1984) (holding that statistical one-sidedness in rulings cannot, by itself, support an inference of judicial bias); *In re IBM*, 618 F.2d 923, 930 (2d Cir. 1980) (explaining that “[i]t seems evident that statistics alone, no matter how computed, cannot establish extrajudicial bias”).

Applicants also cite three evidentiary decisions as evidence of unfairness: the BCC's decision to allow the introduction of what Applicants claim was a privileged email between ETC and its outside counsel, the BCC's refusal to require a CBOE investigator to produce her investigative notes, and the BCC's denial of Applicants' request for documents from an unrelated Commission investigation into CBOE. This recitation of adverse rulings is not evidence of unfairness. CBOE's rules give the BCC broad discretion in ruling on the admissibility of evidence.⁴³ We can find no evidence that the BCC's evidentiary decisions were unreasonable or otherwise improper here. To the contrary, the record shows that the BCC carefully considered the parties' evidentiary disputes after providing the opportunity for both sides to argue their positions through written submissions and/or oral presentation at the hearing.⁴⁴ Moreover, by cherry picking three adverse evidentiary rulings, Applicants ignore the various times the BCC ruled in their favor, including its dismissal of multiple charges against them.

Instead, Applicants assert that the BCC's dismissal of charges against them is further evidence of unfairness, arguing that the dismissal highlights CBOE's lack of a procedure for summary disposition. Without such a procedure, Applicants contend, "respondents can find themselves trapped in a lengthy, expensive, and uncertain disciplinary process on the basis of charges that even the CBOE staff recommends be dismissed—thereby giving the CBOE leverage to extract settlements regardless of the merits (or lack thereof) of the charges at issue." Applicants do not claim or present any evidence that *they* were improperly pressured to enter into a settlement and thus subjected to an unfair proceeding.⁴⁵

Applicants also argue that CBOE's proceedings were unfair because its rules do not expressly forbid *ex parte* communications between adjudicators and staff, but the absence of a specific prohibitory rule does not mean that CBOE allowed such communication to take place. CBOE has other internal structures and procedures to protect against improper communications, including separating its litigation and adjudicatory personnel.⁴⁶ Applicants do not allege that *ex*

⁴³ CBOE Rule 17.6(c) provides that the BCC "shall determine all questions concerning the admissibility of evidence and shall otherwise regulate the conduct of the hearing" and that "[f]ormal rules of evidence shall not apply."

⁴⁴ See, e.g., *Michael Pino*, Exchange Act Release No. 74903, 2015 WL 2125692, at *9 (May 7, 2015) (finding that respondent had been provided with a fair proceeding where he "had an opportunity to testify on his own behalf, to call witnesses, and to cross-examine FINRA's witnesses"); *Jason A. Craig*, Exchange Act Release No. 59137, 2008 WL 5328784, at *6 (Dec. 22, 2008) (same).

⁴⁵ Cf. *Kirlin Sec., Inc.*, Exchange Act Release No. 61135, 2009 WL 4731652, at *13 n.87 (Dec. 10, 2009) ("As always, the burden of proving that an applicant engaged in conduct violating [FINRA rules] rests with FINRA; however, as we have stated previously, the applicant bears the burden of producing evidence to support his claimed defenses.").

⁴⁶ See, e.g., *Scattered Corp.*, Exchange Act Release No. 40646, 1998 WL 774795, at *7 (Nov. 9, 1998) (finding that separation between SRO's adjudicatory and decisions-making functions "protect against *ex parte* communications between parties and those involved in the

(continued...)

parte communications ever took place here.⁴⁷ CBOE’s *ex parte* rules, as with the other procedures about which Applicants complain, were approved by the Commission as providing “a fair procedure for the disciplining of members and persons associated with members,” the standard to which we hold all disciplinary rules promulgated by self-regulatory organizations.⁴⁸ ETC agreed to abide by these rules when it became a CBOE member. We can find no evidence that CBOE failed to observe these or any other procedural rules when it conducted the proceedings against Applicants.

IV. Sanctions

Exchange Act Section 19(e)(2) directs us to sustain CBOE’s sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.⁴⁹ Here, CBOE aggregated its sanctions for Applicants’ alleged violations, imposing a censure on each Applicant, jointly and severally fining Applicants \$1,000,000, and suspending Cloyd and

(...continued)

decision-making process”); CBOE Rule 17.10(b) (stating that “[a]ny Director who participated in a matter before the Business Conduct or other Committee may not participate in any review of that matter by the Board”).

⁴⁷ *Cf. Salem Hosp. Corp. v. NLRB*, 808 F.3d 59, 71 (D.C. Cir. 2015) (stating that “‘ex parte communications, even when undisclosed during agency proceedings, do not necessarily void an agency decision’” and that, for relief, “a party must show that ‘as a result of improper ex parte communications, the agency’s decisionmaking process was irrevocably tainted’” (quoting *Prof'l Air Traffic Controllers Org. v. FLRA*, 685 F.2d 547, 564 (D.C. Cir. 1982)); *Grolier Inc. v. FTC*, 615 F.2d 1215, 1221 (9th Cir. 1980) (stating that the burden of proof is on the party asserting that *ex parte* communications took place and that, “[w]here, as here, the court is presented with no evidence of actual involvement . . . the normal course of action would be to refuse to disqualify [the party alleged to have received the *ex parte* information]”).

⁴⁸ *See, e.g., Chicago Bd. Options Exch.*, Exchange Act Release No. 24252, 1987 WL 755658, at *1 (Mar. 24, 1987) (approving change to CBOE Rule 17.4, which governs *ex parte* communications); 15 U.S.C. § 78f(b)(7) (requiring fair procedures in the event of “the prohibition or limitation by the [exchange or association] of any person with respect to access to services offered by the [exchange or association] or a member thereof”).

⁴⁹ 15 U.S.C. § 78s(e)(2).

Murphy each for six months. Because we are setting aside certain of the violations, we find it appropriate also to set aside and remand so that CBOE can reconsider its determinations regarding sanctions. We do not suggest any view as to the outcome of that reconsideration.

An appropriate order will issue.⁵⁰

By the Commission (Chair WHITE and Commissioners STEIN and PIWOWAR).

Brent J. Fields
Secretary

⁵⁰ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 78093 / June 16, 2016

Admin. Proc. File No. 3-16285

In the Matter of the Application of

ELECTRONIC TRANSACTION
CLEARING, INC., KEVIN MURPHY, and
HARVEY C. CLOYD, JR.

for Review of Disciplinary Action Taken by

CBOE

ORDER SUSTAINING REVIEW PROCEEDING IN PART, SETTING ASIDE REVIEW
PROCEEDING IN PART, AND REMANDING REVIEW PROCEEDING IN PART

On the basis of the Commission's opinion issued this day, it is

ORDERED that CBOE's finding that Electronic Transaction Clearing, Inc., violated CBOE Rules 4.1, 4.2, and 4.20 by failing to implement an adequate anti-money laundering program is set aside; and it is further

ORDERED that CBOE's finding that Kevin Murphy violated CBOE Rule 4.2 by failing to supervise and implement a satisfactory AML program is set aside; and it is further

ORDERED that CBOE's finding that Electronic Transaction Clearing, Inc., violated CBOE Rules 4.1, 4.2, 12.3(j), and 12.4(i) by failing to impose CBOE's margin and portfolio margin requirements properly is set aside; and it is further

ORDERED that CBOE's finding that Kevin Murphy and Harvey C. Cloyd, Jr., violated CBOE Rule 4.2 by allowing Electronic Transaction Clearing, Inc., not to impose day trading buying power and equity limits on individual traders is set aside; and it is further

ORDERED that CBOE's finding that that Electronic Transaction Clearing, Inc., violated CBOE Rules 4.1 and 4.2 by failing to implement effective risk procedures and surveillance tools for detecting suspicious trading activities is set aside; and it is further

ORDERED that CBOE's finding that Electronic Transaction Clearing, Inc., violated CBOE Rules 4.1, 4.2, and 4.20 by failing to perform an independent audit of the firm's 2009 anti-money laundering program is sustained; and it is further

ORDERED that CBOE's finding that Kevin Murphy violated CBOE Rule 4.2 for his conduct related to the firm's 2009 anti-money laundering audit is sustained; and it is further

ORDERED that CBOE's finding that Electronic Transaction Clearing, Inc., violated CBOE Rule 4.2 and Exchange Act Rule 204 of Reg. SHO for failing to timely close out a fail to deliver is sustained; and it is further

ORDERED that CBOE's finding that Electronic Transaction Clearing, Inc., violated CBOE Rule 15.1 is set aside; and it is further

ORDERED that the sanctions imposed by CBOE against Harvey C. Cloyd are vacated; and it is further

ORDERED that the proceeding is remanded to CBOE for reconsideration of sanctions against Electronic Transaction Clearing, Inc., and Kevin Murphy in accordance with this opinion.

By the Commission.

Brent J. Fields
Secretary