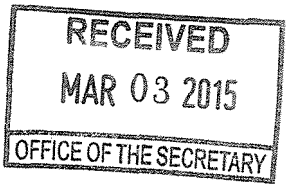
Morgan, Lewis & Bockius LLP
200 South Biscayne Boulevard
Suite 5300
Miami, FL 33131-2339
Tel: 305.415.3000
Fax: 305.415.3001
www.morganlewis.com

Morgan Lewis
COUNSELORS AT LAW

Ivan P. Harris



March 2, 2015

VIA FACSIMILE AND FEDEX

Brent J. Fields, Secretary
Jill M. Peterson, Assistant Secretary
United States Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549

Re: In the Matter of Application of Electronic Transaction Clearing, Inc., Kevin Murphy and Harvey C. Cloyd, Jr., Admin. Proc. File No. 3-16285

Dear Mr. Fields and Ms. Peterson:

On behalf of Electronic Transaction Clearing, Inc, Kevin Murphy and Harvey C. Cloyd, Jr. (collectively, "Applicants"), and pursuant to the Commission's December 17, 2014 Order Scheduling Briefs, enclosed please find Applicants' Reply Brief in Support of the Application for Review. A facsimile copy of the Brief was also transmitted to the Commission's Office of the Secretary on this date to (202) 772-9324.

Applicants further respectfully repeat their request made in their Application for Review for oral argument on the issues raised in this appeal, or on any issues in particular that the Commission deems appropriate.

Sincerely,

Ivan P. Harris

c: Andrew Spiwak, Esq.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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

REPLY BRIEF IN SUPPORT OF APPLICATION FOR REVIEW

Ivan P. Harris
Allyson N. Ho
Megan R. Braden
MORGAN, LEWIS & BOCKIUS LLP

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

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INTRODUCTION

In their opening brief, Applicants Electronic Transaction Clearing, Inc. ("ETC"), Kevin Murphy and Harvey C. Cloyd, Jr. ("Applicants") established that ETC's wash trade surveillance program was effective and fully complied with all regulations, that ETC complied with the Commission's Customer Identification Program Rule ("CIP Rule"), that ETC adhered to all applicable margin requirements, and that ETC should not be sanctioned on the basis of its 2009 annual Anti-Money Laundering ("AML") independent test or its failure to cover a single short sale in 2010. Applicants also demonstrated that the CBOE's positions in this matter are factually flawed and conflict with the clear definitions and guidance provided in the applicable regulations. Finally, Applicants showed that the sanctions imposed below are oppressive in their amount, and based on flawed findings and a failure to consider important mitigating facts.

CBOE's response to those arguments is perhaps most notable for what it does *not* contain. For one thing, it does not dispute key assertions by Applicants in their opening brief—including that not a single fact showed that the traders for certain of ETC's customers are themselves "customers" of ETC with "accounts" who would be subject to the CIP Rule or margin requirements, or that ETC had a trade surveillance report that monitored for precisely the kind of trading that the decisions below found to be lacking. For another thing, it does not cite a single

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authority supporting its unprecedented expansion of the rules and regulations at issue in this case. Instead, CBOE continues to advance the same flawed logic and contradictory arguments that led to the errors below—and throws in some ad hominem attacks for good measure. By doubling down on its illogical factual findings and improper legal interpretations, CBOE only confirms the need to set aside the decisions below.

ARGUMENT

I. Contrary To CBOE's Unsubstantiated Assertions, Applicants Have A Strong Commitment To Compliance.

CBOE's lead argument is not a defense on the merits, but an ad hominem attack on Applicants' commitment to compliance. Sweeping aside Murphy and Cloyd's undisputed, combined 53 years in the securities industry without a blemish on their records, CBOE takes Applicants to task for not having a compliance program in place before 2010, for viewing compliance as a "'necessary evil,'" for "yell[ing]" at their Chief Compliance Officer ("CCO"), and for not caring about "'the legality of [its] customers' business.'" (CBOE's Response in Opposition to Application for Review "Resp." 5, 27 (citations omitted).) But not a single one of these conclusions is based on evidence introduced at the Hearing below or statements actually made by Applicants. What CBOE cites in support are conclusory statements in the Business Conduct Committee ("BCC") Decision or the testimony of its own examiners in support. (*Id.*)

For good reason, however, the Commission must undertake "a full and independent review [of the decisions below] . . . *as to the facts* as well as the law." *Gold v. SEC*, 48 F.3d 987, 990 (7th Cir. 1995) (emphasis added). And as CBOE acknowledges, the Commission can depart from a fact finder's determinations of credibility whenever there is "substantial evidence in the record to the contrary." (Resp. 3.) Here, the record is replete with such evidence, which overcomes the uncorroborated testimony of CBOE's examiners and the conclusory statements of the BCC.

Indeed, the evidence conclusively rebuts CBOE's unfair and self-serving characterization of Applicants' commitment to their compliance program. In addition to Murphy and Cloyd, ETC's CCO, David DiCenso—who was supposedly on the receiving end of some of the alleged statements and viewed as a credible witness by the BCC—denied they were made. (Tr. 1093:3-7, 1112:15-1113:18, 1114:6-17, 1116:14-1120:18 (DiCenso).)

Further, the record establishes that instead of failing to have a compliance program before 2010, ETC spent the first two years of its existence building out its infrastructure, including a compliance and trade surveillance function, and did not take on a single customer or clear a single trade until early 2009. (Tr. 1367:4-16 (Cloyd); Tr. 1476:11-19 (Murphy).) And for most of 2009, when ETC was just beginning its operations and primarily clearing trades for other broker-dealers and

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not public customers, Murphy served as ETC's CCO. (Tr. 1476:2-19, 1477:14-18 (Murphy).) CBOE insists that Murphy was not qualified to act as a compliance professional (Resp. 4), but by that time Murphy had spent over twenty years in the securities industry as a trader, registered securities principal, and compliance consultant. (Tr. 1474:7-20, 1475:8-1476:1, 1476:20-1477:4 (Murphy).) There is simply no evidentiary support for CBOE's contention that he was unqualified to be a CCO.

In addition to Murphy, ETC's trade surveillance during this early period of its existence was carried out by another registered securities principal (Patrick Kelly) with over 20 years of securities industry experience, and a third registered individual (Barnaby Hatchman) with approximately 10 years of industry experience. (Tr. 1480:22-1481:10 (Murphy).) CBOE's contention that these three individuals were somehow not qualified to conduct trade surveillance cannot withstand scrutiny.

In the fall of 2009, ETC underwent a full examination by CBOE's examination staff. (Resp. Ex. 21; Tr. 1478:4-1479:19 (Murphy).) That examination found only minor deficiencies, did not cite ETC for any deficiencies in its trade surveillance, anti-money laundering or margin departments, and

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certainly did not cite ETC for any culture of noncompliance.[1] It will not do for CBOE to engage in post hoc speculation that its examiners somehow "missed" these issues in 2009.

In all events, shortly after CBOE's 2009 examination, ETC bolstered its compliance program by extending a job offer to DiCenso. (Tr. 1481:11-19 (Murphy).) ETC's hiring of a former regulator like DiCenso is itself a testament to its commitment to compliance. And after he was hired, DiCenso was provided with everything he needed to design and implement surveillance reports and further build out ETC's compliance program. (Tr. 1075:21-1076:15, 1078:14-1084:13, 1085:7-1086:16, 1093:20-1094:23, 1119:24-1120:18 (DiCenso); Tr. 1397:1-6 (Cloyd).) All of these efforts were made *before* CBOE's 2010 examination—thereby refuting CBOE's contention that Applicants "failed to take their compliance responsibilities seriously until after they faced regulatory scrutiny." (Resp. 4.)

Citing the BCC's erroneous conclusions, CBOE further asserts that Murphy and Cloyd only sought to protect "'the four walls'" of ETC. (Resp. 5.) But that assertion is at odds with the actual testimony. What Cloyd actually said at the

[1] The only deficiencies cited in CBOE's 2009 Examination report, dated December 30, 2009, were failures to (1) "obtain Insider Trading Attestation forms or letters from 5 of 11 associated persons"; (2) "obtain and review the FBI Civil Applicant Response ('CAR') for 2 out of 9 new associated persons"; and (3) "maintain its electronically stored books and records, other than emails, in a WORM format." (Resp. Ex. 21.)

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Hearing was that his goal in designing ETC was to ensure that improper conduct could not penetrate the firm. As he explained it:

> [W]hat we're trying to do is create an environment that prevents as much as possible . . . for money laundering to happen at ETC. . . . [I]f you could use an analogy of a—you know, you have a house. One has a—you know, a—just a door, and the other one has a beware of dog type sign on it. We want to be the one that says beware of dog, so that our environment is that type of environment.

(Tr. 1398:1-5, 10-15 (Cloyd).) As an example of this conservative philosophy, Murphy testified that ETC does not permit third-party wire transfers from customer accounts. (Tr. 1509:8-1510:21 (Murphy).) These policies further evidence ETC's commitment to designing an effective anti-money laundering program, and rebut wholeheartedly the unsubstantiated testimony of CBOE's examiners and the conclusions reached below.

II. CBOE's Trade Surveillance Charges Are Fundamentally Flawed.

A. CBOE's Attempts To Denigrate ETC's Surveillance Program Do Not Withstand Scrutiny.

In arguing that ETC did not have an adequate surveillance program for wash trades, CBOE (like the BCC and the Board) simply ignores ETC's Trade Participation Report ("TPR"), focusing only on its examiners' faulty conclusion that ETC's Wash Sale Report ("WSR") did not adequately review for *all forms* of potential wash trading. This disregard of the TPR is not surprising, as the Hearing showed that despite being told about the TPR at least nine times during CBOE's examination of ETC, CBOE's examiners failed to understand what it did. (Tr.

1039:13-1042:4 (Sizemore).) Although the crux of the decisions below is that ETC did not monitor for potential wash trading by different traders, CBOE's response does nothing to rebut the uncontested evidence that the TPR—no matter how much the CBOE tries to ignore it—did just that. (Tr. 1079:23-1080:15 (DiCenso).)

Tellingly, in its response CBOE does not challenge how the TPR was designed or the kinds of improper trading for which it monitored. Rather, CBOE's only assertion is that because ETC decided to redesign the TPR in the summer of 2010, the TPR "'was not functioning during the majority of 2010.'" (Resp. 8 (citation and alteration omitted).) But as Applicants made clear in their opening brief (Appl. 37-43), CBOE's assertions about the TPR's functionality make no sense—especially since CBOE does not dispute that the TPR generated exception reports in its original format from February 2010 to May 2010; that DiCenso used those exception reports, together with those generated by the WSR, to monitor for wash trading; that the newly designed TPR came on-line in September 2010; and that the newly designed report conducted a look-back of all trading activity between June and August 2010. (Resp. Ex. 46; Tr. 1152:15-1155:5, 1155:15-1156:1 (DiCenso).)

CBOE points to the BCC's unsupported and illogical conclusion that the "TPR was not an 'effective tool.'" (Resp. 8.) Yet DiCenso, who actually designed

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and used the report, testified that the initial version of the TPR was effective and monitored for violative trading between two different traders. (Tr. 1079:23-1081:13, 1150:15-1152:3, 1159:24-1160:6 (DiCenso).) DiCenso further confirmed that the WSR and TPR cannot be viewed in isolation, as the CBOE's examiners did, but must be viewed together:

> [O]n the individual wash sale report, we're looking for specific traders, and with the TPR, the trade participation report, we're looking for possible prearranged trading or manipulative activity within the whole ETC universe, so that both—you know, it's kind of a two-pronged approach to reviewing the activity.[2]

(Tr. 1149:7-13 (DiCenso).) He was also clear that CBOE's view of ETC's wash trade surveillance program was entirely flawed:

> Q: You heard Ms. Miller-Brouwer's [a CBOE examiner's] testimony on Monday, and her assertion that ETC did not conduct surveillance for wash sales between two different traders of the same MPID or between two different MPIDs. Was her testimony accurate?
>
> A: No.

(Tr. 1149:22-1150:3 (DiCenso).) The decisions below that cleared DiCenso of liability and credited his testimony, but at the same time disregarded his explanation of ETC's wash trade surveillance program in favor of the testimony of CBOE examiners who clearly failed to understand that program, cannot be reconciled.

---

[2] CBOE incorrectly asserts that ETC's argument that the WSR and TPR were designed to work together "cannot be reconciled with the admission by one of ETC's witnesses [Barnaby Hatchman] that ETC no longer runs the WSR." (Resp. 8 n.7.) As CBOE well knows, DiCenso, who reviewed ETC's exception reports, corrected Hatchman's mistaken recollection and testified during the Hearing that ETC continued to review trading using both the WSR and the TPR. (Tr. at 1084:18-1085:6 (DiCenso).)

CBOE incorrectly argues that ETC implemented various anti-wash settings in an attempt to "avoid its duty" to conduct wash trade surveillance. (Resp. 13.) As Applicants have already explained in their opening brief, anti-wash settings are widely used by members of various exchanges as a way to prevent unintended wash trades from occurring. (Appl. 7-8.) The record conclusively established that Applicants added these settings on top of multiple other efforts they undertook to prevent wash trades.[3]

CBOE does not dispute that before its Regulatory Circular 09-118 ("RC-09-118"), issued in late October 2009, CBOE had not provided any guidance to its members on trade surveillance. Nor does CBOE contest that it endorsed the use of manual or exception report-based reviews of trading activity on either a real-time or a post-trade basis. (*See* CBOE Regulatory Circular 09-118, *Supervisory Obligations of Members Providing Access to Exchange Systems* (Oct. 26, 2009) (CBOE Ex. 54) (stating that supervisory procedures "*may be* implemented on a post-trade basis" and "*can be* conducted via exception reports." (emphasis added)).)[4] CBOE does not explain how, if its own regulatory guidance does not require the use of exception reports and does not mandate any particular design of

---

[3] CBOE also confuses anti-wash settings with a different setting to prevent the entry of "two-sided markets." (*See* Resp. 12.) As DiCenso testified, a restriction from entering two-sided markets is even more restrictive than an anti-wash setting, in that it prevents a trader from having an open buy and sell order in the same security outstanding at the same time. (Tr. 1162:1-16 (DiCenso).)

[4] In contrast to CBOE's mistaken interpretation, Applicants have never argued that ETC "was not required to have any trade surveillance program at all." (Resp. 10 n.8). Rather, Applicants cited to RC-09-118 to make the point that, in contrast to the BCC's improperly restrictive holding, CBOE has never mandated the use of exception reports as part of a trade surveillance program, let alone dictated any particular design of those exception reports.

exception reports, Applicants can nonetheless be sanctioned for using exception reports that CBOE mistakenly believes did not surveil for a particular activity.

Moreover, CBOE's argument fails to account for its own examiner's inconsistent testimony and damaging admissions. That examiner (Ellen Miller-Brouwer) initially testified that she was not aware of the TPR during the examination and did not know what a prearranged trade was. (Tr. 231:10-13, 235:14-20 (Miller-Brouwer).) When later confronted with the overwhelming evidence that Applicants told CBOE at least nine times during the examination what the TPR was and how it worked, she changed her story and testified: "I was—heard the term prearranged report. It did not—at the time for us, we did not consider that perhaps that might also be in addition to the wash sale report." (Tr. 1617:17-20 (Miller-Brouwer).)[5] And CBOE is simply wrong that Miller-Brouwer qualified her admission that ETC had an adequate wash trade surveillance program. As she clearly testified:

> Based on the representation within the hearing binders about how the [TPR] report operated, including the testimony we've heard from representatives of ETC, it would appear that—presuming the report was operating as such, that it may have been adequate.

[5] At the Hearing, the TPR was sometimes referred to as the "prearranged" report or "prearranged trading" report. As multiple CBOE examiners acknowledged, prearranged trading can be a form of wash trading. (Tr. 1022:21-1023:9 (Sizemore); Tr. 1616:19-23 (Miller-Brouwer).)

(Tr. 1621:21-1622:2 (Miller-Brouwer).) Miller-Brouwer did not limit her admission to the time period after September 2010, as CBOE now asserts. (Resp. 9.)

The conclusion that Applicants maintained an effective surveillance program is underscored by the total absence of any finding of improper trading activity at ETC. CBOE tries to minimize the importance of that indisputable fact by claiming that "suspicious activity did go undetected on a real time basis before and during 2010" (Resp. 14), but there is no record support for that assertion. Instead, the record is clear that no manipulative activity actually occurred. And while claiming that it "lacked jurisdiction over ETC's client and therefore could not compel that client to produce information" (*id.* at 16), CBOE neglects to mention that its examiners met with and gathered documents and information directly from that client during the investigation. (Tr. 68:8-16, 69:15-17, 74:22-75:10 (Miller-Brouwer); CBOE Ex. 43 (describing the documents and information that CBOE gathered directly from Vantage Point Securities).) CBOE's attempt to obscure the lack of any improper activity by insisting it "could not compel" the production of information—while failing to mention that it was, in fact, able to get information directly from ETC's client—must be rejected.

Similarly, CBOE's attempt to diminish the force of FINRA's decision in *Department of Enforcement v. Sterne, Agee & Leach, Inc.*, Disc. Proc. No.

E052005007501, 2010 FINRA Discip. LEXIS 18 (Mar. 5, 2010), fares no better.[6] That case did not merely involve, as CBOE would have it, a firm's use of an outside vendor's surveillance system and reliance on an outside vendor, much less did it announce a "blanket rule that a firm's failure to have an adequate surveillance program in place will be excused if the firm later conducts a retrospective analysis of the activity in question." (Resp. 15.) *Sterne* stands for the proposition that where, as here, a firm's "compliance efforts were substantial" and included a combination of manual and automated systems to review for suspicious activity, where, as here, the regulator did not establish that the firm "missed suspicious transactions," and where, as here, the firm ensured that all activity was reviewed either at the time or retrospectively, no violations can possibly occur. 2010 FINRA Discip. LEXIS 18, at *19-20, 43, 45.

B. CBOE Cannot Resolve The Fundamental Contradiction Between Absolving DiCenso While Sanctioning ETC.

CBOE devotes significant space in its response trying to reconcile its decision to sanction ETC for having an ineffective trade surveillance program while, at the same time, absolving the person who designed that program of all liability. CBOE weakly surmises that perhaps the BCC and its Board of Directors ("Board") "concluded that DiCenso was doing the best that he could under difficult

[6] While CBOE is correct that *Sterne* was not cited below, that is of no moment. *Sterne* simply provides additional support for Applicants' argument all along that ETC's wash trade surveillance program was reasonable and effective.

circumstances." (Resp. 16.) But that speculation does nothing to justify the obvious inconsistency between absolving DiCenso while sanctioning ETC—an inconsistency that puts in bold relief why the wash trading surveillance charges cannot stand.

The design of the WSR and TPR was exclusively up to DiCenso, based on his years of experience as a regulator. Upon his arrival at ETC in December 2009, just six weeks after CBOE's issuance of RC-09-118, he immediately began implementing these exception reports. (Tr. 1078:14-1080:15, 1094:3-23, 1159:24-1160:6 (DiCenso).) There was no credible evidence in the record that he was operating under "difficult circumstances" or met any resistance when he implemented these reports. DiCenso designed a wash trade surveillance program that worked effectively, the way that system worked was simply not understood by the CBOE's examiners, and, just as DiCenso was found to have committed no violations, the same conclusion should have been reached as to Applicants.

III. CBOE's Interpretation Of The Applicable Customer Identification And Margin Rules Is Illogical And Incorrect.

As an initial matter, CBOE does not contest or dispute facts and assertions that are critical to the issues presented in this appeal on the CIP Rule and margin findings below. CBOE does not dispute that the traders to whom CBOE believes the CIP and margin rules should apply do not have accounts or sub-accounts at ETC; cannot deposit money or securities to, or withdraw money or securities from,

any account at ETC; cannot segregate monies or securities in any account at ETC; do not receive account statements or confirmations from ETC; are not parties to lending agreements with ETC; and do not borrow money from ETC.

CBOE further acknowledges that it presented no evidence at the Hearing to establish that the traders were trading their own funds or had any ownership interest in any customer account at ETC. (Resp. 22-23.) CBOE seeks to distract from this critical gap in the evidence by stating that "it lacked jurisdiction to investigate Vantage Point." (*Id.* at 22.) But CBOE (again) neglects to mention that it did, in fact, obtain information from Vantage Point, and that evidence established that the traders had no beneficial interest in the accounts at ETC. (*See* CBOE Exs. 40 and 42; Tr. 68:8-16, 69:15-17, 74:22-75:14 (Miller-Brouwer).)

CBOE does not contest that, in the entire history of the CIP Rule, only one case, *In the Matter of Pinnacle Capital Markets LLC & Michael A. Paciorek*, Exchange Act Release No. 62811, 99 SEC Docket 779, 2010 WL 3437456 (Sept. 1, 2010), has applied that rule to sub-account traders. And, as the CBOE acknowledges, the sub-account traders in that case were introduced to the broker-dealer by "correspondent accounts"; that is not the case here. As Applicants demonstrated in their opening brief (Appl. 18-19, 24) and, as CBOE does not dispute, the sub-account traders in *Pinnacle* are factually and legally distinguishable from the traders here in numerous additional ways: the *Pinnacle*

traders had sub-accounts that were not proprietary accounts of the entity customer, they effected transactions for their own accounts as opposed to the entity customer, and they did not act on behalf of the entity customer. Those differences likely account for the lack of any effort by CBOE to fit the facts here within the *Pinnacle* framework—it would simply be impossible to do so.

Instead, CBOE attempts to support the CIP and margin charges by resorting to the same so-called "red flags" it raised below, and making the same argument that some of ETC's traders are unregistered broker-dealers. But neither argument provides any support for the faulty proposition that individuals who merely have the ability to enter trades in an entity customer's account could possibly fall within the scope of the CIP Rule or CBOE's margin rules.

A. The Traders Cannot Be Considered "Customers" Under The CIP Rule.

1. CBOE Continues To Press Its Incorrect Interpretation Of The CIP Rule

As it has at every stage of this case, CBOE continues to run as far as it can from the definitions of "customer" and "account" in the CIP Rule and the Commission's interpretations of the rule. CBOE even goes so far as to call the definition of "customer" in the CIP Rule the "default" definition—as if there were some other definition that could apply to support the charges. (Resp. 17.) In reality, that is a tacit acknowledgment that the traders here do not come within the Rule's definition of "customer."

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As Applicants explained in their opening brief, a "customer" under the CIP Rule is a "person that opens a new account" at a broker-dealer—and the Commission has excluded persons "granted trading authority" from that definition. (Appl. 15-16.) CBOE does not attempt to explain how the traders here could fit within that definition—an omission that is not surprising, particularly given that the CIP Rule defines "account" as "a formal relationship with a broker-dealer" established for "the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral." 31 C.F.R. § 1023.100(a)(1).

CBOE points instead to a separate section of the CIP Rule requiring a broker-dealer to obtain information about individuals with authority or control over an entity customer's account "when the broker-dealer cannot verify the customer's true identity using the verification methods described in paragraphs (a)(2)(ii)(A) and (B) of this section." (Resp. 18 (quoting 31 C.F.R. § 1023.220(a)(2)(ii)(C) (alterations omitted)).) CBOE also emphasizes that ETC's written supervisory procedures contain a section that complies with this provision by requiring ETC to gather information about individuals with trading authority where it cannot verify the customer's true identity. (*Id.* at 19.)

But as Applicants have already pointed out in their opening brief, that portion of the CIP Rule and the section of ETC's procedures have no application

here—a conclusion that would have been evident had CBOE gone on to quote the CIP Rule in its entirety, which sets out specific "verification methods" that ETC did, in fact, use to verify its entity customers' identities. (*See* Appl. 25.) CBOE's quotation of the CIP Rule is as partial—and as incomplete—as CBOE's interpretation itself, which seriously misunderstands what the CIP Rule requires.[7]

Lacking any basis in the CIP Rule for categorizing the traders as "customers" with "accounts," CBOE resorts to the "red flags" relied upon by the BCC and Board below to support the charges. None of these so-called "red flags," however, is relevant to the ultimate question of whether the traders are "customers" with "accounts" at ETC.[8]

Indeed, CBOE offers no explanation why or how the red flags somehow transform the traders into "customers." The most CBOE can do is argue is that Applicants' experts—whose credentials CBOE does not attack—were not credible because they "consider[ed] each factor in isolation" and "engaged in an exercise of exalting form over substance." (Resp. 23.) But that is not an accurate description of the testimony. The experts considered the CBOE's so-called "red flags" (e.g.,

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[7] CBOE makes much of DiCenso's 2010 emails to counsel asking whether ETC had an obligation to perform "background checks" on traders for certain customers. (Resp. 20.) The CBOE neglects to mention, however, that DiCenso testified that after these communications with counsel, ETC continued to believe that the CIP Rule did not apply to the traders. (Tr. 1104:4-1105:23 (DiCenso).) The Commission should not support CBOE's efforts to fault a broker-dealer for raising questions to outside counsel, especially when the end result of those questions is that the broker-dealer believes that its conduct is consistent with its regulatory obligations.

[8] For example, CBOE claims that the location of certain traders in China was a "red flag" because China is considered a "Jurisdiction of Primary Concern" by the U.S. Department of State's International Narcotics Control Strategy Report. (Resp. 20 n.14.) But that list also includes Australia, Austria, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Switzerland, and the United Kingdom—and that is why a country's inclusion on that list is irrelevant to a "red flag" determination for AML purposes. (Tr. 1278:24-1280:12, 1321:9-1322:24 (Paulukaitis).)

the number of traders, their location, and their trading strategy) and concluded (correctly) that they were irrelevant to the analysis. (Appl. 24 (citing (Tr. 1271:24-1272:16, 1273:24-1275:3, 1277:16-1278:5, 1280:14-24, 1323:23-1325:5, 1329:6-1330:3, 1332:12-1333:15 (Paulukaitis).). Nor did the experts elevate form over substance. They simply looked at the CIP Rule and (correctly) opined that, based on their extensive knowledge of the rule and their analysis of all of the facts presented here, it did not apply to the traders.

CBOE, however, insists that accepting the conclusion advanced by Applicants and their experts "would effectively eliminate the requirement that AML and CIP programs be risk-based." (Resp. 23.) That is not so—and if anything, it is CBOE's interpretation that would lead to the improper result of extending the CIP Rule's reach far beyond its intended scope and undermining its focus on money-laundering risks. As the Commission explained when it dropped persons with trading authority from the definition of "customer" in the final version of the CIP Rule, "requiring limited resources to be expended on verifying the identities of persons with authority over accounts" would interfere with other, more important CIP functions. *Customer Identification Programs for Broker-Dealers*, 68 Fed. Reg. 25113, 25116 (May 9, 2003) (Resp. Ex. 61). CBOE's interpretation, if accepted, would effectively—and impermissibly—rewrite the CIP Rule to require precisely what the Commission deliberately chose not to require-

and for good reason, so that firms can focus their resources more effectively and efficiently.

CBOE further asserts that its expanded interpretation of the CIP Rule "is consistent with the guidance provided by the SEC's Office of Compliance Inspections and Examinations" ("OCIE") (Resp. 24 n.16), but a closer look at that guidance dispels any such notion. The OCIE Risk Alert cited by CBOE focuses on sub-account holders within a master account structure, which is not present in the instant case. Office of Compliance Inspections and Examinations, *National Exam Risk Alert* (Sept. 29, 2011), at 4, http://www.sec.gov/about/offices/ocie/riskalert-mastersubaccounts.pdf. And like *Pinnacle*, the Risk Alert states that the CIP Rule applies—not to every sub-account holder—but only to a sub-account holder who "is the broker-dealer's 'customer' for purposes of the CIP rule." *Id.*

CBOE does not dispute that neither the BCC nor the Board found that the traders were ETC's customers under the Rule. And unlike CBOE's partial quotation of the CIP Rule, the Risk Alert states plainly that the Rule's requirement that a broker-dealer obtain additional information about individuals with authority over entity customer accounts applies only "when the broker-dealer *cannot verify the customer's true identity* using the documentary or non-documentary verification methods" described in the CIP Rule. *Id.* at 5 (emphasis added). That

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condition was never triggered in this case, so no additional information was required.

FinCEN's recent proposed rule confirms that conclusion. It would extend, for the first time, the CIP Rule to beneficial owners of entity accounts, and would permit broker-dealers to rely on a customer's identification of its beneficial owners. (*See* Appl. 26, 52-53.) CBOE's position that ETC must go beyond beneficial owners (who are not even explicitly covered by the current version of the CIP Rule), and disregard a customer's representations about its beneficial owners, conflicts with both the current CIP Rule and the pending changes to it.

2. CBOE's Focus On Whether Certain ETC Customers Are Unregistered Broker-Dealers Is Irrelevant

CBOE claims that the CIP Rule somehow applies to the traders because certain ETC customers "appeared to be acting as non-registered broker-dealers." (*See, e.g.*, Resp. 2 1.) This argument is a nonstarter.[9] CBOE cites no section of the CIP Rule or its guidance that could support it, nor does CBOE explain why, even if an entity operating as a broker-dealer maintains its own account at another broker-dealer, the analysis would be any different. That is because there is no difference. Whether a trader enters trades for a broker-dealer or a non-broker-dealer, he or she

[9] While arguing repeatedly that certain ETC customers may have been "unregistered broker-dealers," CBOE fails to make the case—since it cannot—that these foreign entities with entirely foreign traders were required to register as broker-dealers. *See* SEC Division of Trading and Markets, *Compliance Guide to the Registration and Regulation of Brokers and Dealers* (Apr. 2008), http://www.sec.gov/divisions/marketreg/bdguide.htm (noting that only "broker-dealers physically operating within the United States that induce or attempt to induce securities transactions must register with the SEC.").

must be a "customer" with an "account" to fall within the CIP Rule. Once again, CBOE's improperly expansive interpretation of the CIP Rule would extend its requirements to every trader for every broker-dealer, hedge fund and mutual fund, and must be rejected.

3. CBOE's Speculation Cannot Make Up For The BCC's Failure To Substantiate Its Holding As To Murphy

CBOE's rules require the *BCC* to state the reasons for its findings. Rule 17.9. CBOE acknowledges that the BCC Decision "did not restate all of the evidence against Murphy" in holding him liable for the CIP charges (Resp. 28)- and that is putting it mildly. The BCC Decision wholly fails to provide any rationale for holding Murphy liable for the CIP Rule charge, and mere speculation by CBOE's staff (or the Board) cannot overcome that fatal flaw.

B. CBOE Fails To Articulate Why The Traders Are Subject To Margin Requirements.

CBOE acknowledges that whether the traders are subject to its margin rules involves the same question as the charge under the CIP Rule—whether the traders are "customers" with "accounts" at ETC. (Resp. 29.) But CBOE cannot articulate how the traders here fall within the definitions of those terms in the applicable margin rules, or why doing so would even make sense.

For example, CBOE points to the BCC's findings that the customers were engaged in day trading, as if that could somehow make the traders subject to the CBOE's margin rules. (Resp. 29-32.) CBOE makes no effort to explain why a

trader for an entity customer—whether that customer is a trading firm like those at issue here or a mutual fund or a hedge fund—should be subject to the margin rules merely because of the trading strategy adopted by the customer. Whether the customer engages in day trading or any other type of trading does not change the analysis of whether its traders are also "customers" with "accounts."

CBOE homes in on the BCC's finding that the "relatively small amount of capital" deposited at ETC by these entity customers raised a "red flag" about whether the traders were really separate customers of ETC. (Resp. 30.) But the opposite is actually true. A small deposit by an entity customer with several traders shows that the individual traders are not contributing their own capital and are not trading their own funds. In fact, the ETC customer interviewed by CBOE's examination staff (Vantage Point) confirmed that its individual traders exclusively trade that entity's proprietary capital. (Tr. 75:11-14 (Miller-Brouwer)) In this way, the traders are similar to mutual or hedge fund traders, to whom the margin rules clearly do not apply, and do not raise a red flag. The decisions below provided no rationale for disregarding this objective evidence that the CBOE obtained directly from ETC's customer.

The only effort the CBOE makes to reference the actual rules and their definitions is to claim that the traders fit within the Regulation T definition of "customer" because, "under the unique facts of this case," ETC "was extending a

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form of credit" to them. (Resp. 31 (emphasis added).) In CBOE's view, because ETC's *customer* received credit, the traders received some "form of credit" too. But that view, if adopted by the Commission, would extend the margin requirements to every trader for every entity customer because there is nothing "unique" about the facts of this case from a margin perspective.

Here, as with virtually every entity customer with a margin account, the entity customer received margin credit directly from the broker-dealer based on the equity that customer established, and then individuals made trades in that customer's account. Neither the customer's trading strategy nor its number of traders is determinative. CBOE's own expert acknowledged this reality when he agreed that a customer can have multiple traders who are not subject to the margin rules, just not "more than a moderate number of individual traders." (Tr. 1606:4-5 (Adams).) CBOE offers no persuasive argument to overcome this damaging admission and the hole it creates in CBOE's margin charge.[10]

C. CBOE's Response To Applicants' Fair Notice Argument Is Wholly Inadequate.

As an initial matter, CBOE accuses Applicants of waiving their argument that the findings on the CIP and margin charges violated fundamental standards of fair notice. Not so. Applicants made this argument to the Board, but the Board

[10] Although the BCC and the Board heavily relied on FINRA Regulatory Notice 10-18, CBOE makes no effort to defend that reliance in the face of Applicants' argument in their opening brief that the Regulatory Notice does not address margin requirements at all, and only applies to broker-dealers who maintain master/sub-account arrangements where the sub-accounts have different beneficial owners than the master account.

ignored it in affirming the BCC's Decision. *See* Petition by Electronic Transaction Clearing, Inc., Kevin Murphy and Harvey Cloyd for Review of March 4, 2014 Decision at 36-38, *In re ETC*, No. 11-0009 (BCC Apr. 7, 2014).

CBOE's attempt to avoid the argument is understandable, but unavailing. This case marks the first time that any regulator has applied the CIP and margin rules to individual traders who are not themselves customers of a broker-dealer. CBOE's only argument in support of its radical departure from the plain text of the applicable rules is that it should be "allowed discretion in determining the meaning of" its rules. (Resp. 33.) But as the Commission has observed, regulatory discretion is no license to deprive a regulated entity of due process and fair notice, as occurred here. *See In re Am. Funds Distribs. Inc.,* Exchange Act Release No. 64747, 2011 WL 2515376, at *5-6 (June 24, 2011).

IV. CBOE Makes No Meaningful Effort To Support The Remaining Charges.

CBOE expends little effort to justify the unwarranted rulings below that ETC failed to perform an independent annual AML test and failed to comply with Regulation SHO.

First, CBOE contends that ETC failed to ensure "that an independent individual conducted the AML Audit" in 2009. (Resp. 28-29.) But the record is clear that DiCenso, who performed the audit, *was* independent under FINRA's

AML independent AML testing rule. CBOE simply had a different rule at the time, but not one that removed DiCenso's independence under FINRA's rule.

Second, Applicants are not "blaming" CBOE for failing to catch this issue in the 2009 examination, as CBOE claims. Applicants have merely pointed out that a finding of liability is not warranted here because ETC complied with the FINRA AML testing rule, told CBOE at the time that it was doing so, and CBOE's 2009 examination staff did not object.

Third, CBOE's position on the Regulation SHO charge—that every broker-dealer must be sanctioned even where, on just one occasion out of millions of short sales, it is unable to borrow or purchase a stock that has been halted or suspended—is beyond draconian. The Commission should reject it in no uncertain terms and make clear that the enforcement provision of the rule was never intended to be applied so stubbornly.

V. Applicants' Procedural Fairness Arguments Are Hardly "Frivolous."

By relying almost exclusively on the testimony of its own examiners, CBOE only further exposes the flaws in its disciplinary process and the evidentiary rulings below. While focusing on CBOE's rules as adopted and approved by the Commission, CBOE does little to justify the manner in which those rules are implemented and applied by the BCC and its Enforcement staff.

In this case, CBOE applied those rules to allow it to rely extensively on examiner testimony about interviews with Applicants and their customers, but to withhold notes of those interviews from Applicants. With no procedure for summary disposition, CBOE forced Applicants to defend against charges that had no merit whatsoever, which CBOE presented no evidence at the Hearing to support, and which even the CBOE's staff agreed at the Hearing should be dismissed.

It is no answer to say, as CBOE does in its response, that the BCC has "discretion" in evidentiary rulings, or that the Wells process provides the same safeguards as summary disposition. (Resp. 35-38.) The discretion to make evidentiary rulings does not give the BCC license to deprive Applicants of evidence that could discredit the otherwise uncorroborated testimony of CBOE's examiners on which the BCC so heavily relied. And a Wells submission does not have the safeguards provided by summary disposition after CBOE's Enforcement Department has presented (or in this case, failed to present) its case. Despite its efforts to justify a system that so heavily favors its own staff, CBOE fails to demonstrate that the system is a fair one.

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VI. CBOE Fails To Provide Support For The Oppressive, Punitive Sanctions Imposed On Applicants.

CBOE resorts to distorting the record in order to justify the sanctions imposed on Applicants. CBOE's own flawed arguments demonstrate that the BCC's sanctions must be set aside.

CBOE repeatedly asserts that Applicants are trying to "'escape liability'" and "justif[y]" their conduct in an effort to reduce the sanctions. (Resp. 39-40 (citation omitted).) Although there is ample evidence in the record demonstrating that Applicants should not have been found liable for anything, CBOE's response completely ignores the relevant issues from a sanctions perspective.

The CBOE imposed the sanctions below because, in part, it inaccurately believed Applicants were on notice from the CBOE and FINRA that their conduct was improper. (Appl. 34-36, 50-58.) CBOE does not rebut that the findings below were not accurate. Rather, CBOE's inapposite (and factually incorrect) arguments that Applicants did not modify their conduct after this case was filed or that their efforts to develop trade surveillance tools immediately after the issuance of CBOE's Regulatory Circular fell short of CBOE's expectations still offer no evidence of *prior* notice of wrongful conduct that could be considered an aggravating factor under a sanctions analysis.

Similarly, CBOE's attack on the *substance* of Lisa Roth's Independent Consultant Report (Resp. 40)—which CBOE itself demanded ETC obtain—fails to

answer Applicants' point, which is that the BCC and Board failed to consider as a mitigating fact a report that undermines the BCC's flawed conclusions, repeated in the Response, that Applicants "ignore[d] regulatory requirements" or "cut corners" in order to avoid applicable regulations. (*Id.* at 41.)

Also unavailing is CBOE's attempt to justify the oppressive and excessive sanctions by claiming that the $1 million fine, representing a substantial portion of ETC's total net capital, can be paid by Murphy and Cloyd, who were found to have committed far fewer violations than ETC. (Resp. 42.) If anything, that argument only highlights how unfair the sanctions are. The $1 million fine does not become less oppressive because it can be paid by two individuals who are not liable for the vast majority of the charges. CBOE also fails to point to any authority allowing for joint and several fines. Its only claim is that it should be given unlimited discretion to fashion its own remedies—an argument that ignores both the prohibition on excessive fines and the Commission's important role in overseeing CBOE's disciplinary process.

Finally, CBOE fails to justify the fundamental unfairness in suspending Cloyd and Murphy simultaneously for six months. As stated above, CBOE's assertion, based on the dubious and uncorroborated testimony of CBOE's examiners, that Cloyd and Murphy established a "lax culture of compliance" and

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need to be reminded of their regulatory responsibilities rings hollow when compared to the actual record.

* * *

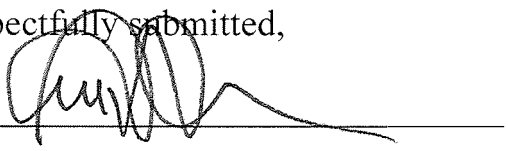
When the Commission undertakes the "full and independent review" of the real facts of this case, and applies those facts to the relevant rules and regulations, only one result is possible—a wholesale rejection of the CBOE's illogical conclusions, improper interpretations of the law, and oppressive sanctions determination.

CONCLUSION

For the foregoing reasons and others in the opening brief, the Board Decision should be set aside.

Dated: March 2, 2015

Respectfully submitted,

By: 

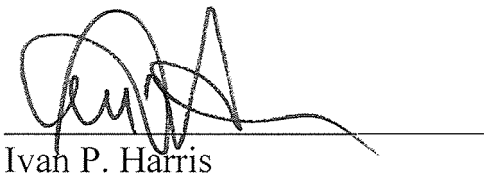
Ivan P. Harris
Allyson N. Ho
Megan R. Braden
Morgan, Lewis & Bockius LLP

Counsel for Applicants Electronic Transaction Clearing, Inc., Kevin Murphy, and Harvey C. Cloyd, Jr.

CERTIFICATE OF COMPLIANCE WITH RULE 450(D)

I, Ivan P. Harris, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 450(d), as it contains 6,945 words, excluding the parts of the brief exempted by the Rule. 17 C.F.R. § 201.450(d).

Dated: March 2, 2015



Ivan P. Harris