HARD COPY

BEFORE THE SECURITIES AND EXCHANGE COMMISSION

RECEIVED
MAY 27 2015
OFFICE OF THE SECRETARY

In the Matter of the Application of LEK SECURITIES CORPORATION, For Review of Action Taken by NYSE Regulation	)	Admin. Proc. File No. 3-16424

LEK SECURITIES CORPORATION'S APPELLATE BRIEF

STEPTOE & JOHNSON LLP
Kevin J. Harnisch
David M. Crane
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 429-6442

Counsel for Lek Securities Corporation

May 22, 2015

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

AGENCY PROCEEDINGS

STATUTES

CODE OF FEDERAL REGULATIONS

BOOKS AND ARTICLES

INTERNET

OTHER AUTHORITIES

I. Introduction

Lek Securities Corp. ("LSC") provides trade execution and clearing services to its customers, and reasonably supervises its customers' trading. Primarily at issue in this case are trades that Dimension Securities ("Dimension"), a SEC-registered broker-dealer at the time, routed to LSC on behalf of Dimension's customers.[1]

LSC appeals the decisions of the Hearing Board and NYSE Regulation Board of Directors (collectively the "Decisions") imposing a punitive $575,000 fine for not having reasonable systems concerning: (i) Blue Line trading; (ii) odd-lot day trading; (iii) the Commission's emergency orders temporarily prohibiting certain short sales; (iv) not closing out certain failures to deliver; and (v) not having specific automated exception reports related to certain types of potentially manipulative trades.[2] Despite a multi-year investigation, the Department of Market Regulation ("Department") did not allege that a single manipulative trade was executed through LSC's systems.

The Decisions' findings are contrary to governing law, contrary to relevant industry standards and practices, ignore the unprecedented circumstances under which some of the relevant temporary rules were implemented, and in many instances suffer from a complete absence of any affirmative evidence to support the allegations. In addition, by refusing to permit the use of well-credentialed experts who could describe the relevant industry practices at the time and thereby place critical context around the trading activity at issue, LSC was prevented from presenting a reasonable defense. Accordingly, the Decisions must be reversed.

---

1 Neither the Commission nor any self-regulatory organization has filed any charges against Dimension or its customers related to the trading activity at issue.

2 LSC is not appealing the portion of the Hearing Board decision censuring LSC for violating Exchange Rule 123C regarding the cancelation of market-on-close and limit-on-close orders.

II. Standard of Review

When a broker-dealer appeals the disciplinary findings of a self-regulatory organization ("SRO") to the Commission, the Commission conducts an independent review of the record.[3] The Commission must overturn the decision if a preponderance of the evidence does not support the SRO's findings and also that the SRO applied its rules in accordance with the purposes of the Exchange Act.[4] Even if the Commission affirms the factual findings of the SRO, it may reduce or cancel the sanctions imposed by the SRO.[5]

III. Rule 70.40 did not Require LSC to Ignore Its Best Execution Obligations

LSC had been approved since 1996 to route orders away from the New York Stock Exchange ("Exchange") in order to obtain better executions for its customers. The Department contended, however, that upon issuance of Rule 70.40 in June 2007, LSC should have ceased routing orders from its floor both to market centers with better prices unless and until the Exchange gave LSC explicit and, necessarily redundant, permission to resume obtaining the best execution of its customers' orders. That position makes no sense, yet the Decisions fined LSC $100,000. The Decision should be reversed.

In 2005, the Commission adopted Regulation NMS which required broker-dealers to route customer orders to the market centers displaying the best price.[6] Unlike many of its competitors, LSC was already a member of the Exchange, the NASD, and other market centers, and thus had long been routing orders to market centers displaying the best prices for its

---

3 *In re Lane & Lane*, 2015 WL 627346, at *5 (SEC Decision, Feb. 13, 2015); *In re Cespedes*, 2009 WL 367026, at *6 (SEC Decision, Feb. 13, 2009).

4 *In re Lane & Lane*, 2015 WL 627346, at *5; *In re Cespedes*, 2009 WL 367026, at *6 & n. 11.

5 15 U.S.C. § 78s(e)(2).

6 Exchange Act Release No. 34-51808 (June 9, 2005), *available at* https://www.sec.gov/rules/final/34-51808.pdf. The Commission promulgated Regulation NMS to address the Congressional mandate that "[i]nvestors must be assured that they are participants in a system which maximizes the opportunities for the most willing seller to meet the most willing buyer." Exchange Act Release No. 34-51808 at 14 (internal citation omitted).

customers' orders. In order to expedite the process for Exchange member firms to become NASD members, which became a practical necessity due to Regulation NMS, the Exchange amended Rule 70 by adding supplemental section .40. That section set forth certain requirements for members to route orders from their floor booths to other markets, including having written procedures covering a variety of issues.[7]

In an effort to explain Rule 70.40, the Exchange issued Information Memo ("IM") 07-77.[8] IM 07-77 had specific sections that pertained to existing NASD member firms (like LSC) and non-NASD member firms. IM 07-77 explained that Exchange members who were also NASD members ("Dual Members") "*already meet[] the requirements* to conduct all trading activity business from its booth premises that it could conduct from an upstairs office, *subject to the requirements* described in this Information Memo."[9]

The Decisions incorrectly concluded that "subject to the requirements" meant that Dual Members were not permitted to route orders from the Exchange floor to other exchanges offering better prices unless and until the Exchange explicitly approved the firm's written procedures.[10] That interpretation ignores the preceding language in that same sentence, namely how a Dual Member "already meets the requirements" to conduct upstairs trading activity from its floor booth.

The proper analysis of Rule 70.40 and IM 07-77 must harmonize: (1) the Exchange's recognition that Dual Members already satisfied the requirements for routing orders to other market centers; (2) best execution obligations; and (3) whether Rule 70.40 imposed new

---

7 Rule 70.40(6) sets forth the necessary contents of the written procedures.

8 JX-98, NYSE Information Memo 07-77 (July 30, 2007) (FINRA011731).

9 *Id.* at FINRA011734-35 (emphasis added).

10 Hearing Board Decision at 71 (FINRA013728).

obligations on Dual Members.[11] That analysis compels the conclusion that Dual Members, like LSC, could continue routing orders to other market centers to obtain the best executions for their customers as long as they segregated their written supervisory procedures ("WSPs") concerning floor operations into a separate document that they provided to the Exchange and maintained them in that manner going forward.

The undisputed purpose of Rule 70.40 was to increase, not decrease, the ability to route orders to other markets from the floor.[12] Thus, construing Rule 70.40 to eliminate that pre-existing ability for Dual Members for an unspecified and unknowable time period contradicts the uncontroverted goal to broaden competition for orders between market centers. With execution speed being a critical component of a broker-dealer's best execution obligations, interpreting Rule 70.40 to require Dual Members to start a new practice of routing orders from the floor to the upstairs operation for further routing illogically and unnecessarily impedes compliance with those members' overarching best execution obligations.[13]

Similarly, the Department's argument ignores the reality that Dual Members like LSC had previously been required to have WSPs that addressed the entirety of their operations, including their floor operations and routing of orders to other market centers. Indeed, the Department's primary witness on the Blue Line issue acknowledged that LSC had such supervisory procedures in place at the time, and contemporaneous emails from LSC to the

---

11 *See, e.g., Duncan v. Walker,* 533 U.S. 167, 174 (2001) ("[A] statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant" (citation and internal quotation marks omitted)); *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) ("A court must . . . interpret the statute as a symmetrical and coherent regulatory scheme, and fit, if possible, all parts into an harmonious whole." (citations and internal quotation marks omitted)).

12 The SRO's statement of purpose accompanying this rule observed that "the Exchange seeks to provide its Floor broker member organizations with the ability to access other markets and trade a wider range of products…." Exchange Act Release No. 34-55908 (June 14, 2007).

13 In fulfilling their best execution obligations, the Commission requires broker-dealers to consider "the opportunity to get a better price than what is currently quoted, the speed of execution, and the likelihood that the trade will be executed." Best Execution, *available at* http://www.sec.gov/answers/bestex.htm.

Exchange staff confirmed that LSC's WSPs already encompassed the specific procedures referenced in Rule 70.40 and IM 07-77.[14]

The findings also ignore IM 07-77's distinction between the requirements for Dual Members and the additional requirements for non-Dual Members. If Dual Members could not route orders from the Exchange floor to other markets until the Exchange had approved their WSPs, there would not have been any need to have a separate section in IM 07-77 for Dual Members. This would render an entire section of IM 07-77 superfluous. Interpreting IM 07-77 in that manner is therefore illogical and incorrect.[15]

IM 07-77's statement that Dual Members are "subject to" the requirements of Rule 70.40 can logically be construed to properly give effect to the rule, without impeding a Dual Member from satisfying its overarching best execution obligations, by requiring Dual Members to separate their floor-related procedures from their general WSPs, provide their floor procedures to the Exchange, and then maintain them separately going forward.[16] Dual Members were not being required to establish new controls for new operations because the process for routing orders to other market centers offering better executions had already been approved and, indeed, was required for Dual Members. There was simply no reason for Dual Members to refrain from fulfilling their best execution obligations while awaiting redundant approval of pre-existing procedures.[17]

---

[14] Hearing Tr. at 534 (D. DeGregorio) (FINRA004444); JX-78 (FINRA011451-52); JX-79 (FINRA011453-56). Mr. Lek also confirmed that the WSPs included what was required by Rule 70.40 and IM 07-77. Hearing Tr. at 1942-1944 (S. Lek) (FINRA005855-57).

[15] *See Duncan,* 533 U.S. at 174 (cautioning against a statutory interpretation that would make part of the statute superfluous).

[16] Upon providing the Exchange with the portions of its WSPs related to floor operations, the Exchange complained that they were too detailed. LSC submitted revised procedures and the Exchange has not provided any further comments. JX-87 (FINRA011579).

[17] The alternative promoted by the Department and endorsed by the Hearing Board effectively permits the Exchange to hold Dual Members hostage without any accountability. For example, LSC's Blue Line application has

Construing Rule 70.40 as preventing a Dual Member from routing an order to another market center without Exchange permission would directly conflict with other prior Commission mandates explicitly prohibiting all market centers, including the Exchange, from interfering with members' ability to execute transactions elsewhere.[18] "No rule, stated policy or practice of this exchange shall prohibit or condition, or be construed to prohibit, condition or otherwise limit, directly or indirectly, the ability of any member to effect any transaction otherwise than on this exchange…."[19] The Department's position would also constitute an illegal restraint on trade and therefore is not enforceable.[20]

LSC's interpretation is the logical approach that preserves and promotes competition among market centers, ensures the best execution of customer orders, and properly gives effect to all portions of Rule 70.40 and IM 07-77. Accordingly, the Decision should be reversed.[21]

IV. The Purported Prohibition on Odd-Lot Day Trading did not Comply With Statutorily-Mandated Procedural Requirements

Despite the fact that nothing in the Exchange's rule book has ever prohibited day trading in odd-lots, the Hearing Board sanctioned LSC $50,000 because some customers placed such orders through LSC. The alleged prohibition stems from IM 94-14, which the Exchange issued in 1994 and subsequently rescinded in 2010. Not only did the Exchange never place the substance of IM 94-14 anywhere in its rulebook, but Amendment 2 of the proposed rule that

---

been pending at the Exchange since 2009. Despite repeated requests for updates, *see* JX-84-87 (FINRA011481-011579), JX 90-91 (FINRA011603-605), JX 94 (FINRA011681), JX 97 (FINRA011729), the Exchange has been non-responsive, which ultimately forced LSC to shut down its floor business because without Blue Line approval, that business could not be competitive. Hearing Tr. at 1940-1951 (S. Lek) (FINRA005853-64).

18 *See, e.g.*, 17 C.F.R. §§ 240.19c-1 and 240.19c-3.

19 *Id.* at § 240.19c-3(a).

20 *See, e.g.*, *Silver v. New York Stock Exchange*, 373 U.S. 341, 364 (1963).

21 The Department made its real concern clear in its pre-hearing brief – that volume was routed away from the Exchange. FINRA003385. The Exchange should be more concerned with construing the relevant rules in a logical manner that also happens to enhance competition and result in best execution of customer orders.

actually defined what constituted prohibited day trading was never published for comment.[22] Consequently, that "rule" is unenforceable.

A. The Exchange Cannot Sanction LSC for Violating Something that was Never in the Exchange's Rulebook

Sanctioning LSC based on a "rule" that for unexplained reasons the Exchange never bothered to incorporate into its rulebook violates basic notions of fundamental fairness. An SRO's rulebook is supposed to aggregate in a single location the rules by which its members are bound. Publishing a rulebook that omits certain rules necessarily causes confusion and uncertainty about what practices are prohibited. The rulebook is the resource that member firms use in the first instance for assessing whether certain activities are prohibited. If nothing in the rulebook addresses a trading practice, that should be the end of the issue.

B. The Portion of IM 94-14 Defining Odd-Lot Day Trading Needed to be Published for Public Comment

Section 19(b) of the Securities Exchange Act of 1934 governs the rulemaking process for SROs, including the Exchange. Before a rule can become effective, and thereby enforceable, the SRO must propose it to the Commission, have a public comment period, and have the Commission vote on whether to approve or modify the rule in light of the public comments.[23] Exceptions to the notice and comment requirements must be narrowly construed.[24] Substantive

---

[22] *See* Exchange Act Release No. 34-33678 (Feb. 24, 1994); 59 Fed. Reg. 10,192, 10,192 n.4 (Mar. 3, 1994) ("Amendment No. 2, in addition to other clarifying amendments, defined the term 'day trading' as used in the Information Memo to describe prohibited odd-lot limit order activity.") Amendment No. 2 was not published for comment prior to enactment. 59 Fed. Reg. at 10,193.

[23] *Fiero v. FINRA*, 660 F.3d 569, 578 (2d Cir. 2011) ("However, for FINRA to have obtained authority under the 1990 Rule Change to enforce the collection of its disciplinary fines through judicial proceedings, the rule must have been properly promulgated under the procedures established by the Exchange Act. It was not."); *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994) (NASD rule interpretation not enforceable because it did not comply with procedural requirements of the Exchange Act).

[24] *American Hosp. Ass'n v. Bowen*, 834 F.2d 1037, 1044 (D.C. Cir. 1987) ("Congress intended the exceptions to § 553's [of the Administrative Procedures Act] notice and comment requirements to be narrow ones."). Section 19(b) of the Exchange Act is modeled after § 553 of the Administrative Procedures Act. *Fiero*, 660 F.3d at 578 n.11.

rules, which create new rights, duties, or obligations, must go through the formal rulemaking process in order to be enforceable.[25]

Despite these requirements, when the Exchange proposed Amendment 2 to the proposal for IM 94-14, which is the amendment that defined what constituted odd-lot day trading, the Exchange did not publish that amendment for public comment. The rationale was that the amendment was merely technical in nature and comments had not been received on the initial proposal and the first amendment.[26] That logic was flawed. There is no exception based on the volume of comments received in response to prior related proposals. Nor was the amendment, which defined the conduct that would be prohibited, merely technical. Indeed, courts have held that agency changes to definitions of terms require a public comment period.[27]

The importance of providing the opportunity for public comments on proposed rule changes was demonstrated when the Exchange filed proposed changes to its odd-lot rules in 2008 and 2009 and finally permitted the public to comment on the totality of the odd-lot rule regime.[28] For example, the NASDAQ OMX wrote:

> [T]he NYSE's odd-lot system is anachronistic and anti-competitive, improperly discriminates against small orders, and operates in a manner that consistently places the desires of the NYSE and its specialists above those of the investing public. . . . Only in the strange world of NYSE odd-lots is expanding bad trading results for more investors justified in the name of consistency.[29]

---

25 *Fiero*, 660 F.3d at 578; *American Hosp.* at 1045; *White v. Shalala*, 7 F.3d 296, 303 (2d Cir. 1993).

26 *See* Exchange Act Release No. 34-33678 (Feb. 24, 1994); 59 Fed. Reg. 10,192, 10,193.

27 *See Michigan v. EPA*, 213 F.3d 663, 692-93 (D.C. Cir. 2000) (rulemaking that redefined a term required notice and comment period); *see also Levesque v. Block*, 723 F.2d 175, 184-85 (1st Cir. 1983) (definitional change to "household" under food stamp regulations was not exempt from notice and comment for "good cause," as this exemption is narrowly construed).

28 Exchange Act Release No. 34-59613 (Mar. 20, 2009), *available at* https://www.sec.gov/rules/sro/nyse/2009/34-59613.pdf; Exchange Act Release No. 34-58979 (Nov. 19, 2008), *available at* http://www.sec.gov/rules/sro/nyse/2008/34-58979.pdf.

29 Letter from Joan C. Conley, NASDAQ OMX, to Elizabeth Murphy, U.S. Securities & Exchange Commission, dated April 17, 2009, *available at* http://www.sec.gov/comments/sr-nyse-2009-27/nyse200927-1.pdf.

In a separate letter, the NASDAQ OMX also wrote:

> Indeed, the written standards contained in existing and proposed NYSE odd-lot guidance are rife with amorphous terms and obligations that, when combined, seem to equate impermissible odd-lot activity with anything that the exclusive odd-lot specialist doesn't like. . . . Further, the NYSE's odd-lot standards appear to directly contradict other regulatory obligations.[30]

Once the public was finally permitted to provide comments on the entirety of IM 94-14, including what was contained in Amendment 2, the Exchange changed its mind, abolished the entire odd-lot system, and rescinded IM 94-14.[31] This further counsels in favor of reversing the Decision.[32] In addition, imposing a fine here serves no remedial purpose.

V. LSC Reasonably Designed Its Systems to Comply with the Commission's Emergency Orders Regarding Short Sales

The Hearing Board fined LSC $75,000 for executing 2,822 short sale orders that the Department contended violated the Commission's September 18, 2008 emergency order ("Emergency Order"). The Emergency Order, which the Commission issued during the height of the financial crisis and amid general fear about the prospect of failing financial institutions, banned short sales of 799 financial institutions until October 2, 2008.[33] Over the next couple of

(Although this document and the other comment letters were not admitted into evidence, the Hearing Officer made clear that they may be used in briefing. Hearing Tr. at 1868-1872 (FINRA 005781-005785)).

[30] Letter from Joan C. Conley, NASDAQ OMX, to Elizabeth Murphy, U.S. Securities & Exchange Commission, dated December 17, 2008, *available at* http://www.sec.gov/comments/sr-nyse-2008-116/nyse2008116-1.pdf.

[31] RX-103, NYSE Information Memo 10-35 (July 30, 2010) (FINRA009451); RX-102, Exchange Act Release No. 34-62578 (July 27, 2010) (FINRA009445).

[32] The Hearing Board also noted that, even if there was no rule prohibiting odd-lot day trading (which there was not), LSC's alleged violation of the policy prohibiting such activity constituted unethical conduct, in violation of NYSE Rules 476(a) and 401. Hearing Board Decision at 42 (FINRA013699). That amounts to a backdoor way of enforcing an unenforceable rule. If that were permitted, there would be no need for SROs to go through the rulemaking process. The Hearing Board's reasoning cannot stand.

[33] CX-129, Exchange Act Release No. 34-58592 (Sept. 18, 2008) (FINRA008537).

weeks, additional issuers were added to the Emergency Order.[34] On October 2, 2008, the Commission extended the Emergency Order until October 8, 2008.[35]

Modifying LSC's systems to prevent short sales in the specified stocks between the issuance of the Emergency Order on the night of September 18th and its effectiveness the following morning was extraordinarily difficult, as firms were dealing with an unprecedented situation.[36] The most efficient way for LSC to overhaul its system in the few hours available was to leverage off of its Reg SHO compliance controls, which rejected short sales in threshold securities unless they could be located through LSC's stock loan desk.[37] LSC added the issuers from the Emergency Order to its threshold securities list because LSC's stock loan desk would not give a locate, thereby ensuring rejection of the orders. That process worked.

Instead, the orders at issue arose because: (i) a third-party improperly provided locates to Dimension; (ii) the Department incorrectly included in the Complaint short sales for recognized options market makers that were explicitly outside the scope of the Emergency Order; (iii) there were unavoidable lags in updating LSC's systems when the Emergency Order was amended intraday with immediate effectiveness; and (iv) an inadvertent programming error did not account for the three-business day extension of the Emergency Order. The Decisions should be reversed because, under the extraordinary circumstances involved, LSC constructed a reasonable system to comply with the Emergency Order.

---

34 RX-20 – RX 26 (FINRA0090011-61), RX 28 (FINRA009069).

35 Exchange Act Release No. 34-58723 (Oct. 2, 2008), *available at* https://www.sec.gov/rules/other/2008/34-58723.pdf.

36 The Commission posted the Emergency Order on its website at 1:42 a.m. on September 19th. *Blue Point Sec., Inc.*, Decision 11-NYSE-7, 2011 WL 11070702, at *2 (Sept. 27, 2011).

37 LSC viewed securities published by various SROs that meet certain fail to deliver thresholds as threshold securities. Hearing Tr. at 958 (S. Lek) (FINRA004868). When a short sale would come to LSC in a threshold security, it would be routed to the Stock Loan desk. *Id.* at 956-57 (FINRA004866-67).

A. It was Reasonable Under the Circumstances to not Construct a Separate System for Dimension

Unlike LSC's other customers at the time, Dimension (which was an introducing broker) did not utilize LSC's stock loan desk because it had a pre-borrow arrangement with a third party, LocateStock.com, to provide the borrows for its customers' short sales. Dimension had reaffirmed that arrangement to LSC as recently as September 16, 2008, two days prior to the Emergency Order.[38]

Contrary to the Department's arguments, LSC did not establish a system to comply with the Emergency Order and then specifically remove Dimension from that process. After issuance of the Emergency Order, LSC reached the reasonable conclusion that there was not a realistic chance of Dimension obtaining locates on any stocks subject to the Emergency Order. Although LSC's judgment turned out to be incorrect in a relatively small number of cases, that does not mean it was unreasonable under the circumstances where LSC handled more than 10 million orders in this time period.[39]

To address the Emergency Order by the market open on September 19th, LSC needed to leverage off of its existing short sale systems, specifically the locate process for threshold securities, which did not apply to Dimension in light of its locate agreement with a third party. Routing all of Dimension's short sales to LSC's stock loan desk would have incorrectly resulted in duplicative borrows for stocks not subject to the Emergency Order.

In addition to the limited time available, LSC's judgment was further informed by the fact that it took a similar approach with Dimension, without incident, when reconstituting its

---

38 RX-17 (FINRA008999 – 009001).

39 *See In re Logay*, 2000 WL 95098, at *21 (SEC Decision, Jan. 28, 2000) (evaluating the reasonableness of supervision based on the attendant circumstances but not knowledge of wrongdoing gleaned with hindsight).

systems to comply with emergency orders the Commission issued two months earlier that prohibited naked short sales in certain financial stocks.[40]

In light of the significant time constraints, limited resources, the fact that no third party could properly provide a locate for stocks subject to the Emergency Order, and the prior successful compliance with the July 2008 emergency orders, LSC made a reasonable decision. LSC should not be sanctioned for constructing a complicated program from scratch, with no time for testing, to address what should have been a non-existent risk.

B. Options Market Makers were not Subject to the Emergency Order

The Emergency Order did not apply to short sales by options market makers related to their market making activities.[41] The Decisions, however, ignored that aspect of the Emergency Order and sanctioned LSC for short sale orders by three options market makers – Optiver US, Diamond Carter Trading and Group One.[42] As Mr. Lek testified, non-self-clearing options market makers can book trades in two types of accounts: (1) market maker accounts; or (2) (off floor) customer accounts.[43] Mr. Lek further explained that options market makers are required to book hedging transactions, such as short sales, related to their market making activities into their

---

[40] Exchange Act Release No. 34-58190 (July 18, 2008), *available at* https://www.sec.gov/rules/other/2008/34-58190.pdf; Exchange Act Release No. 34-58166 (July 15, 2008), *available at* https://www.sec.gov/rules/other/2008/34-58166.pdf.

[41] The Emergency Order provided that "to facilitate the expiration of options on September 20th, options market makers are excepted from the requirements of this Order until 11:59 p.m. on September 19th when selling short as part of bona fide market making and hedging activities related directly to bona fide market making in derivatives on the publicly traded securities of any Included Financial Firm." On September 21st (a Sunday), the Commission amended the Emergency Order to extend the exception for options market makers for the duration of the Emergency Order. CX-130, Exchange Act Release No. 34-58611, at 3 (Sept. 21, 2008) (FINRA008563) (" We are amending the exception so that it continues for the duration of the Order.").

[42] *See* letter from Bastiaan van Kempen and Steven Schwab, Optiver, to Nancy Morris, U.S. Securities & Exchange Commission, dated April 24, 2007, describing Optiver as a registered options market maker, *available at* https://www.sec.gov/comments/s7-12-06/s71206-894.pdf; Group One website describing itself as a leading specialist and market maker in exchange listed derivatives, *available at* http://www.group1.com/Trading.aspx; *see also* http://www.linkedin.com/pub/william-mcbride/18/310/679, which is a LinkedIn profile of former options market maker at Diamond Carter Trading.

[43] *See* FINRA005969-70.

market maker accounts, and their account numbers include Options Clearing Corp. acronyms provided only to market makers.[44] Mr. Lek also testified that he had known these options market makers "for years."[45] Mr. Lek provided uncontroverted testimony that the accounts for the three options market makers were market maker accounts and that they used their OCC acronyms.[46] Therefore, by definition, their trading was related to their market making activities. Although LSC advised the Department during the investigation that the orders in question were for the market maker accounts of three options market makers and were therefore permitted by the Emergency Order, the Department acknowledged that it did not follow up on that point.[47] These trades never should have been included in the Complaint.

Although the Decisions try to absolve the Department of its mistake by claiming that the point about the Emergency Order not applying to options market makers is an affirmative defense, LSC met any arguable burden that it had. As described above, Mr. Lek provided uncontroverted testimony that the orders in question were placed pursuant to market making activities and booked into their market making accounts. Moreover, he was personally familiar with these customers as options market makers. That testimony is confirmed by information in the public domain.[48] This is more than sufficient to meet any supposed burden of proof that LSC had on this issue.[49] The Department provided no rebuttal evidence, and the Hearing Board Decision did not question Mr. Lek's credibility on this point. Instead, the Hearing Board

44 Hearing Tr. at 2057 (S. Lek) (FINRA005970).

45 Hearing Tr. at 2056 (S. Lek) (FINRA005969).

46 Hearing Tr. at 2057 (S. Lek) (FINRA005970).

47 Hearing Tr. at 188-189, 192 (P. Brown) (FINRA004098-99, 004102); JX-20 (FINRA009757); JX-23 (FINRA009795).

48 *See, e.g.*, the information cited in Footnote 42 above.

49 *See United States v. Taylor*, 728 F.2d 930, 933 (7th Cir. 1984) (uncontroverted testimony alone was sufficient to meet the beyond a reasonable doubt standard).

Decision merely cited the absence of other evidence that could have been offered,[50] but offering such additional evidence was not necessary in the absence of any contradictory information from the Department.

C. An Inadvertent Programming Error Stopped the Program Three Business Days Too Soon

An inadvertent programming error resulted in improper short sale executions after the extension of the Emergency Order. When LSC amended its systems to comply with the Emergency Order, it programmed those changes to cease running on the expiration date listed in the Emergency Order. When the Commission amended the Emergency Order to continue from October 2nd until October 8th (three business days), LSC did not realize that one of its programmers had previously hard-coded the October 2nd termination date into the program instead of having the program run until somebody affirmatively stopped it. That should not have happened.

A programming oversight, however, does not render unreasonable LSC's efforts to expedite changes to its trading systems to comply with the Emergency Order, working through the night and early morning hours under unprecedented circumstances. Such exigent circumstances are mitigating factors that should be considered.[51] As those circumstance are unlikely to recur, mitigation counsels against imposing a monetary fine.

D. There was a Brief and Unavoidable Time Lag in Updating LSC's Systems After SROs Published Amendments to the List of Covered Stocks

Between September 19, 2008 and October 2, 2008 (when the Emergency Order was extended), LSC prevented all but five short sales in relevant stocks (excluding short sales by

---

50 Hearing Board Decision at 50 (FINRA013707).

51 *In re Edward Becker*, SEC Release No. 252, 2004 WL 1238256, at *10 n.8 (June 3, 2004) ("Mitigation focuses on the facts and circumstances surrounding the underlying misconduct, and the evidence should show that the wrongdoing at issue arose from some type of exigent circumstances that are unlikely to be repeated in the future."); *In re First Fin. Trading, Inc. et al.*, CFTC No. 00-35, 2002 WL 1453795, at *9 n.110 (July 8, 2002).

Dimension's customers and options market makers).[52] After the Emergency Order became effective, the Commission permitted SROs to expand the list of covered stocks. As a result, SROs began adding companies to the list during the trading day, effective immediately. Although LSC checked the SROs' websites multiple times per day, there were unavoidable time delays between the posting of the new information, a broker-dealer learning of the new information, and a broker-dealer being able to incorporate those new names to its system. Recognizing this difficulty, the SROs ultimately began adding names only once per day, effective the following day. For each of the five orders at issue between September 19th and October 2nd, those stocks were added to the Emergency Order the same day as the violating trades, an understandable occurrence given the inherent delay that was necessarily involved.[53]

There is no practical basis for sanctioning LSC under these circumstances, yet the Decisions failed to address this issue.

VI. The Reg SHO Violations are Premised Upon Incomplete Information and Ignore Operational Realities and Relevant Commission Guidance

The Hearing Board fined LSC $50,000 for violating Reg SHO by failing to timely close out failures to deliver ("Fails") for transactions in fourteen issuers. As a result of that finding, the Hearing Board further found "penalty box" and related customer notification violations of Reg SHO that were derivative of the close-out violations.[54] These findings should be reversed because: (i) LSC should have received pre-fail credits for customer purchases; (ii) customer should not penalized for a lender's Fail; and (iii) industry practice, which was subsequently confirmed in Rule 204, was to apply a T+35 close out period for "deemed to own" securities.

---

52 LSC's Pre-Hearing Brief, at 25-26 (FINRA003213-14).

53 *Id.*

54 Hearing Board Decision at 21 (FINRA013678). Parties are restricted from effecting additional short sales in stocks for which it has an open Fail (when it is in the "penalty box"). Parties must also timely notify their broker-dealer customers of open Fails.

A. LSC Should Have Received Pre-Fail Credit for Customer Purchases

The Decisions erred by not giving LSC pre-fail credit for its customers' purchases of three of the stocks at issue.[55] There is no dispute that LSC's customers made offsetting purchases in those same securities prior to the alleged close out dates, thereby leaving LSC *without* a net short position with CNS.[56] Nevertheless, the Hearing Board found that LSC violated Reg SHO because those purchases were not for LSC's proprietary account.[57]

The Hearing Board's reasoning conflicts with the Commission's guidance, which emphasizes that the key to whether a broker-dealer has a close-out obligation is whether or not the broker-dealer's books and records show a net short position.[58] The initial determination of whether a broker-dealer has a close-out obligation is based on that broker-dealer's net position at CNS.[59]

Disregarding the broker-dealer's new net position at CNS in a security on the close-out date would lead to illogical and impractical results. For example, if a broker-dealer is required to purchase securities after the Fail but prior to the close-out date, despite the fact that the customer has already purchased those same securities, to whom does the broker-dealer allocate those securities and the corresponding costs?[60] There is no reasonable answer to that question.

FINRA and the CBOE realized the absurdity of not giving broker-dealers pre-fail credit for customer purchases and obtained no-action confirmation from the Commission on this issue

---

[55] The three stocks were VWO, SPG and SSW. Hearing Board Decision, at 61-62 (FINRA 013718-19).

[56] CNS is the Continuous Net Settlement system. CNS settles trades for exchanges, markets, and other sources and nets the transactions to one security position per member per day.

[57] *Id.* at 64 (FINRA013721).

[58] RX-39, Exchange Act Release No. 34-60388, at 22 (July 27, 2009) (FINRA009228) (no close-out obligation if the broker-dealer "has a net flat or net long position on its books and records on the applicable close out date . . . .").

[59] Hearing Tr. at 1464, 1510 (N. Louis) (FINRA005376, 005422); *id.* at 2123-2124 (S. Lek) (FINRA006036-37).

[60] Hearing Tr. at 1464-1466 (N. Louis) (FINRA005376-78); *id.* at 2115-2122 (S. Lek) (FINRA006028-35).

("No-Action Letter").[61] FINRA and the CBOE explained, and the Commission agreed, that "[t]he calculation of qualifying net purchases would include the entirety of the bona fide trading activity of the Participant . . ., including proprietary trading *as well as trading effected by or on behalf of customers*, as reflected on the entirety of the Participant's . . . books and records (i.e., the trading ledger)[.]"[62] Thus, as confirmed in the No-Action Letter, determining a "Participant's" purchases for Reg SHO close-out purposes is not limited to proprietary transactions. This logical approach eliminates the anomalous results described above that necessarily flow from the Decisions.

The Hearing Board declined to apply the analysis of this No-Action Letter because it post-dated the trades at issue.[63] The No-Action Letter, however, is the Commission staff's interpretation of Reg SHO, not a change in the statute. There is no suggestion in the No-Action Letter that this interpretation was previously considered non-compliant with Reg SHO. It is absolutely proper to consider the No-Action Letter even though it was issued after the conduct because no-action letters do not change the existing law.[64]

LSC's position makes business sense, is consistent with prior Commission releases and has been verified by the No-Action Letter. Accordingly, the Decisions must be reversed.

B. Customers Should not be Punished for Lender Fails

Six of the stocks at issue were on the easy to borrow to list.[65] Consistent with Commission rules, although LSC was able to give the customers a "good" on those shorts

---

61 Request for No-Action Relief with Respect to Multi-day Pre-fail and Post-fail Credit under Rule 204 of Regulation SHO, *available at* http://www.sec.gov/divisions/marketreg/mr-noaction/2013/finra-cboe-c2-090613-201.pdf (FINRA013502-20).

62 *Id.* at FINRA 013507 (emphasis added).

63 Hearing Board Decision, at 51 n.303 (FINRA013708).

64 *SEC v. Lybrand*, 200 F. Supp. 2d 384, 397 (S.D.N.Y. 2002) ("Defendants incorrectly argue that since the SEC's no-action letters had not issued at the time they entered into their arrangements with Lybrand, the transactions were legal. The SEC's no-action letters do not change the substantive law . . . .").

without necessarily having a definitive arrangement in place with the lender,[66] the lender subsequently failed to deliver to LSC on the settlement date.[67] Thus, LSC was faced with the choice of punishing the customer by buying him in (for a problem he did not cause) or notifying the customer of the Fail, continuing to monitor the position, collecting additional margin if necessary, and working with the lender to resolve the situation.

While Reg SHO contains a multitude of requirements addressing customer Fails, it is silent on lender Fails. Consistent with its understanding of industry norms at the time, LSC made the reasonable decision not to punish customers for the failures of the lenders. The Commission should consider these circumstances when assessing whether this constitutes a violation and, if so, whether a fine is warranted under the circumstances.

C. Rule 204's Recognition of T+35 for Deemed to Own Securities Corrected an Oversight in Rule 204T and Affirmed the Operational Realities of how Industry Participants were Treating those Securities

Four of the stocks at issue qualified as being "deemed to own" and therefore had a 35-day close-out period, which LSC satisfied.[68] Rule 204T, which was a temporary rule in effect during the time of the trades, had a T+35 close-out period for Rule 144 stocks. The purpose of this extended close-out period was that such securities took longer to settle.[69] Although Rule 204T did not explicitly extend the T+35 period to other types of securities, it must be appreciated that the Commission adopted Rule 204T on October 14, 2008 as an interim final rule, without public

---

65 Those stocks were LEN, FRD, YAVY, CVO, MSJ, and MBI.

66 Broker-dealers may permit short sales of stocks on an easy to borrow list that is less than 24-hours old without actually having to contact the lender. Exchange Act Release No. 34-50103 (July 28, 2004), *available at* http://www.sec.gov/rules/final/34-50103.htm ("After considering the comments received, we believe that, absent countervailing factors, 'Easy to Borrow' lists may provide 'reasonable grounds' for a broker-dealer to believe that the security sold short is available for borrowing without directly contacting the source of the borrowed securities.").

67 Hearing Tr. at 2090 (S. Lek) (FINRA006003).

68 The stocks were HTM, GW, NG and AZ.

69 RX-29, Exchange Act Release No. 34-85773, at 34 (Oct. 14, 2008) (FINRA009128).

comment, in the midst of unprecedented market dislocation and chaos.[70] Less than one-year later, after the public finally had an opportunity to comment, the Commission amended the rule and adopted Rule 204, which included a T+35 close-out for all securities that a customer was deemed to own under Rule 200 of Reg SHO, including the four types of situations at issue here.[71]

Rule 200(b) of Reg SHO defines a person as being deemed to own a security if, among other things, the person: (1) has title to the security; (2) has purchased or entered into an unconditional contract to purchase it, but has not yet received it; or (3) owns a security that is convertible into or exchangeable for it and has tendered it for conversion or exchange. With respect to HTM, GW and NG, LSC's customers purchased the stock and then sold it prior to the delivery of those shares. Per Reg SHO, the customers were deemed to own those shares because they had previously and unconditionally purchased them and delivery was simply pending.[72] Thus, the Fails associated with those subsequent sales should have been subject to T+35 and the stocks were, indeed, delivered within that time.[73]

The trades for AZ were part of an international arbitrage strategy that was attempting to profit from price differences in stock in a foreign country and American Depository Receipts ("ADRs") that trade in the U.S. by simultaneously buying and selling those securities.[74] Messrs. Lek and Louis explained that the industry regards ADRs as a type of convertible security,

---

70 *Id.* at FINRA009095; Hearing Tr. at 2092-2094 (S. Lek) (FINRA006005-07).

71 Exchange Act Release No. 34-60388 at 43 (FINRA009249) (extending the T+35 close-out period "to fails to deliver resulting from the sale of an equity security that a person is 'deemed to own' pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed.").

72 Hearing Tr. at 1616-1619 (N. Louis) (FINRA005528-31) (GW), 1625-1629 (FINRA005537-41) (NG), 1629-1632 (FINRA005541-44) (HTM).

73 *Id.*

74 Hearing Tr. at 1568-1570, 1589-1590 (N. Louis) FINRA005480-82, 005501-02); *id.* at 2100-2101 (S. Lek) (FINRA006013-14).

thereby falling within the T+35 close-out period for deemed to own securities.[75] When a customer is engaged in ADR arbitrage, the ADR sponsor bank will not deliver the ADR to the broker-dealer until after the customer has delivered the stock to the broker-dealer. Therefore, by definition, the ADR will not be delivered until after T+3. Applying T+35 to ADR arbitrage also makes sense because there often are clearing locks in these situations, thereby regularly resulting in delayed deliveries.[76] The fact that ADR arbitrage did not cease after the Commission issued Rule 204T or Rule 204 is telling, and supports Messrs. Lek's and Louis' uncontroverted testimony about how the industry treated such transactions.

Messrs. Lek and Louis testified without contradiction that, in practice, the industry applied the T+35 close-out period to deemed to own securities prior to implementation of Rule 204 because of the practical reality that such securities generally took longer than T+3 to settle.[77] Messrs. Lek and Louis confirmed this industry practice by explaining that no other broker-dealer had ever closed out LSC under these circumstances.[78]

Given the rush to implement Rule 204T, it is not surprising that certain practical realities were not considered. The Commission fixed these errors shortly thereafter to reflect how the industry actually operated. LSC should not be punished for acting reasonably and consistent with industry norms in dealing with operational realities overlooked in the chaos surrounding the adoption of a temporary rule, where those operational realities were ultimately addressed and

---

75 Hearing Tr. at 1586, 1593-1595 (N. Louis) (FINRA005498, 005505-07); *id.* at 2102-2104 (S. Lek) (FINRA006015-17).

76 Hearing Tr. at 1596-1602, 1606-1610 (N. Louis) (FINRA005508-14, 005518-22); *id.* at 2099-2100 (S. Lek) (FINRA006012-13); *see also* Exchange Act Release No. 50103, n.85 ("As noted by some commenters, there may be different causes of fails to deliver that could be unrelated to a market participant engaging in naked short selling. . . . For example, one commenter noted that some fails are caused by custodian banks failing to deliver on behalf of their customers for a number of reasons, such as where a foreign domiciled customer engages in arbitrage involving [ADRs] . . ." (citing letter from LSC)).

77 Hearing Tr. at 1671-1672 (N. Louis) (FINRA005583-84); *id.* at 2134-2136 (S. Lek) (FINRA006047-49).

78 Hearing Tr. at 1624-1625 (N. Louis) (FINRA005536-37), *id.* at 2134-2136 (S. Lek) (FINRA006047-49).

explicitly permitted in the final rule. Moreover, sanctioning LSC in such circumstances is purely punitive and serves no remedial purpose.

VII. The Supervision Violations are Based on Sheer Speculation, not Evidence

The Decisions fined LSC $300,000 for violating Rule 342 by failing to supervise and implement reasonable internal controls over the above-described activities and related to potential wash trades, marking the close and pre-market cancelations by Dimension.[79] Rule 342 requires reasonable supervision, not perfection.[80] Evaluation of a respondent's supervision is based on the facts and circumstances of that particular situation and must not be influenced by hindsight.[81] When evaluating the reasonableness of that supervision, industry practice is an important factor to consider.[82] As described in Section VIII, however, the Hearing Officer excluded expert testimony on industry practice and how LSC's controls compared to that standard. That is reversible error.

In considering the reasonableness of LSC's supervision of trades coming from Dimension, it must be remembered that Dimension was an introducing broker that also had its own sophisticated compliance controls[83] and had the direct relationship with the entities and individuals placing the orders. LSC obtained and reviewed Dimension's WSPs to become comfortable with the manner in which Dimension conducted its compliance oversight.[84]

---

79 The NYSE Regulation Board of Directors reduced the Hearing Board's fine from $500,000 to $300,000, citing concern that the original fine may have included a second sanction for LSC's primary violations and thus served no remedial purpose. As explained herein, the $300,000 fine is still unwarranted and punitive.

80 *In re X & Y*, Decisions 07-157 & 07-158 at 25-26 (NYSE Hearing Board Dec. 14, 2007).

81 *In re William A. Lobb*, 2000 NASD Discip. LEXIS 11, at *22 n.19 (Apr. 6, 2000); *In re Logay*, 2000 WL 95098, at *21 (SEC Decision, Jan. 28, 2000) (evaluating the reasonableness of supervision based on the attendant circumstances but not knowledge of wrongdoing gleaned with hindsight).

82 *In re Midas Sec. LLC & Jay S. Lee*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *45 (Jan. 20, 2012).

83 Hearing Tr. at 918-920 (S. Lek) (FINRA004828-30).

84 Hearing Tr. at 1798 (S. Lek) (FINRA005710).

Contrary to the Decisions' conclusions, this does not mean that LSC paid no attention to Dimension's orders. Instead, in evaluating whether particular trades necessitated additional follow up, Dimension's compliance controls were a factor in determining what, if any, additional follow up was appropriate under the circumstances.

A. LSC Discovered and Remediated the Only Potential Wash Trades the Department Identified

The Hearing Board reasoned that because LSC did not have a specific automated exception report exclusively dedicated to potential wash trades until the summer of 2009, LSC did not surveil for potential wash trades prior that time. That conclusion is contrary to the facts and the law, and must be reversed.

The arguments about the lack of an effective automated exception report ignore the important automated controls that addressed critical variables often associated with potential wash trades, such as limitations on order sizes (as percentage of trading volume is an important factor when analyzing for potentially manipulative wash trades) and reports flagging trades in stocks with significant market movements. Such automated exception reports strike at the heart of identifying trades with the indicia of potential manipulation and therefore were a reasonable and effective means at the time for LSC to guard against potential wash trades. Of course, as technology improved and the pace of trading increased, LSC created a dedicated potential wash trade exception report, which has continued to improve to the point where LSC is now able to block potential wash trades before those orders reach the market.

The Decisions' reasoning also completely discounts any technology-assisted manual review, including through the application of filtering tools associated with LSC's ROX system. ROX is a sophisticated order management system, and its use in reviewing trades is hardly "manual;" it is much more akin to a tool that produces real-time exception reports. As Mr. Lek explained, it is not feasible to have an exception report for every conceivable type of potential misconduct.[85] Nor is it prudent to rely solely on exception reports – people need to keep their eyes and ears open and be vigilant in thinking about how to prevent and detect potentially manipulative activity.[86] This type of proactive approach to trade surveillance is precisely what broker-dealers should be doing to supplement their automated processes.

FINRA itself has issued guidance recognizing that small firms like LSC are permitted to incorporate manual reviews into their overall compliance structures.[87] While FINRA has certainly encouraged clearing firms to have automated systems – which LSC had in place during the entirety of the relevant time period – neither FINRA nor any other securities regulator had provided guidance on the type or degree of automation that was recommended, let alone required.[88] Thus, it is inappropriate to sanction LSC for not having purportedly sufficient automated controls absent, at a minimum, establishing "that Respondent's mix of manual and automated monitoring missed suspicious transactions that an automated system would have caught."[89]

The Department did not offer any such evidence; just attorney arguments and speculation based on hindsight. "Conclusory allegations, speculation and unsubstantiated assertions are not

---

85 Hearing Tr. at 2027 (S. Lek) (FINRA005940).

86 *Id.* at 2029 (FINRA005942).

87 *See* FINRA Small Firm Template for anti-money laundering compliance stating that firms may use manual or automated methods for surveilling for potential suspicious trading activity (which includes potentially manipulative trades, including wash trades) provided the overall approach is reasonable. http://www.finra.org/Industry/Issues/AML/P011419.

88 *Department of Enforcement v. Sterne, Agee & Leach, Inc.*, Discip. Proceeding No. E052005007501 at 23 (March 5, 2010).

89 *Id.* at 25.

evidence."[90] This lack of a factual record is fatal to the Department's allegations as it precludes a finding that the Department met its burden of proof.[91]

Importantly, the only evidence concerning potential wash trades that the Department presented related to certain odd-lot transactions in 2007.[92] The unrefuted evidence showed that, prior to the Department's investigation, LSC discovered those trades, determined that they were improper, ensured that the responsible trader was dismissed, and reimbursed the impacted specialists.[93] The fact that LSC identified and took corrective action on the only potential wash trades the Department identified conclusively illustrates the fallacy of the Department's allegations. If anything, it demonstrates that LSC's supervision for potential wash trades was effective.

Accordingly, the Decisions must be reversed.

B. The Department Did Not Identify a Single Trade Suggestive of Potential Marking the Close or the Existence of Circumstances that Made Marking the Close a Risk Requiring Surveillance Different From What LSC was Doing

Similar to its reasoning on potential wash trades, the Decisions sanctioned LSC because it did not institute an automated exception report entitled "marking the close" until 2010. LSC's WSPs prohibited marking the close. Although LSC had been using a "rapid succession order report" that flagged orders over a certain size within one minute of each other, the Hearing Board summarily concluded that was not reasonable because it is possible that somebody could hypothetically try to mark the close by entering smaller sized orders.

---

90 *Pearce v. Faurecia Exhaust Sys., Inc.*, 529 F. App'x 454, 458 (6th Cir. 2013).

91 *See Nat'l Labor Relations Bd. v. Louis A. Weiss Mem'l Hosp.*, 172 F.3d 432, 446 (7th Cir. 1999) ("The failure of [plaintiff] to create a factual record in no way supports a finding that [plaintiff] met its burden of proof.").

92 CX-11 (FINRA006357); CX-12 (FINRA006361); Hearing Tr. at 215 (M. Dalton) (FINRA004125).

93 Hearing Tr. at 908-911 (S. Lek) (FINRA004818-21).

The Hearing Board's reasoning is flawed for many reasons. Just because it is theoretically possible that somebody could use trades smaller than the threshold in LSC's rapid succession order report does not render LSC's report unreasonable or ineffective under the circumstances. The Department presented absolutely no evidence that the parameters were unreasonable or insufficient in light of LSC's actual customer base and the type of order flow that LSC received. The Department did not identify any trades that allegedly should have been red flags of marking the close. Nor did the Department offer evidence about the size of orders that should prompt additional review. There is simply the standard-less argument that people theoretically could use "small" orders to mark the close, thereby suggesting that all late day orders need to be investigated. There is no evidentiary basis for that conclusion, let alone any connection whatsoever to LSC's business.

Indeed, the Department's flawed approach ignores the well-established fact that trading at the end of the day is neither prohibited nor suspicious. "Indeed, studies have shown that trading in organized securities is heaviest just before the market closes, as traders monitor activity and their positions throughout the day before conducting their trades."[94] In addition, "[t]rading at the end of the day is most likely to be manipulative when the trading is designed to trigger contractual rights or benefits linked to the closing price on a particular day."[95] Thus, in *Masri*, the court stated that "the SEC goes too far in arguing that end-of-day transactions, by themselves, have long been actionable . . . ."[96] Unless "*the only possible purpose*" for doing

---

[94] *SEC v. Masri*, 523 F. Supp. 2d 361, 370 (S.D.N.Y. 2007) (citing Daniel R. Fischel and David J. Ross, Should the Law Prohibit "Manipulation" in Financial Markets?, 105 Harv. L. Rev. 503, 520 (1991)).

[95] Fischel and Ross at 520.

[96] *Masri*, 523 F. Supp. 2d at 370.

large trades at the end of the day is to artificially impact the price, an executing broker has no reason to be suspicious of the trades.[97]

There is no evidence that LSC failed to enforce its procedures regarding the rapid succession order report or that the report missed trades suggestive of a customer trying to mark the close. Moreover, the Department did not provide any testimony or documents suggesting that, in the event a customer had an overnight position, the trader would receive some sort of benefit, such as a performance fee, if that position increased in value. Significantly, the Department presented no evidence of any instances where a customer had a long position in a stock, purchased additional stock shortly before the close, the price increased, and the customer then carried that position overnight.

Thus, there was a complete lack of evidence that any factual circumstances existed giving rise to an incentive for LSC's customers to mark the close, or that trades suggestive of that activity took place but were not detected by LSC's rapid succession order report. Given the Department's access to LSC's trade data, the Department could have presented those trades during the Hearing had they existed. Accordingly, the Department did not demonstrate that the general manner in which LSC monitored for marking the close was unreasonable under the circumstances.

The marking the close allegations are based on nothing more than mere speculation, which does not amount to evidence upon which a finding of liability can be based.[98] Accordingly, the Decisions must be reversed.

---

97 *Id.* at 375 (emphasis added).

98 *Pearce,* 529 F. App'x at 458.

C. The Failure to Call Critical Witnesses with Answers to Important Questions about the Context of the Pre-Market Cancelations is a Fatal Gap in the Department's Case

The Decisions sanctioned LSC for not implementing an automated exception report for pre-market cancelations until 2010. No Exchange rule prohibits or otherwise addresses pre-market cancelations. Moreover, during the time period at issue, the Exchange had not issued any guidance regarding whether members should address pre-market cancelations in their compliance procedures.[99]

The Department's theory that Dimension's customers' pre-opening cancelations were potentially manipulative is premised on those orders impacting the imbalance information in a manner that would hypothetically attracted additional orders on the same side of the market. The Department then theorizes that Dimension's customers canceled those orders shortly before the opening, thereby unduly impacting the opening print because other market participants did not have sufficient time to react.

As an initial matter, there is nothing inherently suspicious about a customer canceling a large volume of orders.[100] Data publicly available on the Commission's website shows that 95.8% - 97.5% of orders are cancelled.[101] High volumes of cancelations simply are not by themselves indicative of anything improper.

---

99 Hearing Tr. at 783 (J. Scrofani) (FINRA004693).

100 The Department's approach to this part of the case is particularly troubling. When asked about the well-known, highly publicized and undeniable fact that most orders are canceled and not executed, the Director of the Special Reviews Unit at FINRA's Department of Market Regulation professed ignorance and would not agree with that fact. *Id.* at 789 (FINRA004699). Nor did he agree with the basic concept that it is easier to manipulate the price of a thinly traded stock as opposed to an actively traded stock. *Id.* at 823 (FINRA004733). He also claimed not to know that Goldman Sachs (one of the stocks at issue with the pre-market cancelation issue) was an actively traded stock. *Id.* This transparent lack of candor raises questions about the Department's motivations and tactics in prosecuting this case.

101 Trade to Order Volume Ratios, *available at* www.sec.gov./marketstructure/research/highlight-2013-01.html. During a speech in 2010, then Commission Chair Mary Shapiro stated that many high frequency trading firms "will generate 90 or more orders for each executed trade." Strengthening Our Equity Market Structure (Sept. 7, 2010), *available at* www.sec.gov/news/speech/2010/spch090710mls.htm. In Congressional testimony in 2009, an

With respect to the market opening process, specialists determine the opening price of a stock using a methodology based upon actual (not canceled) orders. Imbalance information is disseminated every five minutes from 8:30 a.m. – 9:00 a.m.; every minute from 9:00 a.m. – 9:20 a.m.; and every 15 seconds from 9:20 a.m. until the opening.[102] Indicative opening price information is included in the imbalance information beginning at 9:28 a.m. This process is designed to ensure that those interested in trading at the opening have sufficient time to react to changes in the imbalance information, including changes that occur in the final minutes and seconds preceding the opening. In addition, if a specialist is concerned that there has not been sufficient time to react to new imbalance information, the specialist is supposed to delay the opening of the stock.

The Department's theory is flawed in several respects. For example, it presumes that the same market participants who were so closely following the imbalance information that Dimension's orders supposedly induced them to enter orders miraculously stopped following, and did not account for, the revised imbalance information, and did not have time to react to the impact caused by the Dimension cancelations despite their likely use of high-speed computerized algorithms. No witnesses or documents addressed this faulty and theoretical premise – *it is pure speculation.*

The speculative nature of the Department's allegations is further demonstrated by the fact that the Department presented no evidence about the pre-market activity surrounding Dimension's cancelations, such as what types of orders were placed or canceled after

---

Executive Vice President of the Exchange acknowledged that high frequency traders "respond quickly to price changes by entering and canceling many orders at a time" but that the Exchange *has not observed manipulation concerns with respect to that activity. Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues: Hearing Before the Senate Comm. On Banking, Hous. and Urban Affairs*, 111th Cong. 97 (2009) (statement of Larry Leibowitz, Grp. Exec. Vice President, NYSE Euronext).

102 Exchange Act Release No. 34-57862 (May 23, 2008), *available at* https://www.sec.gov/rules/sro/nyse/2008/34-57862.pdf.

Dimension's pre-opening orders and cancelations, or whether there were other cancelations at approximately the same time and how Dimension's cancelations compared to those other cancelations. LSC sought this type of information but the Hearing Officer denied those requests.[103]

Importantly, despite vague assertions that unnamed specialists had complained about Dimension's cancelations, the Department did not call as a witness a single specialist to answer the above questions and explain whether the cancelations had any impact on the opening process or the opening price and, if so, why the specialist did not delay the opening if he/she was concerned as to whether there had been sufficient time to react to the revised imbalance information.[104]

Instead, the only evidence consisted of vague references to hearsay complaints by unidentified specialists whom LSC never had the opportunity to question. When the party with the burden of proof fails to call witnesses with relevant information, that failure raises the presumption that such testimony would have been unfavorable to that party.[105] The Department's silence here speaks volumes. The Department's approach to making a string of allegations and not permitting LSC to explore the context surrounding those allegations (such as getting answers to the questions above) precludes a finding a liability against LSC.[106]

---

103 *See* FINRA000428-29.

104 LSC is not suggesting that specialists did not complain. Indeed, they may very well have complained if cancelations shortly before the market opening impacted their plans on how to be trading from their proprietary accounts. That inconvenience to the specialists, however, does not translate to indicia of manipulation by Dimension's customers. Had there been valid concerns about potential manipulation, one would reasonably expect that the Department would have put such a specialist on the stand and permitted LSC to cross examination them.

105 *Thomas E. Snyder Sons Co. v. Comm'r of Internal Revenue*, 288 F.2d 36, 39 (7th Cir. 1961); *see SEC v. Schvacho*, No. 1:12-CV-2557, 2014 WL 54801, at *16 (N.D. Ga 2014) (noting that the Commission's failure to offer text message evidence of supposed communications between defendants was "telling" because text message content is often available).

106 *See Cozzarelli v. Inspire Pharm. Inc.*, 549 F.3d 618, 625 (4th Cir. 2008) ("Plaintiffs' proposed inference of scienter depends on stringing together a series of isolated allegations without considering the necessary context.

The Department's chief witness regarding the pre-market cancelations confirmed that the Department's allegations were premised on speculation, not fact. Specifically, he admitted that the Department did not actually investigate whether LSC's approach to the particular pre-market cancelations at issue was reasonable under the circumstances.[107] He further admitted that he was not aware of any evidence demonstrating that LSC's conduct was unreasonable.[108]

Without any testimony from the specialists themselves or from experts, there is no foundation for concluding that LSC's supervision of pre-market order flow was unreasonable under the circumstances. This reversible error is compounded by the exclusion of expert testimony that would have further explained how pre-market cancelations were not indicative of potential manipulation.

VIII. The Denial of Expert Testimony Prevented LSC from Reasonably Defending Itself

The Hearing Officer improperly denied LSC's motion for expert testimony.[109] The Department alleged that LSC violated several rules regarding complex trading issues and failed to reasonably supervise certain types of trading activities, as described above. In order to defend itself, LSC sought to introduce expert testimony on the industry standards and practices with respect to the types of trading activities at issue. For many of the allegations, an understanding of industry practice was a critical component of LSC's defense, including Blue Line trading, Reg SHO and close out obligations, and the design of controls to comply with the Emergency Order.

Moreover, several of the Department's arguments were premised on LSC's trade surveillance practices not being sufficient, such as with respect to wash trades, pre-market

---

Plaintiffs insist that we should rely solely on their discrete allegations, and they urge us not to look beyond the complaint for additional facts.").

107 Hearing Tr. at 890, 894, 897 (R. Steketee) (FINRA004800, 004804, 004807).

108 *Id.* at 897 (FINRA004807).

109 FINRA002915-20.

cancelations and marking-the-close, which necessarily requires a benchmark for comparison (*i.e.*, industry standards and practices).

Industry standards and practices are unquestionably relevant to whether LSC acted reasonably. How others in the industry addressed the same issues is the logical and common way in which to demonstrate the reasonableness of a control structure.[110] In *Geon*, the Second Circuit explained:

> The SEC adduced no evidence, and makes no argument, that it or any stock exchange . . . had proposed a prophylactic practice of this sort or that it was common in the industry. Had such a practice existed, we would have expected the SEC to have been zealous in showing it, and, of course, the Commission had the burden of proof. Accordingly, we think that the lack of proof of any specific industry practice . . . argues in [defendant's] favor ....[111]

During the course of this matter, the Department tried to minimize the importance of industry practice by arguing that industry practice is not dispositive as to the appropriate standard of care. LSC does not claim that such information is dispositive. As the Second Circuit has explained, however, ignoring the industry practice requires proof that the whole industry was acting unreasonably:

> We do not mean, of course, that this absence of proof is conclusive, for a whole calling may have unduly lagged in the adoption of new and available devices. . . . But what this lack of proof does indicate is that the SEC must argue, in this part of the case, that the standard of supervision for the whole brokerage industry should have been upgraded, not just that [defendant] ought to have been more careful."[112]

The Commission has agreed that "expert testimony as to industry practice... is relevant to show the standard of care necessary to evaluate [the respondent's] liability..."[113] and that such

---

110 *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 52-53 (2d Cir. 1976).

111 *Id.* (citations omitted)

112 *Id.*

113 *In re Ira Weiss*, Exchange Act Release No. 52875, 2005 SEC LEXIS 3107, at *19 n.21 (Dec. 2, 2005).

testimony is important in helping to analyze a respondent's conduct in the context of enforcement actions.[114]

The Hearing Officer even acknowledged the propriety of LSC's anticipated use of expert testimony to explain the pertinent industry practices when she denied LSC's request for certain types of discovery. Specifically, in denying a discovery motion, the Hearing Officer reasoned that "[t]o the extent that Respondent is arguing that its odd-lot orders were consistent with widely accepted industry standards, such standards would be well-known in the securities industry and the subject of expert testimony."[115] Denying discovery on the basis that such information would be addressed through expert testimony and then subsequently denying LSC the ability to call expert witnesses to testify about that information necessarily deprived LSC of information critical to its ability to formulate a defense.

The Hearing Officer also erroneously concluded that expert testimony would have encompassed the ultimate legal issues that must be determined.[116] The purpose of the proposed expert testimony was to inform the Hearing Board as to the relevant industry standards and practices related to the wide array of complex trading activities at issue and how LSC's conduct compared to those industry standards. It would then be up to the Hearing Board to decide how much weight to give to the experts' testimony and to decide whether any deviations from industry standards were reasonable.[117]

As a result, this matter came down to the Department saying LSC's supervision was unreasonable without articulating any benchmarks or metrics for the Hearing Board to consider

---

114 *In re Stephen Sohmer & Spyder Sec., Inc.*, Exchange Act Release No. 49052 at 7, 16-17 (Jan. 12, 2004).

115 FINRA000421-22.

116 FINRA002919.

117 As LSC explained in its Motion for Leave to Permit Expert Testimony, while the testimony was expected to "support" LSC's defenses, it was the Hearing Board that had the ultimate responsibility for "determining whether [the regulations] were violated and whether sanctions would be remedial." FINRA002740-41.

when assessing whether the supervision was reasonable. While hearing panels must have two members from the industry, by rule, at least one panelist must have experience in securities activities that are different from the respondent.[118] Given the multitude of complex trading activities and related supervisory control structures at issue, including the fact that LSC is one of a very small number of execution and clearing firms, and that Dimension was an introducing broker and therefore had the direct relationship with the individuals placing the trades at issue, it is unlikely that the panelists had experience and expertise in all of those issues such that expert testimony would not have been helpful to the panel. Particularly where the Department cited to no codified rules setting forth such standards, expert testimony was highly probative and essential to LSC's defense.

The Hearing Officer's decision to preclude expert testimony, which contradicted her prior discovery ruling, prejudiced LSC by preventing it from pursuing key parts of its defense. Therefore, the Decisions must be reversed.

IX. The Sanctions are Punitive

Sanctions imposed by the Exchange must be remedial, not punitive.[119] Even if one were to erroneously conclude that LSC violated certain of the Exchange rules as alleged, the $575,000 fine against a very small firm, is punitive in light of the circumstances described above. For example, the Exchange has rescinded IM 94-14 and the entire odd-lot system so there is no risk of future violations; the Blue Line issues involved LSC seeking best execution for its customers and LSC has now closed its floor business because the Exchange failed to act on its 2009 Blue Line application; LSC's treatment of "deemed to own" securities has been incorporated into Rule

---

118 NYSE Rule 9232(a).

119 *In re Michael Cunningham Young*, NYSE Decision No. 07-38, at 10 (Hearing Board May 11, 2007) ("The purpose of a disciplinary action is to 'protect investors, not penalize brokers.'" (quoting *McCarthy v. SEC*, 406 F.3d 179, 188 (2d Cir. 2005)).

204 so there is no risk of a future violation and the Commission issued a no-action letter affirming LSC's position on pre-fail credits; the Emergency Order situation arose from unprecedented events that are unlikely to recur; and LSC has implemented specific automated exception reports for potential wash trades, marking the close and pre-market cancelations (as well as other exception reports related to its electronic order flow).

These mitigating factors, coupled with the Department's repeated acknowledgements that it did not allege that any manipulative trades actually were executed through LSC's systems, collectively show that the $575,000 fine serves punitive, not remedial purposes.

X. Conclusion

The Decisions must be reversed. Notably, the Decisions, among other things: (i) made no attempt to reconcile Rule 70.40 with LSC's overarching duty of best execution; (ii) did not address the substantive procedural failures regarding the purported prohibition on odd-lot day trades; (iii) ignored that the Emergency Order explicitly permitted short sales by options market makers; (iv) condemned LSC for handling Fails in accordance with its understanding of industry standards, including in manners that the Commission subsequently specifically endorsed; and (v) incorrectly assumed that the absence of specific automated exception reports necessarily meant that LSC was not surveilling for potentially manipulative activity.

Moreover, although industry practice is a critical component to assessing the reasonableness of a broker-dealer's supervisory control structure, the Hearing Officer denied LSC's ability to present expert testimony on that issue, which prejudiced LSC's defense.

All of these considerations, coupled with the punitive nature of the fine, compel the conclusion that the Decisions must be reversed.

Respectfully submitted,

Kevin J. Harnisch
David M. Crane
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 429-6442 - telephone
(202) 429-3902 - facsimile
kharnisch@steptoe.com
dcrane@steptoe.com

May 22, 2015

CERTIFICATE OF COMPLIANCE

Pursuant to the Commission's Rule of Practice 450(c) and (d), I hereby certify that this brief contains 12,860 words according to Microsoft Word's word count function.

David M. Crane
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 429-1323 - telephone
(202) 429-3902 - facsimile
dcrane@steptoe.com

CERTIFICATE OF SERVICE

I hereby certify that on the 22nd day of May, 2015, I caused a true and correct copy of the foregoing to be served by U.S. mail on the following:

The Office of the Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Mail Stop 1090 – Room 10915
Washington, DC 20549

Alan Lawhead
Andrew J. Love
Jennifer C. Brooks
Office of General Counsel
FINRA
1735 K Street, NW
Washington, DC 20006

David M. Crane

David M. Crane
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 429-1323 - telephone
(202) 429-3902 - facsimile
dcrane@steptoe.com

****
*** TX REPORT ***
****

TRANSMISSION OK

TX/RX NO	1437
RECIPIENT ADDRESS	92027729324
DESTINATION ID	
ST. TIME	05/22 15:53
TIME USE	05'51
PAGES SENT	45
RESULT	OK

RECEIVED
MAY 27 2015
OFFICE OF THE SECRETARY

Steptoe
STEPTOE & JOHNSON LLP

1330 CONNECTICUT AVENUE, NW
WASHINGTON, D.C. 20036-1795
FACSIMILE: 202 429 3902
VERIFICATION: 202 429 8045
MAIN NUMBER: 202 429 3000
www.steptoe.com

BEIJING, CHINA
FACSIMILE: 011 86 10 5969 6099
MAIN NUMBER: 011 86 10 5834 1000

BRUSSELS, BELGIUM
FACSIMILE: 011 322 626 0510
VERIFICATION: 011 322 626 0500

CENTURY CITY, CALIFORNIA
FACSIMILE: 310 734 3300
VERIFICATION: 310 734 3200

CHICAGO, ILLINOIS
FACSIMILE: 312 577 1370
VERIFICATION: 312 577 1300

LONDON, ENGLAND
FACSIMILE: 011 44 207 367 8001
VERIFICATION: 011 44 207 367 8000

LOS ANGELES, CALIFORNIA
FACSIMILE: 213 439 9599
VERIFICATION: 213 439 9400

NEW YORK, NEW YORK
FACSIMILE: 212 506 3950
VERIFICATION: 212 506 3900

PALO ALTO, CALIFORNIA
FACSIMILE: 650 687 9499
VERIFICATION: 650 687 9500

PHOENIX, ARIZONA
FACSIMILE: 602 257 5299
VERIFICATION: 602 257 5287

DELIVER TO:

NAME: **Office of the Secretary** TELECOPY PHONE NUMBER: **202-772-9324**

COMPANY: **Securities & Exchange Commission** VERIFICATION NUMBER: **202-551-5400**

TOTAL PAGES & COVER SHEET: **45** DATE TRANSMITTED: **May 22, 2015**

S&J OPERATOR'S NAME: [redacted] TELEPHONE NUMBER: [redacted]

FROM:

NAME: **David Crane**

REQUEST MADE ON DATE: **5/22/15** TIME: **3:16 PM**

Steptoe

STEPTOE & JOHNSON LLP

BEIJING, CHINA
FACSIMILE: 011 86 10 5969 6099
MAIN NUMBER: 011 86 10 5834 1000

BRUSSELS, BELGIUM
FACSIMILE: 011 322 626 0510
VERIFICATION: 011 322 626 0500

CENTURY CITY, CALIFORNIA
FACSIMILE 310 734 3300
VERIFICATION: 310 734 3200

CHICAGO, ILLINOIS
FACSIMILE 312 577 1370
VERIFICATION: 312 577 1300

1330 CONNECTICUT AVENUE, NW
WASHINGTON, D.C. 20036-1795
FACSIMILE: 202 429 3902
VERIFICATION: 202 429 8045
MAIN NUMBER: 202 429 3000
www.steptoe.com

LONDON, ENGLAND
FACSIMILE: 011 44 207 367 8001
VERIFICATION: 011 44 207 367 8000

LOS ANGELES, CALIFORNIA
FACSIMILE 213 439 9599
VERIFICATION: 213 439 9400

NEW YORK, NEW YORK
FACSIMILE: 212 506 3950
VERIFICATION: 212 506 3900

PALO ALTO, CALIFORNIA
FACSIMILE: 650 687 9499
VERIFICATION: 650 687 9500

PHOENIX, ARIZONA
FACSIMILE: 602 257 5299
VERIFICATION: 602 257 5287

DELIVER TO:

NAME: **Office of the Secretary** TELECOPY PHONE NUMBER: **202-772-9324**

COMPANY: **Securities & Exchange Commission** VERIFICATION NUMBER: **202-551-5400**

TOTAL PAGES & COVER SHEET: **45** DATE TRANSMITTED: **May 22, 2015**

S&J OPERATOR'S NAME: [redacted] TELEPHONE NUMBER: [redacted]

FROM:

NAME: **David Crane**

REQUEST MADE ON DATE: **5/22/15** TIME: **3:16 PM**

CCMPLETION REQUIRED BY DATE: **5/22/15** TIME: **ASAP**

SPECIAL INSTRUCTIONS: