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BEFORE THE SECURITIES AND EXCHANGE COMMISSION

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

LEK SECURITIES CORPORATION'S REPLY 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

July 6, 2015

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I. Introduction

The Hearing Board and NYSE Regulation Board of Directors (collectively the "Decisions") imposed punitive sanctions on Lek Securities Corp. ("LSC") for several direct rule violations and supervisory failures arising from a multi-year investigation by the Department of Market Regulation ("Department"). Tellingly, that multi-year investigation did not yield any allegations of manipulative trades executed through LSC's systems. The Decisions relied on insufficient and speculative evidence, ignored industry standards to which LSC conformed, and failed to take into consideration relevant rule changes that confirmed the propriety of how LSC (and others) were handling certain types of orders. For these reasons and those in LSC's Appellate Brief, the Decisions must be reversed.

II. FINRA's Interpretation of Rule 70.40 Conflicts with LSC's Best Execution Obligations

The adoption of Regulation NMS in 2005 required broker-dealers to route customer orders to the market centers displaying the best price.[1] For nearly a decade by 2005, LSC had been routing orders away from the New York Stock Exchange ("Exchange") floor when other market centers were offering better executions. LSC did so with the approval of the Exchange.

The Exchange promulgated Rule 70.40 in the aftermath of Regulation NMS, with the purpose of increasing its members' ability to route orders to other markets from the NYSE floor in order to obtain better executions.[2] Unlike LSC, many of these members were not previously

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[1] 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).

[2] 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).

approved to route orders to other market centers, and Rule 70.40 implemented a regime to approve those members for such activity.

While FINRA admits that the Exchange added Rule 70.40 to allow "greater access to markets in furtherance of Regulation NMS," it side-steps any consideration of these best execution requirements.[3] Instead, FINRA simply argues that LSC had obligations under Rule 70.40 that prevented it from accessing other markets until it received redundant approval from the Exchange. Thus, according to FINRA, LSC should have ignored its best execution requirements and waited for an indeterminable amount of time to obtain the Exchange's repetitive approval so that it could comply with Rule 70.40's purpose of expanding access to markets. This is nonsensical. FINRA does not even attempt to address, much less dispute, LSC's best execution argument.

Similarly, FINRA does not address the conflict between Rule 70.40 and other prior Commission mandates explicitly prohibiting market centers, including the Exchange, from interfering with members' ability to execute transactions elsewhere.[4] Indeed, the Securities Exchange Act of 1934 expressly prohibits the Exchange from passing rules that have the type of effect for which FINRA is advocating in this matter. Specifically, "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…."[5] This statutory mandate cannot be reconciled with the interpretation of Rule 70.40 set forth in the Decisions.

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[3] FINRA's Opposition at 29.

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

[5] *Id.* at § 240.19c-3(a).

LSC was approved to route orders away from the Exchange and did so to satisfy its best execution obligations and the best interests of its customers. Rule 70.40 did not override those obligations. As a result, the sanctions against LSC must be reversed.

FINRA also incorrectly suggests that LSC flagrantly disregarded the Exchange's order to cease Blue Line Trading.[6] When the Exchange directed LSC to stop trading away, it immediately told its booth traders to cease such activity.[7] When it learned that those traders had not done so, Sam Lek personally directed them to stop, which they did, and LSC ultimately shut down its floor operations.[8] This was a good faith effort to immediately cease the trading that the Exchange objected to – despite not having a rational legal basis for its objections – not a conscious effort to disregard the Exchange.

III. The Exchange's Odd-Lot Rule was Procedurally Defective and Ultimately Rescinded

It is undisputed that Amendment 2 of the Exchange's proposed odd-lot day trading rule, which defined what constituted prohibited day trading, was never published for comment.[9] FINRA's conclusory statement that the amendment was merely "technical"[10] wholly ignores LSC's argument and the case law explaining that definitional changes, such as Amendment 2, must undergo the notice and comment process.[11] Definitions matter. A failure to engage in this process renders the odd-lot rule unenforceable against LSC.

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6 Opposition at 31.

7 Hearing Tr. at 1937 (S. Lek) (FINRA005850).

8 *Id.*

9 *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.

10 Opposition at 14.

11 *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

Importantly, the Exchange has rescinded its odd-lot rule. Once the public was finally permitted to provide comments on the entirety of the rule, including what was contained in Amendment 2, the Exchange abolished the entire odd-lot system.[12] This further tilts the scale towards reversal here, as imposing a fine would serve no remedial purpose.

Lastly, FINRA concedes that the odd-lot rule was not included in the Exchange's rule book. While this point may not be dispositive, at the very least it should be considered and goes to the fundamental fairness of the sanction at issue. LSC should not be sanctioned for alleged violations of a rule that the Exchange did not view as important enough to put in its own rule book. FINRA argues that LSC had notice of the rule, and relies on language in a footnote, published a decade after the rule approval, suggested that the requirements were "deemed to be a rule change."[13] This did not meaningfully broadcast the rule, particularly where a rule book exists. Fairness dictates that NYSE place its rules in its rule book. Its unexplained failure to do so must be taken into account here.

IV. LSC Responded Appropriately to the Emergency Order

A. LSC's Emergency Order Controls were Reasonable Under the Circumstances

The Commission's Emergency Order prohibiting short sales of certain financial institutions occurred during the height of the financial crisis. The Commission posted the Emergency Order on its website at 1:42 a.m. on September 19, 2008 and the order went into effect that morning.[14] Given the unprecedented, chaotic, and time-sensitive situation that

to "household" under food stamp regulations was not exempt from notice and comment for "good cause," as this exemption is narrowly construed).

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

[13] Opposition at 15 (citing NYSE Information Memo 04-14, n.1).

[14] *Blue Point Sec., Inc.*, Decision 11-NYSE-7, 2011 WL 11070702, at *2 (Sept. 27, 2011).

required an immediate response, LSC took the reasonable approach of leveraging off of its existing short sale controls. It used its Reg SHO compliance controls that routed certain short sales to its stock loan desk to find a locate. LSC added the issuers listed on the Emergency Order to this procedure, thereby ensuring that any short sales in those issuers would be rejected because LSC's stock loan desk would not give a locate. This process made sense, it could be implemented quickly, and it worked.

One of LSC's customers (Dimension Securities) did not use LSC's stock loan desk because it had a pre-borrow arrangement with a third party. Contrary to LSC's reasonable assumption, that third party inexplicably provided locates to Dimension for short sales of stocks subject to the Emergency Order. Nevertheless, LSC's emergency control was reasonable under the circumstances. It reflected an immediate fix under LSC's existing parameters to the Emergency Order. There was simply no time for LSC to develop, test, troubleshoot, and implement a control as it normally would. The Emergency Order required an emergency response, and LSC's response was reasonable.

Not only was this control reasonable, but it had previously been implemented in response to the Commission's emergency orders in July 2008.[15] FINRA ignores this point by summarily proclaiming that this proven compliance is not relevant.[16] This prior effective approach of complying with a similar emergency order is, indeed, insightful as to why LSC concluded that its approach would achieve compliance with the Emergency Order. Contrary to the Decisions findings, LSC made a well-reasoned decision.

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[15] 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.

[16] Opposition at 22 n.8.

B. Uncontroverted Evidence Demonstrates that LSC's Options Market Maker Customers were Exempt from the Emergency Order

The Emergency Order did not apply to short sales by options market makers related to their market making activities.[17] LSC provided testimony about the market making activities of some of its customers that Mr. Lek had known for years.[18] This evidence was uncontroverted and unquestioned by the review panels. It is further confirmed by information in the public domain.[19] FINRA admittedly ignored these facts during the investigatory phase of this matter despite LSC's advisement.[20]

FINRA attempts to sidestep this issue by claiming that LSC did not demonstrate that its customers who were options market makers were registered market makers for the issuers in question. First, that ignores the uncontroverted testimony about how the trades were booked into their market making accounts. Second, the argument is premised on the incorrect assumption that an options market maker may only make markets in options for which it has registered – that is not true and FINRA's brief tellingly cites no authority for this assertion.

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[17] 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.").

[18] Hearing Tr. at 2056-57 (S. Lek) (FINRA005969-70).

[19] *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.

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

C. Same Day Violations Should not be Sanctioned

After the Emergency Order became effective, SROs began adding companies to the list of covered stocks during the trading day, effective immediately. 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 Dimension's customers and options market makers).[21] In all five instances, those stocks were added to the Emergency Order the same day as the violating trades. Given the inherent delay in updating LSC's controls to implement the SROs mandates, these violations were not unreasonable. Tellingly, FINRA does not even attempt to dispute this argument or otherwise support the sanctions here.[22]

V. Commission Guidance and Practical Realities Diminish Reg SHO Violations

The Decisions erred by ignoring Commission guidance and dismissing operational realities relating to the closing out of fail-to-deliver positions.

For example, LSC should have received pre-fail credit for its customers' purchases of three of the stocks at issue. Prior to the alleged close out dates, customers purchased these stocks, thereby leaving LSC *without* a net short position in the Continuous Net Settlement ("CNS") system.[23] LSC thus had no net short position to close out. A 2013 Commission No-Action Letter confirms LSC's interpretation that qualifying transactions include customer purchases.[24] FINRA suggests that the No-Action Letter did not provide retroactive relief.[25] But a No-Action Letter does not change the law. Rather, it merely reflects the Commission staff's

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

22 *See* Opposition at 23.

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

24 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).

25 Opposition at 26.

interpretation. In this case, it confirmed LSC's understanding of pre-fail credits and unequivocally demonstrates the reasonableness of that position.

This appropriateness of LSC's position is underscored when the alternative is considered. 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?[26] FINRA's brief provides no answer to that question. In sum, LSC's reasonable approach, subsequently confirmed by the Commission, should not subject LSC to sanctions.

Similarly, LSC did not close out positions in six stocks on the easy to borrow list where lenders failed to deliver.[27] It was entirely reasonable not to punish innocent customers (by buying them in) for a lender's failure to meet its obligations. FINRA notes that there is no easy to borrow exception under Rule 204.[28] Yet this is not an easy to borrow issue. It is a common sense approach and treats customers fairly when they have done nothing wrong.

Lastly, practical realities required a T+35 close-out period for deemed to own securities. Rule 204 incorporated this close-out period, yet the hastily adopted temporary Rule 204T did not. That oversight must be considered here. FINRA asks the Commission to ignore this lapse, the unprecedented market chaos of October 2008 when Rule 204T was adopted, and the practical realties that require a longer close-out period. It likewise ignores the undisputed testimony from industry professionals that such securities take longer than T+3 to settle, and that LSC has never been closed out by another broker-dealer under these circumstances.[29] FINRA is asking the

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

[27] Those stocks were LEN, FRD, YAVY, CVO, MSJ, and MBI.

[28] Opposition at 24.

[29] Hearing Tr. at 1671-72, 1624-25 (N. Louis) (FINRA005583-84; FINRA005536-37), *id.* at 2134-2136 (S. Lek) (FINRA006047-49).

Commission to punish LSC for acting in a manner that the Commission ultimately ratified. That makes no sense. At the very least, these practical realities and the conforming final Rule 204 caution against imposing sanctions that would serve no remedial purpose here.

VI. LSC's Supervision was Reasonable

A. LSC Had Wash Trade Controls in Place

FINRA would have the Commission believe that, prior to August 2009, LSC had "non-existent" controls for wash trades.[30] This is categorically false. LSC had automated controls that focused on certain indicia often associated with potential wash trades. LSC supplemented those controls with technology-assisted manual reviews through filtering tools available in LSC's ROX system, a practice FINRA itself has endorsed.[31] Thus, LSC did, indeed, have wash trade controls in place prior to August 2009. Those controls have evolved over time, despite the fact that no securities regulator provided guidance on the type or degree of automation that was recommended, let alone required.[32] LSC developed and implemented an automated exception report to track potential wash trades, and subsequently refined its controls to the point where it can now block potential wash trades before those orders are sent to the market.

Not only did LSC have controls in place to monitor for potential wash trades prior to August 2009, but those controls worked. The only evidence concerning potential wash trades that the Department presented related to certain odd-lot transactions in 2007.[33] However, LSC

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[30] Opposition at 35.

[31] *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.

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

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

discovered those trades and took corrective action prior to the Department's investigation.[34] FINRA attempts to dismiss these facts as not absolving LSC of liability.[35] But they are persuasive evidence that LSC's controls were reasonable, and worked. FINRA cites to no contrary examples demonstrating unreasonableness. Its reliance on inaccurate statements about LSC' controls and general pronouncements do not meet its burden. For these reasons, LSC should not be sanctioned.

B. There was no Evidence that LSC's Marking the Close Control was Unreasonable or Failed to Catch any Orders Suggestive of Potential Marking the Close

There was no evidence whatsoever that any of LSC's customers engaged in marking the close. While FINRA concedes that there was no actual violative trading, it argues that LSC's supervision was not reasonable.[36] FINRA's arguments rely on nothing more than a theoretical critique of what could potentially get around LSC's control parameters. 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. This is not evidence that LSC's controls and supervision were unreasonable. Reasonable supervision should be based on the circumstances, realistic risks, industry practice, and actual trading. The Department provided no evidence on any of these topics. Its standard-less argument does not show LSC was unreasonable, nor can it provide the basis for sanctions.

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[34] Hearing Tr. at 908-911 (S. Lek) (FINRA004818-21).

[35] Opposition at 36.

[36] *Id.* at 37.

C. The Department Failed to Meet its Burden of Proof Regarding Pre-Market Cancelations

There is no Exchange rule, let alone any guidance, on pre-market cancelations. Canceled orders alone are not suspicious, and in fact, occur between 95.8% - 97.5% of the time.[37] Nonetheless, LSC put a surveillance control in place to monitor and detect pre-market cancels. This was reasonable. FINRA relies on assertions from unnamed specialists who did not testify and were therefore shielded from cross-examination, and thus did not demonstrate that Dimension's pre-market cancelations had any impact on the opening process or the opening price. 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.[38] That failure is fatal to the Department's case here. Contrary to FINRA's assertion, LSC has not shifted the burden to investors and market makers.[39] Rather, LSC has conclusively demonstrated that the Department did not meet its burden in this case. FINRA cannot sue a broker-dealer based on market maker complaints but not elaborate on those complaints, identify the market maker, or otherwise permit the broker-dealer to explore the legitimacy of those complaints.

D. Any Direct Rule Violations do not Constitute a Failure to Supervise

Sanctions against LSC for failing to supervise the direct rule violations must also be reversed. LSC made reasoned decisions regarding its Reg SHO and Emergency Order compliance. Its compliance and supervision thereof reasonably reflected the realities on the

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[37] Trade to Order Volume Ratios, *available at* www.sec.gov./marketstructure/research/highlight-2013-01.html.

[38] *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).

[39] Opposition at 35.

ground. Even if the Commission disagrees with LSC's underlying conduct, those violations cannot be repackaged as a failure to supervise. Additionally, the sanctions for Blue Line trading and odd-lot orders are not enforceable due to the best execution requirements and procedurally deficiencies previously noted. Again, this was not a failure to supervise.

VII. It was Unfairly Prejudicial to Deny LSC's Proffer of Expert Testimony

Evaluating LSC's conduct and supervision rests on the amorphous standard of reasonableness. Conduct is either reasonable or unreasonable when compared to a standard, and experts could have provided relevant evidence on what those standards were. FINRA does not deny that expert testimony would be relevant and helpful. It merely suggests the Hearing Board panelists were familiar with industry custom.[40] But at least one panelist must have experience in securities activities that are different from the respondent in any hearing.[41] FINRA conveniently avoids this fact. The notion that one of the panelists had such expertise in the multitude of different and complicated issues in this case, and therefore that the testimony of an expert would not have been helpful, strains credulity.

The failure to admit expert testimony prejudiced LSC's defense. It cannot merely be chalked up to the Hearing Officer's discretion, but rather requires an inference in LSC's favor. "[W]e think that the lack of proof of any specific industry practice . . . argues in [defendant's] favor . . . ."[42] Additionally, the Hearing Officer understood that industry standards were the purview of expert testimony, and used this rationale to deny an LSC discovery motion in this matter.[43] The subsequent denial of experts deprived LSC of information critical to its defense. Particularly here, where the alleged deficiencies relied on a finding that LSC was not reasonable

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40 *Id.* at 38.

41 NYSE Rule 9232(a).

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

43 FINRA000421-22.

in diverse areas of its operations, expert testimony explaining what those standards actually were was critical. Its absence was unfairly prejudicial, and for this reason, the Decisions must be reversed.

VIII. The Punitive Sanctions Must Be Reduced

Sanctions imposed must be remedial and not penal.[44] That principle was violated here. It is undisputed that much of the sanctioned conduct could not happen again, which counsels against these sanctions. FINRA attempts to discredit this argument by suggesting that it will allow firms to violate future Commission orders so long as the order expires before the misconduct is detected.[45] FINRA's conjecture distracts from the actual circumstances, is highly speculative, and deserves no weight here. What actually happened here is that (1) LSC no longer conducts Blue Line trading, (2) the relevant odd-lot rules were revoked once the public was able to comment on the entire rule, (3) the Emergency Order was terminated after the unprecedented market crisis subsided, (4) the final Rule 204 conformed to market realities and embraced what LSC and other broker-dealers had been doing, and (5) LSC improved its systems as technology advanced. A remedial focus demands that the sanctions be reduced.

FINRA also equates LSC's legal arguments with refusing to accept responsibility, blaming third parties, and misunderstanding its regulatory obligations.[46] LSC is entitled to defend itself and make legal arguments. Its failure to settle or concede does not provide a basis for sanctions.

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[44] *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)).

[45] Opposition at 44 n.20.

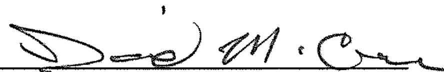
[46] *See id.* at 40-41.

IX. Conclusion

LSC has conclusively demonstrated that the Decisions failed to account for industry custom, disregarded the current status of the regulations at issue, and relied on insufficient evidence. The direct rule violation findings ignore that the relevant rules conflicted with existing rules, came about through impermissible procedural defects, or were subsequently amended or abolished to conform to LSC's practice. Likewise, the supervisory findings depend on speculative assertions of what could have happened while discounting what actually happened - and no manipulative trades were even alleged here. Equally erroneous was the fact that the Decisions determined what was reasonable after actively precluding relevant testimony on the very standards it measured LSC's conduct against.

These errors, coupled with the overly punitive 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

July 6, 2015

CERTIFICATE OF COMPLIANCE

Pursuant to the Commission's Rule of Practice 450(c) and (d), I hereby certify that this brief contains 4,859 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

<u>**CERTIFICATE OF SERVICE**</u>

I hereby certify that on the 6th day of July, 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
STEPTOE & JOHNSON LLP
1330 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 429-1323 - telephone
(202) 429-3902 - facsimile
dcrane@steptoe.com