INITIAL DECISION RELEASE NO. 490
ADMINISTRATIVE PROCEEDING
FILE NO. 3-14848

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of	:	
	:	INITIAL DECISION
OPTIONSXPRESS, INC.,	:	June 7, 2013
THOMAS E. STERN, and	:	
JONATHAN I. FELDMAN	:	

APPEARANCES: Frederick L. Block, Jill S. Henderson, Paul E. Kim, and Christian Schultz, for the Division of Enforcement, Securities and Exchange Commission.

Stephen J. Senderowitz, Charles B. Klein, Joseph L. Siders, and William E. Walsh for optionsXpress, Inc.

Vincent P. Schmeltz III and Austin J. Burke for Thomas E. Stern

Gregory T. Lawrence, Hannah Kon, and Daniel J. McCartin for Jonathan I. Feldman

BEFORE: Brenda P. Murray, Chief Administrative Law Judge

The Securities and Exchange Commission (Commission) issued an Order Instituting Administrative and Cease-and-Desist Proceedings (OIP) on April 16, 2012.[1] Seventeen days of hearing produced a 5,035 page transcript and approximately 320 exhibits. The Division of Enforcement (Division) presented testimony from nineteen witnesses, including two experts.

[1] The OIP was issued pursuant to Section 8A of the Securities Act of 1933 (Securities Act), Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act), and Section 9(b) of the Investment Company Act of 1940 (Investment Company Act). It named twenty-five securities, including Amedisys Inc. (AMED), American International Group, Inc. (AIG), China Sky One Medical, Inc. (CSKI), Citigroup, Inc. (C or Citi), Direxion Daily Financial Bull 3X Shares (FAS), Greenhill & Co., Inc. (GHL), Jos. A. Banks Clothiers Inc. (JOSB), MannKind Corporation (MNKD), Mead Johnston Nutritional Company (MJN), Sears Holding Corporation (Sears or SHLD), and Texas Industries Inc. (TXI). OIP at 7-9.

Respondents presented testimony from seven witnesses, including an individual expert for each Respondent. The last brief was filed on February 1, 2013.[2]

Pending Motions

At the conclusion of the hearing, I ordered a briefing schedule by which the Division would file its Brief and Proposed Findings of Fact on December 12, 2012, Respondents would respond with their Briefs and Proposed Findings of Fact on January 11, 2013, and the Division would file a Reply Brief on February 1, 2013.

On December 7, 2012, the Division filed a Post-Hearing Brief and Proposed Findings of Fact. Respondents filed their Briefs and Proposed Findings of Fact on January 11, 2013. On February 1, 2013, the Division filed a Post Hearing Reply Brief for each Respondent and Consolidated Reply Findings of Fact. All Respondents filed Motions to Strike the Division's Consolidated Reply Findings of Fact (Motions to Strike) and all references to it in the Division's Reply Briefs. The Division filed separate Oppositions to each Motion to Strike. Each Respondent filed a Reply in support of its Motion.

As part of his Motion to Strike, Thomas E. Stern (Stern) would strike the Division's reference to a settlement, which I refused to take official notice of previously. optionsXpress, Inc., Administrative Proceedings Ruling Release No. 748 (Feb. 6, 2013); Stern Motion to Strike at 3. The Division did not oppose Stern's request. Div. Opposition at 4. I GRANT Stern's request and will not consider footnote 11 on page 13 of the Division's Reply Brief Against Stern.

Rule 340(a) of the Commission's Rules of Practice provides that before "an initial decision is issued, each party shall have an opportunity, reasonable in light of all the circumstances, to file in writing proposed findings and conclusions together with, or as a part of, its brief." See 17 C.F.R. § 201.340. I GRANT Respondents' Motions to Strike. The Commission's Rules of Practice do not allow a party to file consecutive versions of the facts. To accept the Division's Consolidated Reply Findings of Fact would be unfair as it would deprive Respondents of their ability to contest in writing the Division's new factual assertions. See 17 C.F.R. § 201.300. The Division's Consolidated Reply Findings of Fact and references to it are not a part of the record.

Issues

The issues presented are whether a clearing broker can meet its obligation to deliver securities by executing buy-writes, i.e., does a purchase of securities offset by a simultaneous sale of a deep-in-the-money call option count as delivery. If the answer is no, did the clearing

[2] I will cite to the transcript of the hearing as "(Tr. __.)." I will cite to the Division's and Respondents' exhibits as "(Div. Ex. __.)," "(OPX Ex. __.)." I will use similar designations in citations to the post-hearing filings. Technical support during the hearing was provided by Jonathan Owens for the Division and Ted Haw for Respondents.

broker's customer commit fraud by engaging in buy-writes, did the clearing broker's Chief Financial Officer (CFO) cause and aid and abet all the violations, and did the clearing broker cause and aid and abet its customer's violations. Tr. 4329, 4945. The OIP alleges that from at least October 2008 to March 18, 2010 (relevant period): (1) optionsXpress, Inc. (optionsXpress), willfully violated Rules 204 and 204T of Regulation SHO – Regulation of Short Sales (Reg. SHO); (2) Jonathan I. Feldman (Feldman) willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21; (3) Stern caused and willfully aided and abetted optionsXpress's and Feldman's violations; and (4) optionsXpress caused and willfully aided and abetted Feldman's violations. OIP at 2, 24-25.

The OIP alleges that five optionsXpress customers engaged in similar illegal conduct in six accounts during the relevant period: Feldman, Mark Zelezney (Zelezney), Blake Gentry (Gentry), a friend of Zelezney, Dean Kolocouris (Kolocouris), a friend of Feldman's, and Bradley Nielson (Nielson). Tr. 1111-12; Div. Ex. 310 at 49. Feldman was the largest trader among these customers. Tr. 1515.

Factual Findings

The factual findings and legal conclusions are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 102 (1981). I have considered and rejected all arguments and proposed findings and conclusions that are inconsistent with this Initial Decision.

optionsXpress

optionsXpress is the broker-dealer subsidiary of optionsXpress Holdings, Inc. (optionsXpress Holdings), a public parent company that was acquired by The Charles Schwab Corporation on September 1, 2011. Tr. 1622; OIP at 2; optionsXpress Answer at 2. optionsXpress was formed in late 2000, began taking customers in early 2001, and has been a self-directed, self-clearing options broker for retail customers since September 2006.[3] Tr. 149, 245, 505, 1618. optionsXpress is not a market maker and does not trade in its own account. Tr. 3278. The firm is one of the largest options brokerage firms, and unsworn estimates are that it had approximately 250,000 customers in 2008 and 320,000 customers in 2010. Tr. 3263-64, 3278. optionsXpress's policy is not to provide retail customers with investment advice. Tr. 3462. This proceeding involves shares of twenty-five securities in six customer accounts. OIP at 5, 7-9; Tr. 3265.

Thomas Edward Stern

Stern joined optionsXpress in 2000-2001, and was the CFO, registered financial operations principal (FINOP), primary regulatory liaison beginning in 2009, and member of the

[3] Customers can go to the website and place orders to buy and sell options. optionsXpress executes the transactions, it does not offer trading strategy advice. Tr. 506, 632.

board of directors of optionsXpress from 2007 through mid-2009. Tr. 270, 1618, 1623-24. Stern has been active in the options industry for a very long time. He became a Chicago Board Options Exchange (CBOE) member in 1973, and worked as a floor trader for about seventeen years. Tr. 1625-27. At optionsXpress, Stern reported to the Chief Executive Officer (CEO). Tr. 1622. Stern was an Options Clearing Corporation (OCC) Board member from September 2009 until optionsXpress terminated his employment on January 11, 2012. Tr. 1618, 1623-25. Stern disputes the statement on his Form U-5 that he failed to assure that the information submitted to a regulator was accurate and that he violated the employee code of conduct. Tr. 1619.

Stern testified he was never in operations, and while he became optionsXpress's primary regulatory liaison when the former Chief Compliance Officer (CCO) left in 2009, he was not responsible for compliance with Reg. SHO. Tr. 1622-23, 1703. Stern describes his position as similar to a baseball utility infielder in that he was called on for an opinion, but had no responsibilities. Tr. 1818. Stern monitored optionsXpress's liquidity status, and on a daily basis, he monitored the sites where it had settlements – futures, CBOE, money markets, and the National Securities Clearing Corporation (NSCC) – to make sure there was sufficient cash. Tr. 1836.

Jonathan I. Feldman[4]

Feldman, age 56, was employed as a Senior Vice President at Eastern Savings Bank, Hunt Valley, Maryland, from 1993 until he resigned in late April 2012. He is now self-employed.[5] Tr. 2099-2100, 2348; Div. Ex. 118. Feldman was a self-directed customer of optionsXpress from December 12, 2008, through April 1, 2010. Tr. 2393. He initiated his trade strategies and placed his own orders. Tr. 1196. Feldman was one of optionsXpress's biggest retail clients, and he entered sales orders every day. Tr. 2313, 2317-18, 4340. One expert considered Feldman to be a professional in the sense that he was a sophisticated, highly educated trader. Tr. 4520-23, 4526.

Background

The Commission adopted Reg. SHO in 2004 to address concerns associated with persistent fails to deliver and abusive naked short selling. Div. Ex. 401 at 6. As to the matters at issue here, there are no differences between Rules 204 and 204T of Reg. SHO. I will use Rule 204 to refer to both.

[4] Feldman and the Division stipulated that the Commission entered the order of investigation in this proceeding on February 16, 2010, which, according to Feldman, was the day before he returned the Division's telephone call and it told him it was conducting an informal inquiry. Tr. 4784-85.

[5] Feldman holds a Rabbinical ordinance and a Bachelor's degree granted jointly by Ner Israel Rabbinical College and Johns Hopkins University (Hopkins), and a Masters in Computer Science from Hopkins. Tr. 2343.

> Rule 204. Close-Out Requirement
>
> (a) A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity.

17 C.F.R. § 242.204; OPX Ex. 915 at 40. Rule 204 became effective July 31, 2009.[6] It replaced Rule 204T, in effect since September 18, 2008.[7]

The terms buy-write and deep-in-the-money call do not appear in Rules 204 or 204T of Reg. SHO. See 17 C.F.R. §§ 242.204, .204T. A call option is characterized as in-the-money when the stock price is higher than the strike price. OPX Ex. 248 at 7. A deep-in-the-money call option has a strike price that is substantially below the market price of the stock.[8] Div. Ex. 310 at 21; John Downes & Jordan Elliot Goodman, Finance & Investment Handbook 332 (7th ed. 2007). The deeper the call is in-the-money, the greater the likelihood that it will be assigned. Tr. 4409. If the deep-in-the-money call was assigned, the customer could be short in his customer account. Tr. 419-20, 522. On hard-to-borrow securities, the price of a put is generally higher than the price of an equivalent call option for the same strike price and expiration. Tr. 420, 531-32, 1110.

In options parlance, the terms exercise and assignment have significantly different meanings. Exercise means to make use of a right available in an options contract; a buyer of a call contract may exercise the right to buy underlying shares at a particular price; a put option is exercised when the holder of the put decides to invoke the right to sell and the underlying shares are sold at the agreed-upon price. Finance & Investment Handbook 395. When an option holder decides to exercise the option, it is assigned to an option writer. Div. Exs. 310 at 16, 375 at 8-9. The option writer receiving an assignment must honor the options contract. Div. Ex. 310 at 16.

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[6] Amendments to Regulation SHO, 74 Fed. Reg. 38,266 (July 31, 2009).

[7] Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, 73 Fed. Reg. 54,875 (Sept. 17, 2008); Amendments to Regulation SHO, 73 Fed. Reg. 61,706 (Oct. 17, 2008).

[8] In the money means that the holder of the option will get a better price than the strike price. Tr. 338. In-the-money calls are listed on the exchange and every option market makers offer them on public sites.

Feldman, Gentry, Kolocouris, Nielson, and Zelezney, who optionsXpress treated as institutional clients, employed a strategy that included a synthetic long (sell a put and buy a call for the same number of shares at the same strike price and same expiration date) hedged by selling in-the-money calls or shorting the stock, a strategy referred to as a three-way or reverse conversion. Tr. 1111, 1193, 4107-08; Div. Ex. 310 at 16-17. This version of a three-way strategy involved large volumes of shares. Tr. 520. The customers employed this strategy predominantly in hard-to-borrow stocks[9] by placing orders with Jeremy Coronado (Coronado), Giovanni Stella (Stella), and Terrence Gallery (Gallery) on optionsXpress's Execution Desk.[10] Tr. 1110-11, 1117, 1122. When faced with buy-in notices that resulted from assignments, optionsXpress allowed these customers to execute buy-writes. Tr. 1116-26.

Buy-writes

Buying shares and selling a call option in the same amount of the same security simultaneously is a buy-write. Tr. 548-49; OPX 915 at 13. A buy and write strategy is described as a "conservative options strategy that entails buying stocks and then writing covered call options on them." Finance & Investment Handbook 253. Buy-writes are common. A pattern and practice or continuous stream of buy-write transactions is not common and is a red flag for options regulators. Tr. 2820, 3785, 3914-15.

August (Gus) Payne (Payne), a trading specialist, testified that optionsXpress began to use buys to cover with an option, buy-writes, in early 2009.[11] Tr. 2044-45. optionsXpress allowed certain customers to use buy-writes to cover shorts in their accounts. Div. Exs. 33, 310 at 7, 12.

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[9] A hard-to-borrow stock is a stock for which there is a mismatch of demand and supply. Div. Ex. 375 at 20. Experts defined it as meaning a broker had to pay more to borrow it. Tr. 1105-07, 3080, 4210.

[10] Coronado was the primary person on the Execution Desk for the accounts at issue. He worked on the part of the Execution Desk that dealt with large trades. Tr. 515-16, 518. In 2012, Coronado had been employed by optionsXpress for almost nine years, and had ten or eleven years as a trading specialist. Tr. 514, 614.

Stella, a graduate of Loras College with a number of security licenses and ten years trading experience, was an execution trader who facilitated block trades and helped with electronic order management. Tr. 1194-95, 1224-25. He followed up customer e-mails with phone calls to meet optionsXpress's policy of requiring phone calls for all orders. Tr. 1112-13.

[11] Payne was at optionsXpress from February 2007 to December 31, 2009. Tr. 163, 1819, 1868. He was the customer contact on clearing, execution, and trading, and placed orders. Tr. 1877-78, 2039-40. Payne considered himself a middleman between departments. Tr. 1874. He monitored fails to deliver and made sure they were covered. Tr. 1875. He graduated from the University of Colorado, and is now a Relationship Manager at Beacon Financial. Tr. 2038.

Continuous Net Settlement System (CNS)

The Depository Trust and Clearing Corporation (DTCC) operates two divisions which work together. Tr. 123. It operates the Depository Trust Company (DTC), record holder of all equity securities listed on the United States exchanges, and the NSCC, which serves as the clearing agent on the settlement date for the majority of United States transactions in equities.[12] Tr. 31, 117, 123; OPX Ex. 915 at 15-16.

NSCC members are broker-dealers, and optionsXpress is a NSCC member. Tr. 34; OPX Ex. 915 at 34 n.51. When NSCC members purchase or sell securities on the exchanges, the exchanges send the trade information to the NSCC. Tr. 89, 114-15. NSCC operates the CNS, which from 3:10 to 3:15 p.m. daily, runs a process that nets all transactions in CNS eligible securities. Tr. 35-37.

CNS members are obligated to deliver shares to settle trades to CNS. Tr. 97, 117, 248. Settlement refers to the delivery of shares by the seller to the contraparty represented by CNS. Tr. 277. The delivery obligation to CNS is with the clearing broker-dealer, a customer cannot deliver into CNS directly, and no one contends that Feldman had a delivery obligation to CNS.[13] Tr. 248-49, 1494. "[D]elivery occurs when the NSCC instructs the DTC to move shares out of the clearing account of a Clearing member who has a net delivery obligation, and the DTC moves the securities." OPX Ex. 915 at 17.

Trades, including those that result from option assignments, are regularly cleared through CNS on a trade date plus three (T+3) basis, where T is the date of the assignment. Tr. 34-36, 52, 1545; OPX Ex. 915 at 17-18. A fail to deliver occurs when a clearing member does not have sufficient shares in its DTC account to satisfy its net obligations to NSCC. Tr. 3140; OPX Ex. 915 at 17. Failures to deliver to CNS are common and do not violate a CNS protocol. Tr. 118, 132.

CNS sent an Accounting Summary each evening to NSCC members. The Accounting Summary shows the broker-dealer's opening position at CNS, that day's activity, its closing position, and has a column that includes stock dividends and stock splits.[14] Tr. 496; OPX Ex.

[12] Every NSCC member has to be a member of the DTC. Tr. 123-24. DTC, through its nominee name "Cede and Co.," is the registered owner of the shares of most publicly traded United States companies. Investor owned shares are held indirectly through DTC participants as entitlements in book entry form at DTC. OPX Ex. 915 at 15.

[13] The broker-dealer's delivery arrangements with its customers are a separate matter that is not an issue in this proceeding. Tr. 1517.

[14] At the hearing, Div. Ex. 18, an excerpt of a 700-page Accounting Summary, was used in examining witnesses. This version of the Accounting Summary had all broker-dealer accounts.

840. The Accounting Summary lists net fails to deliver in each security arranged by CUSIP as of T+3. Tr. 49, 91, 324. A fail to deliver number is a cumulative figure of outstanding fails and new fails that occurred that day, less fails that settled that day; the number does not show the age of the fail, or trades that occurred that day. Tr. 66-68, 434, 3355-56; OPX Ex. 680. Stated succinctly:

> [E]vening of T3, CNS will notice the firm you have a fail to deliver, I believe it's late in the evening. Then the rule then kicks in so that the morning of T4 the firm has to buy that amount that's due at CNS. It's not customer level.

Tr. 3633.

On the CNS Accounting Summary, a participant's flat position is shown by a zero, a participant's failure to deliver securities to CNS on the settlement date is shown by a negative number, and if CNS owes a participant shares, it is shown as a positive number. Tr. 67-68. Because the CNS system is a balanced system, when CNS fails to receive shares, it fails to deliver shares to another CNS member.[15] Tr. 37-38, 64. CNS furnishes the Financial Industry Regulatory Authority (FINRA) with fail to deliver information, which FINRA incorporates into its surveillance systems.[16] Tr. 2805.

A CNS participant that does not receive shares for a customer account when due can submit an Original Buy-In Notice to CNS to settle its trades. Tr. 495, 4325; Div. Ex. 310 at 15. CNS then issues a CNS Buy-In Activity report (Intent to Buy-In Notice) to the non-delivering participant who has forty-eight hours before the non-receiving party can initiate a buy-in, i.e., purchase the securities it failed to receive in the open market.[17] During the forty-eight hour

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In fact, each broker-dealer only received an Accounting Summary showing its customer accounts. OPX Ex. 840.

[15] With permission, CNS can go into DTC and take shares from a member's position electronically to satisfy the member's short position. Tr. 36, 67, 2875. The Accounting Summary shows total shorts, shares owed to CNS, and total longs, shares CNS owes to participants. The number should add to zero. Tr. 64; Div. Ex. 18.

[16] FINRA is a private, not-for-profit, self-regulatory organization (SRO) registered and overseen by the Commission. FINRA has jurisdiction over member firms and firms that are members of exchanges for which it has contracts. Tr. 2751.

[17]
> You are hereby notified that a notice of intention to buy-in for the security(ies) described below has been received under the rules and procedures of the [NSCC]. Unless you deliver such security(ies) in accordance with the guidelines specified in the [NSCC] rules and procedures, the security(ies) may be bought in for your account and risk.

period, CNS allocates shares received to the non-receiving participants first. CNS allocates shares to the buyers with the oldest unsettled position using FIFO (first in first out). Tr. 1411-12; Div. Ex. 310 at 15. Participant initiated buy-ins are fairly rare because most buyers obtain settlement on their trades within a few days. Tr. 1424, 1575-76, 4846; Div. Ex. 310 at 15.

According to Respondents, and a credible optionsXpress employee, optionsXpress received a pretty low number of Intent to Buy-in Notices for Sears during the relevant period. Tr. 500. This representation, however, does not agree with the evidence that optionsXpress received many Intent to Buy-in Notices for Sears and other securities noted in the OIP. Tr. 4460-62; Div. Ex. 54. Div. Ex. 54 consists of about ninety-seven pages of copies of Intent to Buy-In Notices, sometimes two to a page, issued to optionsXpress in the relevant period. The securities named in the OIP, including Sears, appear often. Just a few examples: on October 1, 2009, optionsXpress received an Intent to Buy-in Notice that it needed to deliver 130,027 shares of Sears by the end of the day on October 2, 2009, to avoid a buy-in by UBS Securities, LLC, Cantor Fitzgerald & Co., and CIBC World Markets, Inc./CDS. On January 27, 2010, optionsXpress received an Intent to Buy-in Notice that it needed to deliver 401,168 shares of Sears by the end of the day on January 28, 2010, to avoid buy-ins by eleven CNS members. On January 28, 2010, optionsXpress received an Intent to Buy-in Notice that it needed to deliver 396,748 shares of Sears by the end of the day on January 29, 2010, to avoid buy-ins by ten CNS members. Tr. 73-74, 77-79; Div. Ex. 54.

The Options Clearing Corporation (OCC)

The OCC, founded in 1973, is the issuer and guarantor of every options contract executed on every security options exchange in the United States, the counterparty for all transactions. Finance & Investment Handbook 654. Individuals hold option positions indirectly through a broker who is an OCC member. OPX Ex. 915 at 27. Options are cleared through the OCC. Tr. 3154. Failure to deliver on T+1, T+2, and T+3 triggers an obligation to post collateral with the OCC. Tr. 832. The OCC requires member firms to post collateral on a daily basis. Tr. 767.

Tr. 72, 139; Div. Ex. 54. The Intent to Buy-in Notice has two results: it moves a non-receiving participant up in priority at CNS to receive shares and it permits the non-receiving participant to buy the securities it failed to receive after forty-eight hours. Tr. 107, 140-41. CNS issues the Intent to Buy-in Notice to the participant with the longest failure to deliver position in that security. Tr. 139-40. Intent to Buy-in Notices are making a statement that non-receiving participants do not want to wait any longer to receive their shares. Tr. 75-76. The forty-eight hour period means that the participant owed the shares cannot forcibly buy-in the other participant until forty-eight hours after the Intent to Buy-in Notice is issued. Tr. 79, 138, 495. It is possible that the non-receiving participant might receive the shares from another source since issuance of the Intent to Buy-in Notice moves the participant up in priority to receive shares. Tr. 80. The evidence establishes that CNS fails do not impact a person's right to vote the shares and receive dividends because optionsXpress records trades and assignments in customer accounts on the day they occur. Tr. 4473-75, 4481-85. CNS processes the dividends declared when the shares are not delivered, and the long broker/dealer receives the dividends. Tr. 113.

The party exercising the option notifies her or his broker and the broker notifies the OCC of the exercise of the option. Tr. 502-03, 1369; OPX Ex. 915 at 27.

> When the [OCC] learns of the exercise of an option, it prepares an assignment form notifying a broker-dealer that an option written by one of its clients has been exercised. The firm in turns assigns the exercise in accordance with its internal procedures.

Finance & Investment Handbook 203. The OCC uses an automated assignment algorithm to allocate the assignments among broker-dealers that have a written position in that particular option. OPX Ex. 915 at 28. The assignment process is random and anonymous. Tr. 612, 2623. The OCC member representing the call option writer is responsible for the delivery obligation arising from the assignment. OPX Ex. 915 at 28. The OCC conveys assignment notices to broker-dealers after trading closes on the day the option is exercised. OPX Ex. 915 at 29. No one knows the identity of the parties to an options transaction. Tr. 438-39, 467, 1465, 3453.

optionsXpress's Operations

Delivery and Assignment

As a clearing broker, optionsXpress knew it had a duty to deliver shares into the CNS system on settlement date for its customers. Tr. 279, 1645. It knew that a "failure to deliver" occurs when a customer's account does not have enough shares for optionsXpress to satisfy its delivery obligation to CNS by T+3, and optionsXpress was then obligated to deliver shares to CNS to close its failure to deliver position at CNS on T+4. Tr. 279, 335, 3141.

When a call is assigned to optionsXpress, it is recorded on optionsXpress's books as a stock transaction on the day the assignment is received, which is the trade date. Tr. 1661. 1665, 3019. If optionsXpress received an assignment and its customers wrote options in an amount that exceeded the quantity of option contracts assigned to it by OCC, optionsXpress used an algorithm to allocate the assignment among its customers. Tr. 340-42; OPX Ex. 828. When a customer's account receives an assignment, the account is credited with payment for the number of shares sold at the strike price, so it is usually possible to tell which call was assigned in full or in part. Tr. 4160. If optionsXpress allocates the assignment, in whole or in part, to the customer and the customer does not have sufficient shares in his/her account to cover, then a short position is created in the customer's account. Tr. 310, 419, 2567.

During the relevant period, Reg. SHO required optionsXpress to close out fails to deliver no later than the beginning of regular trading hours on T+4.

Buy-In Procedures

optionsXpress received an Accounting Summary from CNS for its account daily, very late at night or very early in the morning. Tr. 115, 150, 177. The Accounting Summary first went to the information technology (IT) or back office. If more than one customer had transactions in a security, IT personnel used an algorithm to determine which customers

corresponded to the short position. Tr. 280, 367-68. Scott Tortorella (Tortorella), a manager in the Clearing Department (Clearing) received a report from IT based on the CNS Accounting Summary and began working on it as soon as he arrived at about 6:40 a.m.[18] Tr. 443.

Tortorella checked the holdings in customer accounts to determine how many shares of a particular security needed to be bought-in for what customers, and others checked whether the stock could be borrowed. If optionsXpress was able to borrow the stock, then the customer could stay short. Tr. 343. optionsXpress did not charge its customer if it had to pay to borrow shares for their accounts. It considered the borrowing expense a cost of doing business; however, as a matter of policy, it would not borrow shares where the borrowing cost was above the threshold of a negative one percent. Tr. 233-34, 266, 1226. The cost of borrowing "hard-to-borrow shares" was typically very high, much higher than negative one percent.[19] Tr. 239-40, 274, 293, 1646. There is no evidence that optionsXpress paid anyone to borrow shares for the transactions at issue here. Tr. 4208.

If the customer's account receiving the assignment was short shares, and the shares were not available for optionsXpress to borrow, then Reg. SHO required optionsXpress to buy in the shares.[20] Tr. 234, 278, 280, 282, 310, 343, 450, 518, 2567. Clearing was responsible for getting buy-in notices to the Trading Desk, which was responsible for executing the buy-ins to close out CNS failures to deliver. Tr. 281-82, 289-90, 309, 423-24. Tortorella was responsible for sending a buy-in notification (buy-in notice) by e-mail to the Trading Desk before the markets opened. Tr. 230-31, 234-35, 280-81, 314, 364-66, 381; Div. Ex. 138.[21] For most of the relevant

[18] Tortorella, a graduate of Western Illinois University, has held his present position for more than six years. Tr. 513. He has worked in the securities industry for about thirty-two years, including two years at DTC. Tr. 511, 513. Tortorella worked on the equity side as opposed to the options side, but when optionsXpress received an assignment and it was necessary to deal with a customer's account, the equity side of the operation got involved. Tr. 366, 417.

[19] Short sellers have to deposit collateral to borrow. The difference between the interest paid on the collateral and the interest charged to borrow is the short interest rebate. Div. Exs. 310 at 14, 375 at 18. During the relevant period, the short interest rebate rates were negative for all hard-to-borrow stocks because the hard-to-borrow loan fees were much higher than the interest rates. Div. Ex. 310 at 14.

[20] A party who is subject to a buy-in can deliver the shares from another source to meet the obligation. Tr. 250. optionsXpress had contractual agreements with certain broker-dealers from whom it could try to borrow securities. Tr. 471. optionsXpress does not carry inventory; the stock it had available internally to loan came from customer accounts that had excess securities. Tr. 265.

[21] Div. Ex. 138, an e-mail Tortorella sent on November 6, 2008, at 9:05 a.m., is an example of the buy-in notification that Tortorella sent to the Trading Desk. Tortorella assumed that the Trading Desk notified the customer of the buy-in as soon as it received the buy-in notice. Tr. 459.

period, Tortorella sent the account names of those who were often on the buy-in list – Feldman, Kolocouris, Nielson, Gentry, and Zelezney – to Payne and the Trading Desk before the market opened, and he sent the remaining names after the market opened.[22] Tr. 1878-81, 1962-65, 1980; Div. Exs. 194, 204.

If optionsXpress cannot borrow the stock, the customer cannot reject the buy-in, because optionsXpress has a delivery obligation under Reg. SHO. Tr. 250-51. Any buy-ins that optionsXpress executed became part of its CNS position. Tr. 494. Purchases have three days to settle so it is possible that the Accounting Summary could include as fails to deliver some transactions that occurred on T+3, or on the morning of T+4, but had not yet settled; a purchase on T+4 would not settle until T+4 plus three, or T+7. Tr. 324-25, 434-35, 493. However, the clearing broker's books and records would show the customer's account as flat on the buy-in or trade date.[23] Tr. 454, 493-94, 4331.

Payne was responsible for monitoring fails and making sure they were covered.[24] Tr. 1875-76. When Payne received the buy-in notices, he would e-mail Feldman, Kolocouris, Nielson, Gentry, Zelezney, and a few others before informing Execution to buy in shares in their accounts.[25] Tr. 1881-89, 1984-85; Div. Exs. 56, 79, 195, 359. Payne only gave notice to the traders of customers on the buy-in list that were doing buy-writes. Tr. 1891-93. For example, on September 14, 2009, at 9:52 a.m. ET, Feldman was notified that his account was short and would be bought in. He executed a buy-write for the number of shares needed to cover at 12:35 p.m. ET. Tr. 2014-17; Div. Ex. 195, 196. Zelezney was given a similar notice on September 14, 2009, at 9:54 a.m. ET. Tr. 2018; Div. Ex. 197. He "Bought to Cover" the same amount of shares and sold the same number of option contracts on September 14, 2009, at 11:53 a.m. ET. Tr. 2021; Div. Ex. 198. Other customers were notified they were being bought in after the market opened and the buy-ins were executed. Tr. 1986-89; Div. Ex. 61.

Tortorella expected that the buy-in notice would cause trades to be executed by the opening of the market. Tr. 394. Ronald Molnar (Molnar) did not know how the buy-ins were

[22] The terms Trading Desk and Execution Desk (Execution) are used interchangeably in the transcript and in this Initial Decision. Tr. 235, 286, 379, 510, 514, 516. The Trading Desk was in a different department from Clearing. Tr. 402.

[23] optionsXpress showed a customer's account as long shares on the buy-in date even if the customer owed the shares had not received them. Tr. 494-95.

[24] Trading specialists Robert Kurzatkowski (Kurzatkowski), Christopher Benson (Benson), and Scott Snyder (Snyder) performed Payne's responsibilities when he was unavailable. Tr. 1168-69, 1686-70, 1882, 2004; Div. Ex. 56.

[25] Div. Exs. 359-62 are buy-in notices sent to Feldman, Nielson, Zelezney, and Kolocouris, respectively, during the relevant period. Some of these buy-in notices were sent after the market opened, e.g., 9:58 a.m., 10:00 a.m., and 10:01 a.m. ET.

executed by the Trading Desk.[26] Tr. 282. Most of the time, Clearing received an e-mail notice when a buy-in was executed and Tortorella expected to receive one. Tr. 234-35, 314-15, 392-93. Tortorella testified that Feldman's frequent appearance on the Accounting Summary did not concern him because from optionsXpress's perspective, Feldman was not doing anything wrong. Tr. 476. It is common for optionsXpress to buy in a customer where the customer does not have shares to make delivery. Tr. 251. optionsXpress does not view a high volume of buy-ins for a customer as a concern as long as it can meet its Reg. SHO obligation. Tr. 252.

To execute the orders, Execution used an International Stock Exchange (ISE) electronic trading platform, PrecISE, or communicated with a floor broker, referred to as a two-dollar broker, such as On Point Executions LLC (On Point). Tr. 1105, 1113-15.

optionsXpress's Buy-In Procedures Following Rule 204T in October 2008

optionsXpress's procedures for sending buy-in notices to the Trading Desk changed between October 2008 and March 2010. Tr. 380, 403. When Rule 204T took effect in October 2008, Tortorella only received a basic, rudimentary report from IT, and it was a lot of work for him to manually determine what shares needed to be bought in at market open on T+4. Tr. 381, 384-85, 448. Late reports from IT and CNS and the need to involve the vendor that operated optionsXpress's back office also caused delays in getting the buy-in list to the Trading Desk when Rule 204T first took effect. Tr. 386. Molnar conceded that on days that Clearing did not send the Trading Desk a notice of buy-ins until after the market opened, that the trades were not executed around the market open.[27] Tr. 350.

Payne does not recall being told in October 2008, that buy-ins had to be accomplished at the opening of the market. In October 2008, Payne gave customers throughout the day to cover short positions. Tr. 1916. Payne testified that for the first month after Rule 204T went into effect, optionsXpress notified customers and allowed them to place trades during the day. Tr. 2043. The evidence shows, however, that Payne was copied on an October 27, 2008, e-mail from Kevin Strine (Strine), Vice President Compliance, that stated, "According to the rules, [CNS fails] need to be closed out at the opening."[28] Tr. 1917-19; Div. Ex. 202.

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[26] Molnar, with about forty years of clearing experience, and Tortorella's superior, was one of five direct reports to Jay Risley (Risley), Executive Vice President of Clearing (Clearing). Tr. 150-51, 276, 308-09.

[27] CNS participants waiting to receive shares would not notice any difference in buy-ins occurring late in the day because all trades that occurred during the business hours of the exchange get the same trade date. Tr. 477-78.

[28] Strine is a graduate of the University of Nebraska and the University of Wisconsin Law School, and is a member of the Wisconsin State Bar. He began working for optionsXpress in 1996 in his present position and he has Series 4, 7, 24, and 63 licenses. Strine supervised approximately six people in the Compliance Department and reported to the CCO. Tr. 3277-83.

On October 23, 2008, at 8:13 a.m., Tortorella sent Payne a list of "Today's CNS buy-ins." Tr. 287-89; Div. Ex. 137. Payne sent the buy-in notices he received from Clearing to Execution. Tr. 2040. At 2:44 p.m., Tortorella inquired, "Hey Gus, these go OK?" Payne responded at 2:49 p.m., "Only ones waiting are the SPS and UB, have market on close orders on them, so everything will be covered." Div. Ex. 137. The phrase "the market on close orders," means that the trades would not necessarily be executed at market open but would take place at the end of the day. Tr. 289, 423. Tortorella e-mailed Molnar at 3:09 p.m., "I thought we were supposed to be covering at the open?" Tr. 288; Div. Ex. 137. Molnar e-mailed Payne at 5:17 p.m., "I believe the new SEC rule requires that the position has to be closed out on the open. Was this changed?" Div. Ex. 137.

On October 27, 2008, at 8:36 a.m., Tortorella sent Payne and Snyder an e-mail with "Today's CNS buy-ins." Tr. 290-91, 383; Div. Ex. 202. At 8:58 a.m., Payne responded to Tortorella's e-mail with copies to Molnar and Snyder, "Is there a timeline you want these closed out by since the markets already open? I have been letting them close out by the end of the day." Div. Ex. 202. At 8:42 a.m., Molnar e-mailed Strine:

> Kevin, Can you give some clarification when we need to cover our CNS fails. Is it by the opening, or anytime today as long as the position is covered? These are fails that were not covered on Friday, and now we have a T+4 CNS fail.

Div. Ex. 202. Strine e-mailed Molnar at 1:45 p.m., with copies to Payne, Tortorella, and Snyder, "According to the rules, they need to be closed out at the opening. The industry is pushing back on this and requesting the day, but as it is now, we need to cover at the opening." Id.

On November 5, 2008, Bottini e-mailed Molnar asking whether Sears was really hard to borrow. Bottini also asked, "If the firm account gets assigned on short calls will that trigger an immediate buy/in?" Div. Ex. 41. Molnar responded:

> Yes, SHLD is very hard to borrow. It is at a negative rate. I'm getting what the rate is currently. Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle. Prior to the new short call rule, we had a window with Reg SHO. If we were able to get the CNS fail to zero for one day, the Reg SHO clock would get reset to a new 10 days. Unfortunately now we have to cover any CNS fail immediately.
>
> I think we should comment to the SEC regarding covering shorts from the result of an option assignment (not put exercise because the customer is controlling). The assignment has no impact on the market because the short is based entirely on

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Strine entered a settlement with the Commission on April 16, 2012. Peter J. Bottini, Exchange Act Release No. 66814 (Apr. 16, 2012), 103 SEC Docket 53204.

> the strike price. The CNS fail created by the customer short is protected on our side by Reg T requirements, and the customer would still be subject to CNS buy-in rules.
>
> This just in, SHLD is at a neg rate of the high 50's.[29]

Tr. 292-94, 322-23, 347; Div. Ex. 41.

On November 6, 2008, Payne questioned why the buy-in list was not getting shorter "with all these regulations." Tr. 383-88; Div. Ex. 138. Tortorella responded that "people can be selling short and, if as a firm we have excess that gets covered up-until we have no excuses. I say we laser all shorts daily." Div. Ex. 138. Payne commented that "this is really starting to tick these customers off," to which Tortorella responded, "I bet. The [Sears] game is just silly. Regulation at its finest." Id.

On May 21, 2009, at 10:47 a.m. Central Time (CT), Payne sent Coronado a list of buy-ins for six securities in four accounts so that Coronado could start building orders, i.e., buy-writes, in the accounts. Tr. 1890-93; Div. Ex. 55. On June 29, 2009, Payne informed Feldman that optionsXpress's practice was to allow customers who were notified that their accounts were being bought in to take all day to buy-in and they could place trades directly online. Tr. 1901-04, 1910; Div. Ex. 274.

On June 29, 2009, Feldman e-mailed Coronado, Gallery, and Stella, thanking them for helping him place the buy-writes and complaining that for the Citi buy-writes he has always had to pay $1.01, "the ask on the stock and getting 'par' on the call" and that he tries to do the buy-writes for $1.00 but cannot. He announced that he was going to change the call so that he may not get assigned as much because it has more open interest.[30] Feldman complained that he traded literally millions of shares on this buy-write and questioned whether optionsXpress could get him a better price. Tr. 1189-90; Div. Ex. 38. Feldman wondered whether there was a way to call a market maker ahead of time and arrange a better price, perhaps even a half a cent difference. Tr. 1189-90; Div. Ex. 38. He thought a market maker would be willing, stating, "[]I've been doing like 500,000sh, 600,000 shs and over 1mm shares at a time every day. Perhaps a MM would be happy to 'get the business' and make $3,000 in a shot?" Tr. 1189-90; Div. Ex. 38. Feldman noted optionsXpress was getting thousands and thousands of dollars in commissions on these easy trades. Div. Ex. 38. Stella replied that he would try to get the buy-writes filled for a penny better, but after exchange, clearing, and execution fees, buy-writes are a

[29] Reference is to an interest rate to borrow of fifty percent. Tr. 293. Molnar testified that he was trying to tell Bottini that under Reg. SHO as effective in November 2008, optionsXpress was required to buy-in on T+4, when previously it had a ten-day buy-in window. Tr. 323.

[30] Open interest refers to the number of outstanding options contracts. Tr. 2196, 2567. The lower the open interest, the higher the probability that an option in that series at that strike price would be assigned. Tr. 2197, 2205.

"loser" for market makers. Feldman responded that perhaps direct negotiation or arrangement would allow for an exception. Id. He noted his "$1.6mm account" and that he had paid "probably $50k" in commissions. Id.

On July 31, 2009, at 9:13 a.m., Tortorella sent an e-mail to Benson and others titled "CNS fail buy-ins."[31] Tr. 283-84, 390; Div. Ex. 125. At 3:03 p.m., Benson e-mailed Tortorella "covered." Div. Ex. 125. Tortorella e-mailed Molnar at 3:07 p.m., "Surely it's 'opening of business' somewhere." Id. Molnar replied, "Yeah, it's starting to worry me. I'm wondering if they are letting the customers cover their own shorts. This is one of the points I wanted to bring up on Monday." Id. Tortorella replied, "They used to when we first started this. Remember also, when they would let Zelezney pick which account [he] would cover." Tr. 394; Div. Ex. 125. Neither Molnar nor Tortorella agree that Benson's e-mail shows that the buy-in occurred as late as 3:03 p.m., only that that was when they received notice of execution. Tr. 353, 392. Molnar agrees that it would be a violation of Reg. SHO if optionsXpress did not close out the fail on T+4. Tr. 355.

Payne testified that there can be confusion about when an order is filled because a time-stamped order taken by hand may be filled, but the trader may not bill the customer's account until later. An order entered electronically, on the other hand, is recorded when it is filled. Tr. 2059-60. Payne relied on the customer's account to determine whether the buy-in had been executed and passed the information back to Tortorella. Tr. 2046.

optionsXpress's Buy-In Procedures Following Enactment of Rule 204

On August 2, 2009, Payne was informed that the language of Rule 204T was permanent. Div. Ex. 282. On August 6, 2009, Payne informed Feldman that Rule 204 was permanent and he would continue to contact him with the amount of shares he was short, but now the buy-ins must be accomplished immediately. Tr. 1913; Div. Ex. 172. On August 14, 2009, Payne e-mailed Strine and expressed concern that optionsXpress was allowing Feldman and Zelezney "too much leeway with these buy-writes instead of covering them on the short shares first." Tr. 1924; Div. 102. Strine responded to Payne on August 14, 2009, stating that the firm would no longer let customers do their own buy-ins, that buy-ins would be processed at the open, or as soon as possible after receiving the buy-in notice from Clearing, and they would work to get files to him earlier. Tr. 148, 1923-27; Div. Ex. 102.

In August 2009, Tortorella began sending the Trading Desk two types of buy-in notices: a chronic or perpetual failure list (CNS 1), large positions in hard-to-borrow securities traded frequently, which appeared on the buy-in notice most days, and where borrowing shares was not going to happen; and a normal list (CNS 2). Tr. 404-06, 1962, 2253; Div. Ex. 204. Tortorella sent the CNS 1 list to Payne before the market opened and the CNS 2 list out after the market opened. Div. Exs. 194, 204. Feldman, Kolocouris, Nielson, Gentry, and Zelezney's accounts were frequently on the CNS 1 list and sometimes on the CNS 2 list. Tr. 1964-65, 1980. Payne

[31] The Feldman and Zelezney accounts were listed for buy-ins for AIG shares. Tr. 391.

e-mailed Feldman, Kolocouris, Nielson, Gentry, Zelezney, and a few others when their names appeared on either buy-in list before informing Execution. Div. Exs. 56, 79, 195, 359, 360, 361. Other names on the CNS 1 and CNS 2 lists were notified after the market opened and after the buy-ins were executed. Tr. 1986-89; Div. Ex. 61. The result is that some people were told the price of the buy-in that had occurred, while "big name customers" were given choices for how to cover the failure to deliver. Payne testified customers would have been given advanced notice if they asked for it; however, he did not know how customers would have known this was optionsXpress's policy. Tr. 2025

Payne described the perpetual list as positions that are always short. Div. Ex. 58. Molnar referred to Feldman's position in-house as rolling or continuous fails because when a position appeared closed, a new position appeared. Tr. 299-300. Tortorella referred to Feldman and other customers as having chronic fails. Tr. 301-02. Several securities in Feldman's account were named in an e-mail Molnar sent to the traders on August 20, 2009, at 7:19 a.m., listing "rolling CNS fails that need to be covered." Tr. 299-301; Div. Ex. 127.

On September 14, 2009, Feldman, whose account appeared on a CNS 2 list, was notified of this fact at 9:52 a.m. ET, and executed a buy-write for the number of shares needed to cover at 12:35 p.m. ET. Tr. 2014-17; Div. Exs. 195, 196. Zelezney was given a similar notice on September 14, 2009, at 9:54 a.m. ET, and "Bought to Cover" the same amount of shares and sold the same number of contracts on September 14, 2009, at 11:53 a.m. ET. Tr. 2018, 2021; Div. Exs. 197, 198.

On August 20, 2009, Payne e-mailed Molnar, with a copy to Strine, asking, "Can we continue to place these orders as buy-writes? Buy to cover the stock and sell to open the calls as one order. The fills came back immediately today." Tr. 303-07; Div. Ex. 131. On the same day, Payne also e-mailed Phillip Hoeh (Hoeh), CCO, asking whether Zelezney and Feldman could "continue these buy writes at the open, or do the trades have to be separate? If they can't place buy-writes, the trades they're doing are worthless."[32] Div. Ex. 105. Strine quickly responded to Payne:

> I don't know if anyone else responded, but the answer is absolutely not. We do not want to be an active party in the call transactions. We are fulfilling our obligation to issue the buy-in. If we process the buy-write, regulators could consider the buy-ins as sham transactions.

Tr. 1929-31; Div. Exs. 104, 131. Strine then e-mailed Hoeh on August 20, 2009:

> I responded to his question about doing the buy-writes. I told him the answer is absolutely not. We do not want to be an active participant in the call trade. They will need to do that trade on their own. I believe that if we do the buy-write for

[32] Hoeh became the CCO in March 2009 when Ben Morof left the firm. Tr. 3280. He was not an attorney. Tr. 3391. Hoeh entered a settlement with the Commission. Peter J. Bottini, Exchange Act Release No. 66814 (Apr. 16, 2012), 103 SEC Docket 53204.

> them, auditors will consider them sham transactions as the SEC did with the two fined prop trading institutions.

Div. Ex. 105. Strine testified that he did not believe the buy-writes violated Rule 204, but he gave this advice because he is a conservative compliance officer and was concerned that FINRA would not understand and view it differently. Tr. 3380-81, 3388.

On August 20, 2009, Hoeh e-mailed Payne that it is generally accepted that buy-ins that occur within the first thirty minutes of trading are considered to be at the "beginning" of trading hours, and optionsXpress must execute the buy-in at the opening for the amount necessary to cover the fail; the customer then can do whatever other transaction they want, but it is an earlier, separate transaction.[33] Tr. 3385-86. Hoeh's e-mail was in response to Payne's e-mail earlier on the same day. Tr. 1934.

Payne informed Strine on August 20, 2009, that he had gotten the same answer from Hoeh and "unfortunately this will close the customers down, but it's the law." Div. Ex. 109. Strine testified that he understood Payne's reference to the law to be optionsXpress's policies, not Rule 204. Tr. 3391. Payne testified that after Compliance (Hoeh and Strine) provided this advice, there was a meeting where it was decided that buy-writes were not allowed, followed immediately by a meeting among Bottini, Coronado, and Hoeh, where it was decided buy-writes were allowed, but required separate orders. Tr. 1950-51. Payne testified that he does not believe that buy-writes continued after August 20, 2009, because the transaction was placed as two separate orders. Tr. 1958-61, 2047.

Molnar responded to Strine regarding Payne's August 20, 2009, e-mail on September 23, 2009:

> BTW, I knew you had already addressed this. I also remember Phil [Hoeh] asking me around the same time. I believe you were working from home that day. When we were talking Gus [Payne], Jeremy [Coronado], and Pete [Bottini] came over, and Phil basically said the same thing. Cannot cover a short as a buy write. The orders must be placed separate. Don't want to get anyone in trouble, but somewhere down the road this is going to bite us . . . like not asking for a review on a possible TD.
>
> Maybe you should touch bases with Phil to get his interp of the conversation.

Div. Ex. 131. Molnar did not consider that this information from Compliance impacted his responsibility to provide the Trading Desk with the list of securities to be bought in. Tr. 303, 327-28. Molnar is emphatic that it was not Clearing's responsibility to determine if a customer's

[33] The transcript references Div. Ex. 60 as Hoeh's August 20, 2009, e-mail. This is not the material in the official record as Div. Ex. 60, but is in the material I was given during the hearing.

trading strategy complied with the rules and regulations or whether the use of buy-writes to close out failure to deliver positions complied with Reg. SHO. Tr. 328.

Strine testified that after this e-mail exchange with Molnar on September 23, 2009, he learned from Hoeh of Bottini's position that best execution required optionsXpress to bundle the buy and the write. Tr. 3397. optionsXpress defines best execution as "using reasonable diligence to determine the best market to buy or sell a security and obtaining a price as favorable as possible under prevailing market conditions." Tr. 3398; OPX Ex. 102. optionsXpress would enter a buy-write for purposes of best execution, but consider the buy-write as separate transactions. Tr. 3397.

On August 20, 2009, Payne sent to trading specialists Tom Gemmel, Kurzatkowski, Benson, and Snyder, with copies to Coronado, Stella, and Gallery in Executions, an e-mail titled, "Buy ins for Feldman, Zelezney."

> Compliance is telling us that buy writes can no longer be used to cover a buy in. We must place the orders separately. Since this will ultimately shut down these orders, we can place them another way. I will have ops include all of us in the buy in email. Execution will put in market orders to cover the shares at the open. All we require the customer to do is call in and place a <u>not held</u> option order with execution. The outcome will basically be the same, but two separate orders will be in customers account, which the SEC wants to see.
>
> Feldman and Zelezney have been notified.

Tr. 1953-57, 1960; Div. Ex. 106. In an August 19, 2009, e-mail sent to Feldman, Payne stated that Compliance decided that the stocks on the perpetual buy-in list would be received before the opening; the orders must be placed prior to the market open so they are executed immediately, and that calls that had been attached to these orders will have to be placed separately. Tr. 1966-68; Div. Exs. 58, 204. Payne assured his superiors that he spent a lot of time with the large customers – Feldman, Nielson, Kolocouris, and Zelezney – and their buy to cover orders went smoothly. Tr. 1969; Div. Ex. 204. Feldman responded with a request for the Commission rule that required the change and the following comments:

> . . .
>
> U mention MTLQQ. That sounds ridiculous, as I've been short for 2 months and have had maybe 4 buyins for small amts (until 20k today). So what makes a stock go on that [perpetual] list? Some overzealous compliance person?
>
> 6) doing the buy-writes is crucial to maintain the neutral hedge. Separating them creates mkt risk for you and the client. If a stock (like C or AIG) has a routine buy-write price (like .01 or .02) that is routinely accepted limmediately (sic), the (sic) is no reason on this earth why that shouldn't be allowed. So I assume that will be allowed still as long as there's a fill?

> If you guys don't want my $250k/yr or (sic) commissions then of course just say so.
>
> . . .

Tr. 1969-71; Div. Ex. 58. Payne replied to Feldman on August 20, 2009, provided a link to the Commission's short sale rule, and stated that "[b]asically they have told us our practices our (sic) not consistent with the rules, and that changes must be made." Tr. 2237; Div. Ex. 58. Payne informed Feldman:

> By shorting options deep in the money, to get assigned, your trade date position stays constant, and the settled position never closes or goes long.
> As long as we have a fill we can continue to work your orders, but we have to get them filled at the open."

Tr. 1975; Div. Ex. 58. Payne agreed that a stock position that never closes is never removed and the opposite of never going long is always going short. Tr. 1975-76.

Also on August 19 or 20, 2009, optionsXpress stopped calculating T+4 for securities on the perpetual failure list and initiated a procedure of buying in shares of securities that were frequently on the buy-in list and were hard to borrow on T+1. Tr. 237, 441-42, 446, 1698, 3374; OPX Ex. 518. Strine testified that optionsXpress bought in every short position in all accounts on T+1, even though the requirement was to deliver on T+4. Tr. 3376-79. Feldman testified that in August 2009, optionsXpress changed its policy and a customer who was assigned had to buy the full amount of securities on the CNS 1 list, even if the assignment was for a partial amount, and optionsXpress had shares to borrow. Tr. 2457.

Stern testified that optionsXpress implemented buy-ins on T+1 for operating efficiency, not because it was required to do so. He also testified that at the request of Adam DeWitt (DeWitt), CFO of optionsXpress Holdings, he investigated and found a lot of optionsXpress's new capital requirements came from buying in assignments that resulted in fails. Tr. 1835-37. As a solution, Stern recommended buying in on T+1, which was accepted. Tr. 1837. According to Molnar, after August 2009, "if we had a continuous fail in a certain security and it was caused by an assignment, [optionsXpress] would automatically on T+1 just buy-in the amount of the assignment." Tr. 313. Buy-ins at T+1 reduced the computer problems that Molnar blamed for optionsXpress's T+4 violations.[34] Tr. 352-53. optionsXpress's implementation of T+1 for buying in certain customer accounts in hard-to-borrow securities did not have any effect on the CNS Accounting Summary. Tr. 507. A buy-in on T+1 would not settle until T+1 plus 3, or T+4, and the short would appear on the Accounting Summary every day until T+4. Tr. 444-45, 501. When optionsXpress used T+1 to buy in certain securities, the buy-in notice Clearing sent

[34] Molnar did not agree that this resulted in Reg. SHO violations. Based on his conversations with Compliance, he believed there was no violation where technical problems beyond the broker-dealer's control prevented timely execution and the broker-dealer acted as quickly as possible to execute orders. Tr. 352.

to the Trading Desk had different accounts than what appeared in the Accounting Summary. Tr. 445-46. According to Tortorella, "once [optionsXpress] started buying the T+1 thing for the chronic offenders, there were many, many instances where we were closing out far more shares than we were short CNS for that morning." Tr. 511. However, a customer was only sent a buy-in notice when there was a failure to deliver shares to CNS. Tr. 512

On August 31, 2009, a customer wrote to Strine complaining about the speed in which the buy-in was accomplished in his account without affording him an opportunity to close out the position himself. Tr. 2006-13; Div. Ex. 107. Another customer who complained about lack of notice before the buy-in occurred on September 15, 2009, was told that optionsXpress was following Commission regulations regarding short selling. Tr. 2022-26.

On August 3, 2009, Payne e-mailed Feldman a list of buy-ins for five securities. Div. Exs. 278, 281. Feldman responded in part, "I don't understand – I have 750,000 long [Citi] "when issued" shares. The preferred xchange finished last week. Why can I not use the c/wd to cover MY short position?" Id. Tortorella e-mailed Feldman:

> I know this seems unfair to you, but we are acting as we are required per SEC Rule 204, which I have attached for you. We are short settled shares in [Citi]. The [when issued] shares stopped trading after Thursday and it0,s [sic], three day settlement after that, regardless of the original trade date. We cannot apply the [when issued] shares against your short until they settle into [Citi].[35]

Tr. 428-30; Div. Ex. 278.

> Feldman responded in part:
>
> I should be able to "borrow" or "short" (sell) [to be delivered stock] today, since u have a "locate" on them for sure.. as I will have clear/delivered tomorrow? (Just as when I "cover" my buyin shares today, they don't really settle for 3 days too, right?)
>
> I suspect you will explain why I can't. (Unless I'm on to something.).
>
> If that is the case, I would have to cover the short today, and create an offsetting trx by virtue of further selling AUG 1 Calls to maintain my neutral position, which I have maintained all along. (Which will cost me at least .01 per share in round trip costs). I am requesting that, as a gesture for all this, (and the > $120,000 in commissions I have paid towards all this), that o.x allow me these last trades commission-free.

[35] Feldman wanted to avoid a buy-in on Citi by using his Citi "when issued" shares. Tortorella refused because those shares "didn't exist until they are merged in with the common symbol" and to do so would violate the rules. Tr. 484-85.

Tr. 431; Div. Ex. 281.

On August 5, 2009, the Commission issued two settlements involving alleged violations of Reg. SHO. Hazan Capital Management, LLC, Exchange Act Release No. 60441, 96 SEC Docket 19539; TJM Proprietary Trading, LLC, Exchange Act Release No. 60440, 96 SEC Docket 19529. Stella learned of Hazan on September 23, 2009, at 8:16 a.m., and he forwarded excerpts and a link to the Commission's administrative proceedings release to Coronado and Bottini.[36] Tr. 1146-47. On September 23, 2009, Stella e-mailed Bottini and Coronado the following excerpts from Hazan:

> 3. The second type of transaction - referred to herein as a 'reset' - a transaction in which a market participant who has a 'fail-to-deliver' position in a threshold security buys shares of that security while simultaneously selling short-term, deep in-the-money (footnote omitted) call options to - or buying short-term, deep in-the-money put options from - the counterparty to the share purchase. The purchase of shares creates the illusion that the market participant has satisfied the close out obligation of Reg. SHO. However, the shares that are apparently purchased in the reset transactions are never actually delivered to the purchaser because on the day after executing the reset, the option is either exercised (if a call) or assigned (if a put), transferring the shares back to the party that apparently sold them the previous day. This paired transaction allows the market participant with the fail-to-deliver position to effectively borrow the stock for a day, in order to appear to have satisfied the close out requirement of Rule 203(b)(3).
>
> 4. . . . Because HCM improperly failed to borrow or arrange to borrow securities to make delivery when delivery was due, the short sales (footnote omitted) were 'naked' short sales that violated Reg. SHO.

Div. Ex. 108.

Strine considered the factual situation in the published cases as inapplicable to optionsXpress's conduct.[37] Tr. 3343-48; OPX Ex. 678. Strine informed Hoeh, Ned Bennett

[36] Hazan defines a "naked" short sale as where the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period and thus fails to deliver. Hazan, 96 SEC Docket at 19541 n.5.

[37] On July 20, 2007, the American Stock Exchange LLC (AMEX) issued two decisions: Scott H. Arenstein, AMEX, Disciplinary Panel, Case No. 07-71 and Brian A. Arenstein, AMEX Disciplinary Panel, Case No. 07-174. Scott H. Arenstein refers to buy-writes on page five of the Stipulated Facts and Consent to Penalty as an example of transactions used to circumvent the obligation to deliver securities. Brian A. Arenstein includes buy-writes among the transactions used to avoid the delivery obligation in footnote 12 on page four of the Stipulated Facts and

(Bennett), CEO optionsXpress, Hillary Victor (Victor), and Shuja Kahn (Kahn), a compliance officer, that "[t]he end result in all situations [Hazan, TJM, and optionsXpress customers] is similar: the shares are bought in, but the subsequent exercise or assignment of the option that night results in a continuation of the fail."[38] Tr. 3352; OPX Ex. 678. Strine testified that his reference to a continuation of the fail was to a continuous fail to deliver to the CNS system and not any individual trade not settling. Tr. 3354. Strine told Stella that the activities in Hazan resembled what optionsXpress customers were doing, the firm had to note it, and the Hazan settlement could be found by searching "sham buy-ins" on the internet search engine, Google. Tr. 1141-43.

On September 23, 2009, Coronado informed Bottini that he was not placing any orders that day because the strategy employed in Hazan appeared similar to the trading strategies of optionsXpress customers. Tr. 543-45, 616-17, 1141; Div. Ex. 35. On the same day, at 8:29 a.m., Bottini advised Coronado and Stella to execute the buy-ins and customer orders and represented that Compliance had reviewed Hazan, was not convinced it was applicable, had asked FINRA for an opinion but had not received it, and that "we" would meet again and reconsider. Tr. 618-19, 1148, 1210; Div. Exs. 35, 149. Later, Bottini and Hoeh told Stella and Coronado to continue processing trades because their customers were in a different situation than Hazan. Tr. 1210-12. They also discussed that the motive for pairing the buy-in and the options order was to get the customer the best possible price, i.e., best execution. Tr. 1219. Stella had no further conversations with Strine about Hazan. Tr. 1220.

On August 9, 2009, at 9:40 a.m., Tortorella sent the Trading Desk a buy-in notice.[39] Tr. 407-08; Div. Ex. 140. Payne responded, "From the list today, which one's would qualify as perpetual buy ins?" Tortorella named two securities out of the twelve listed and added "a little bad news would probably clinch it."[40] Tr. 409; Div. 140. Payne then inquired, "What qualifies as a perpetual buy in?" Tr. 408; Div. Ex. 140. Tortorella answered:

> Always short, covers your buys by [selling] short options deep in the money, so if they get assigned. More or less, their trade date position stays constant, settled position never closes or goes long. Do we need to get a meeting together?

Consent to Penalty. Scott H. Arenstein is in evidence as Div. Ex. 121. I take official notice and make part of the record the decision in Brian A. Arenstein. See 17 C.F.R. § 201.323.

[38] Victor was an in-house counsel at optionsXpress. Tr. 1757. She is no longer with the firm. Tr. 3545.

[39] Tortorella acknowledged that this buy-in notice occurred months after Reg. SHO took effect. Tr. 442-43. He testified that he did the best he could every day beginning at 6:40 a.m. to compile the list of securities that needed to be purchased and other buy-in notices not in evidence were sent before the market opened. Tr. 443.

[40] Meaning if there was bad news, short sellers would likely make it hard to borrow. Tr. 409.

Tr. 408-11; Div. Ex. 140.

On August 10, 2009, at 9:10 a.m., after the market opened, Tortorella sent an e-mail titled "CNS fail buy-ins" to Benson and others. Tr. 285-86, 396-97; Div. Ex. 126. Molnar followed up with an e-mail at 9:20 a.m. to Mike Kemp and Tortorella stating:

> We need to get better with getting this to the trade desk. Mike, please make sure these guys get answers to us within 5 minutes of when you send the borrows to them. We need to have our short cover buy-in email to the trade desk before the market opens.
>
> . . .
>
> I know that the SEC is coming down on some firms, and this is a hot topic for them. So we need to get the list out to prevent the SEC or any other regulator to come in and fine us because of a tardy buy-in cover.

Tr. 286; Div. Ex. 126.

Snyder and another optionsXpress employee engaged in an Instant Message stream on August 13, 2009, initiated by a request to increase the quantity from 500 contracts for "Feldman's friend."

> Thank you. You can see he wants to put on a box. He is selling deep calls and puts.
>
> yeah we are all too familiar with his strategy
>
> It's a keeper fosho.
>
> Gus is excited about this guy.
>
> ohhh im sure
>
> it kinda makes you wonder who is running the eastern savings bank when all the vp's are tied up trading boxes full time. . .
>
> Why would anyone move their account here to do these. We get bought in a ton and our commissions are not cheap. Nice
>
> must me a nice gig
>
> Fantastic
>
> well feldman managed to make a ton even on top of comms but yea

pennies add up.

true

Tr. 1943-46; Div. Ex. 57 at 46, 62-63.[41]

Payne, Kurzatkowski, Benson, Coronado, and Stella notified customers of buy-ins and worked with the "big names" – Feldman, Kolocouris, Nielson, Gentry, and Zelezney – to execute buy-writes.[42] Tr. 601-04, 1116-20. During the relevant period, when optionsXpress's big name customers were notified they were the subject of a buy-in notice, they requested Coronado and Stella to enter a "buy-write" transaction which combined the purchase of hard-to-borrow shares with writing in-the-money calls for the same or similar amount of shares, which were assigned daily. Tr. 523-28, 536-37, 541, 1116-19; Div. Exs. 253, 303. Stella testified that he received a copy of the e-mail to the customer that a buy-in would occur, and in response, the customer would place separate orders that were paired together to make a buy-write. Tr. 1119-20. He also testified that when he saw the buy-in notice to the customer he would begin to "build" the buy to cover order into the customer's account.[43] Tr. 1126-28. Stella testified that two separate orders were paired for best execution. Tr. 1116-17.

On September 3, 2009, Payne e-mailed that he and Kurzatkowski would be out on Friday, that Coronado will contact the "big names," and that Benson should place market orders at 8:25 a.m. to cover the other names on the CNS 1 list and then send the normal e-mail notification. Payne stated that the customers on the CNS 2 list should be covered, and then e-mailed the share amount and price. Tr. 601-05, 1987; Div. Ex. 61.

Coronado was Feldman's main contact at optionsXpress and they had many conversations. Tr. 637. On October 22, 2009, at 5:26 a.m., Feldman e-mailed Coronado, "Gmorning. Can do the same today re [Sears] as yest re buy writes. Same applies tomorrow (Fri.) too. Thx." Coronado responded at 11:58 a.m., Greenwich Mean Time (GMT). Ok I got it." Div. Ex. 303. Coronado testified that he required Feldman to call in with an order following that e-mail exchange. Tr. 630.

Feldman wrote in an e-mail to Bottini on November 30, 2009:

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[41] The quoted material appears at Div. Ex. 57 at 63 in the copy of the exhibit given to me at the hearing, which was allowed into evidence. Tr. 1950. The underlined language has been cut off in the copy of Div. Ex. 57 furnished to the Office of the Secretary.

[42] Coronado, Stella, and Gallery were execution traders. Tr. 1106. Feldman, Zelezney, Nielson, Kolocouris, and others asked Coronado about the "open interest of particular strike price call option contracts." Tr. 534.

[43] Build an order refers to inputting orders manually because buy-write orders were not done electronically. Tr. 1889-90.

> In fact, I usually give 'standing orders' to Jeremy, and don't even talk to him each day. In fact, he then places one order with the : 'liquidity provider', and that order (in the instance of [Sears] for example), is to someone to whom I referred him, and combines the buy-writes for your other customers too (especially in [Sears], where I know fr the volume and fr other means that you have another big customer who does > 1,000 per day , and was doing > 2,000 per day until Nov expiration.)."

Div. Ex. 72. In reference to his "standing order" statement, Feldman testified that he and Coronado understood each other's lingo that there is a standing order and he might have called and left an early morning voicemail or talked to someone else. Tr. 2248-52. Feldman testified that optionsXpress did a buy-write without a phone call maybe once or twice. Id.

Coronado testified that when he received a buy-in notice for a customer like Feldman, he would enter a purchase order into his computer but would wait to send it to the exchange until he spoke with Feldman and received from him the strike price and expiration date he wanted to use for the call. Tr. 549-50. Coronado testified that Feldman called in each day and placed an order. Tr. 627-28. According to Coronado, he never advised customers to satisfy their buy-in obligation by using buy-writes, buy-writes are used commonly in the securities industry, and there are no rules or regulations that prohibit them. Tr. 632-34. Coronado testified that buy-writes are traded in the open market and executed on numerous exchanges including the CBOE, AMEX, and ISE. Tr. 634-35.

Stella testified that originally optionsXpress's system could not handle a buy to cover for a stock transaction simultaneously with a sell to open for a call transaction as one ticket order. Tr. 1122-23. He would write two separate order tickets. Tr. 1123. Most buy-writes were placed with floor brokers with directions not to send to an exchange. Tr. 1124-25. Stella testified he used floor brokers to prevent duplicate trades and to get the best price. Tr. 1128-29. Not using an exchange also allowed time to group orders in the customer's account. Tr. 1129-30.

After a conversation with Feldman or another customer, Stella would transmit the buy-in and buy-write as a single package to a floor broker or PrecISE.[44] Tr. 1135. There was one order for the buy-write. Tr. 1136. PrecISE trading would have been quicker, but optionsXpress would not know if the buyer would take the other side of the buy-write. Tr. 1136-37. At some point during the relevant period, Coronado and Stella moved all their buy-write transactions to On Point. Tr. 1138-39.

[44] In July 2009, the PrecISE complex order book had resting orders to take the other side of Feldman and Zelezney's buy-writes, which appeared every day. Tr. 1159-60; Div. Ex. 146. Resting orders refers to the fact that the market maker was ready to take the other side of Feldman's trade, which would cost Feldman a penny a share. Tr. 1200.

In the relevant period, John George Lapertosa, Jr. (Lapertosa), managing partner of On Point, received from Coronado and Stella, orders that were packaged as buy-writes, often for between 50 to 10,000 contracts that had strict limits.[45] Tr. 1250-51. Buy-writes are common but Lapertosa found these a little odd because the strike price was very deep-in-the-money, they occurred every day, and they were right around the open interest. Tr. 1254-56, 1266. Most, if not all, of the orders were limit orders for hard-to-borrow securities.[46] Tr. 1255, 1260. On Point brokered a lot of optionsXpress's buy-writes with one market maker, Integral Derivatives, which sold the stock and bought the calls.[47] Tr. 1261-63. On Point did not charge optionsXpress commissions but charged for clearing and made commissions where it found liquidity. Tr. 1337-38. On Point could not handle a separate stock purchase because it was an options broker; the buy-writes came as packaged orders. Tr. 1256.

No one at optionsXpress complained to Lapertosa as to the time buy-writes were getting filled, and Coronado did not directly tell Lapertosa that the buy-writes had to be done first thing in the morning. Tr. 578-80, 1271. Typically, optionsXpress would give On Point a buy-write order in the morning or "somewhere after the morning." Tr. 1342. On January 14, 2010, On Point received buy-write orders from optionsXpress at 9:52 a.m. and 12:40 p.m. and Coronado advised an execution clerk at On Point, who apologized at 11:11 a.m. for taking so long to accomplish a buy-in, to take his time. Tr. 578-79, 1272-76; Div. Ex. 90. On February 2, 2010, a Sears buy-write occurred between 12:38 p.m. and 1:39 p.m. Tr. 1282; Div. Ex. 91. When On Point acknowledged on February 2, 2010, at 3:36 p.m. that the buy-writes have been coming over later and later and offered to do them first thing if needed, Coronado replied at 3:42 p.m., "[I] need to get them done as close to the open as possible, but if your (sic) swamped [I] understand. [I] know its tedious work." Div. Ex. 91; Tr. 575, 1271. Lapertosa testified that he remembered one instance where On Point was a little late in executing the buy-writes, they were executed around 11:00 or 11:30 a.m., and Coronado asked him to try his best to get them filled as close to market open as possible. Tr. 1271. Coronado did not give Lapertosa a reason why the buy-writes had to be executed at market open or any other indication that the buy-writes had to be executed at a certain time of day. Id.

After August 20, 2009, Stella would build a stock purchase order into a customer's account when he received a buy-in notice, but he would not send the order to an exchange until the customer called in with an options order, which he would pair with the purchase order and send as a buy-write to PrecISE or a floor broker. Tr. 1165-66. The evidence is confusing but it

[45] On Point, an agency-only options broker-dealer, conducted most of its business from the floor of the New York Stock Exchange (NYSE). Tr. 1235-36. Lapertosa began the firm with three partners in 2004. Tr. 1238. As an American Stock Exchange, now NYSE, broker-dealer, On Point can only deal and communicate with institutional clients. Tr. 1240.

[46] A market order is executed right away at the best possible price. Tr. 1257. A limit order is price sensitive and is only executed when the customer's limits are met. Tr. 1257-58.

[47] Integral Derivatives appears to have exercised the deep-in-the-money calls the day after it purchased them. Tr. 1268-70, 1345.

appears that Payne's method of getting around the requirement of two separate orders was to have customers place a "not held" option order. According to Stella, a "not held" order gave the broker discretion on price and time of execution, but because the buy had to be executed immediately in this situation, the "not held" only applied to the price of the option, not the time. Tr. 1204, 1227-29. According to Lapertosa, a "not held" order, like a market order, gives the executing broker the freedom to exercise his ability to execute right away at the best price. Tr. 1257-59. Payne sometimes assisted Stella with building the buy-in order in a customer's account. Tr. 1178-79.

Stella testified that the optionsXpress traders needed "discretion in terms of price what the option was going to print at, because we didn't know what the stock was going to print at. To match it up with that penny over we needed price discretion." Tr. 1229. I take this to mean that optionsXpress did not execute the buy-in quickly because it needed to know the price of the stock to match it up with the option contract to get a penny over the parity price for the buy-write. Tr. 1228-29. The stock purchase and option (buy-write) continued to be placed as one transaction to get the best available price. Tr. 1204, 1227. According to Stella, if the orders are not paired, the customer risked "getting legged out and paying a lot more to re-establish his hedge." Tr. 1204. Stella testified he always considered the buy to be an optionsXpress order and the write to be a customer order, and he would not have held up a buy order waiting for a customer to write a call option. Tr. 1205.

Feldman would e-mail his buy-write orders directly to the Execution Desk when optionsXpress's policy required two separate orders, but Stella testified he did not consider them official orders. Tr. 1166. However, before and after optionsXpress's policy required two separate orders, Stella sent one order for buy-writes to PrecISE or to a floor broker. Tr. 1167-68.

On August 26, 2009, Coronado e-mailed persons at Merrill Lynch:

> I have been executing some large buy-write transactions for our customers in AIG. I (sic) appears to me that you may be on the other side of these transactions.
>
> What I have been doing is buying stock and selling deep in the money calls. It appears to me that you or one of your customers have loaded the book up on the [International Stock Exchange] on the sell side of these buy-writes for a penny edge.
>
> What I was trying to achieve here is find out who is on the other side of my transactions and see if we can find a better way to coordinate these transactions. I might have more business other than AIG that may interest you or your customer.

Div. Ex. 327. Coronado did not receive a response to his attempt to find liquidity and a better price for his customer. Tr. 626.

Benson e-mailed Stella on August 31, 2009, at 9.32 a.m. CT, stating "Subject: Buy in, [Neilson's account] 500 Wants to do it with the options try for a penny over with the options," referring to a buy-write. Tr. 1168-74, 2000-01; Div. Ex. 200. Earlier that day, at 14:05 GMT,

10:05 a.m. ET, Tortorella sent a CNS 2 list to Payne, Benson, and others.[48] Tr. 1994; Div. Ex. 199. optionsXpress e-mailed Nielson on August 31, 2009, that his account had bought 500 shares of FAS at 12:32:13 p.m. ET and had sold five FAS option contracts at 12:32:32 p.m. ET.[49] Tr. 1173-75, 2001-02; Div. Ex. 201. Stella testified that he likely filled the orders at 10:30 or 11:30 a.m. and the execution times were incorrectly noted. Tr. 1176-77. He acknowledged that the two transactions were traded as a buy-write, which occurred after the market opened. Tr. 1175-77.

In early October 2009, optionsXpress was buying in the same four customers almost every day: Feldman, Nielson, Zelezney, and Kolocouris. Tr. 415-16; Div. Ex. 290. Tortorella was aware that the short positions were occurring because of options assignments. Tr. 437, 439. On October 9, 2009, Stella acknowledged an e-mail from Payne, with the subject "Buy writes 10/9," that stated, "Market orders are built for all accounts [Zelezney, Gentry, Nielson, and Feldman] and marked 'Do not send exchange.' Customers will be calling in orders for the options." Div. Ex. 151.

Payne sent Feldman an e-mail on December 4, 2009, at 7:49 a.m., informing him that optionsXpress was buying him in in three securities. Div. Ex. 28. Feldman responded at 8:33 a.m., "Last week when we xferred SHLD, it was 3 days till I had to buyin (due to new position (T+3). Is that not the case w the new SHLD and MJN?" Id. Payne responded at 8:38 a.m. "That was my understanding as well. Scott T would have more info regarding the settlement." Id. Feldman then e-mailed Tortorella at 8:42 a.m., "When I got new SHLD positions fr TN a week ago, I had 3 days till buyins. Wouldn't it b the same here w new MJN + SHLD?" Id..

Tortorella responded at 8:58 a.m.:

> Your 250,000 SHLD shares settled on 12/2. I waited until yesterday morning, T+4, to start having you bought in. You have not cleared your settled position in MJN, where we have been buying you in on roughly 220,000 shares for the past four days, so any increase in your short is being bought in as well. If you continually roll your position, we need to buy in, in total. This would apply to the increased SHLD, also.

Id. Feldman replied, still confused, and elicited a detailed e-mail from Strine, which states in part:

[48] Payne refused to agree that the "big names" were called in advance of the buy-ins if their names appeared on CNS 2 list. Tr. 1994-97.

[49] Payne does not consider this to be a buy-write because there were two separate orders. Tr. 2002-03. Later he testified that they were separate transactions because there were two different order numbers and different securities. Tr. 2055-56.

> [I]n this new era, with the implementation of the SEC's Reg. SHO Rule 204, we have to be much more proactive. The MJN situation involved a new position, and new fail. That triggered our Reg. SHO Rule 204 response on T+4. With the SHLD and the additional MJN shorts, however, we are experiencing persistent fails. Because of that, we must take action every day.
>
> With the initial short position (resulting in a fail to deliver) of MJN, Rule 204 was triggered, requiring us to make delivery of those shares on T+3. Because we weren't able to make delivery on T+3, the rule required us to issue the buy-in on T+4. Until that fail to deliver is completely cleared up, we are prohibited from allowing any additional short sales in that security. Option assignments pose an interesting dilemma under the rule. With an assignment, we cannot prohibit the short sale, so when an assignment results in a short sale in a security we are already failing to deliver, we have to take action to clean up the entire fail immediately. That is why we cannot wait until T+4 on the "add-on" positions, but must issue the buy-in today for your entire short position.

Id. Tortorella brought Strine into the e-mail exchange because Clearing did not usually communicate with customers and he wanted Compliance involved on a potentially sensitive issue. Tr. 488. Tortorella agreed with the information Strine provided Feldman. Tr. 489-90. Feldman thanked Strine for the thorough explanation and asked if they could talk as he wondered "if there might not be some different strategies [he] could use to avoid buyins, or 'restart the clock' sometimes." Tr. 3461-62; Div. Ex. 28. At the hearing, Strine denied that he interpreted Feldman's inquiry as looking for advice on how to do sham transactions, but during the investigation that was his interpretation. Tr. 3471-75. Stern testified that prior to the hearing he had not seen that e-mail from Strine to Feldman. Tr. 1726-27; Div. Ex. 28.

On March 4, 2010, optionsXpress was 214,189 shares short, or owed the CNS system 214,189 shares of Sears, as of the opening.[50] Tr. 53-54; Div. Ex. 18. During the day, optionsXpress increased its short position in Sears by a net 13,600 shares, and when CNS closed its books for the day, its closing position was 227,789 shares short.[51] Tr. 55-56; Div. Ex. 18. The market value of those shares was approximately $21.9 million. Tr. 62; Div. Ex. 18. As of March 4, 2010, optionsXpress had been short or had failed to deliver Sears stock to CNS for settlement on 228 consecutive settlement days. Tr. 57, 96; Div. Ex. 18. The participant's view of the Accounting Summary that optionsXpress received did not have the age column, but for 228 days the open position column would have had a negative number. Tr. 68-70, 244.

[50] optionsXpress's number in all CNS documents, including the Accounting Summary, was 338. Tr. 50-51; Div. Exs. 18, 54.

[51] The closing position was generated from the opening position and netting of new settlements. Tr. 94-95.

In March 2010, optionsXpress stopped allowing Feldman and others from doing buy-writes to cover buy-ins. Tr. 597, 1187, 2644. The decision appears to have been made by DeWitt, Bottini, and Hoeh, with consultation from Stern, who believed if the firm wanted to stop, it should. Tr. 1769-70. Strine testified that the Commission told optionsXpress to stop allowing buy-writes to cover assignments. Tr. 3441. On March 24, 2010, Strine directed Molnar and Tortorella that orders to buy-in shares must be sent for execution alone and new restrictions applied to trading in hard-to-borrow securities with "persistent fails." OPX Ex. 485.

Chicago Board Options Exchange

CBOE was founded in 1973. Stern and Strine considered it to be optionsXpress's primary SRO regulator. Tr. 1842, 3308-09; OPX Ex. 250 at 6. On August 9, 2007, CBOE issued Regulatory Circular RG07-87, subject "Short Sales, Regulation SHO Requirement to Close-out Short Positions in Threshold Securities," which stated in part:

> According to Regulation SHO, purchases to close-out fail to deliver positions in threshold securities must be bona-fide purchases. In this regard, the purchase of stock paired with one or more short-term option transactions, such as, but not limited to, a one-day FLEX option, that is designed to create the appearance of a bona fide purchase of securities, but that is nothing more than a device to improperly reset the close-out date, would not satisfy Regulation SHO's close-out requirement.
>
> Regulation SHO expressly states that the close-out requirement is not deemed to have been fulfilled where the person responsible for the close-out enters into an arrangement with another party to purchase securities as required by Regulation SHO, and the party responsible for close-out knows or has reason to know that the other person will not deliver securities in settlement of the purchase.
>
> . . . .
>
> The Exchange strongly cautions members that . . . pairing the close-out with one or more short-term option positions that are utilized to reverse the close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement.

Div. Ex. 124 at 1-3. CBOE issued another Regulatory Circular (RG08-63) on May 19, 2008, stating that transactions that are a device to improperly re-set the close-out date are unacceptable, but that transactions pairing options with stock may be used as part of general trading/hedging strategies. Div. Ex. 129 at 5.

CBOE's Investigation of Zelezney's Trading in January-February 2009

CBOE investigated transactions in a hard-to-borrow stock in Zelezney's[52] accounts at optionsXpress for the period January 1 through February 28, 2009, because market makers were concerned that as counterparties they might be a part of violations. Tr. 3818, 3916-17, 4028-29, 4031; OPX Ex. 122. Hoeh, Molnar, and Strine, met with Timothy MacDonald (MacDonald), Director Market Regulation at CBOE, and Daniel Overmyer (Overmyer), CBOE chief investigator, on April 30, 2009, to explain, among other things, optionsXpress's buy-in practices.[53] Tr. 3332-34; OPX Exs. 34, 72.

In connection with the Zelezney investigation, Overmyer recalls making several inquiries to the Commission's Division of Trading and Markets (Trading and Markets) beginning in May 2009 because CBOE did not have jurisdiction over Zelezney, a customer, who CBOE thought might have violated Rule 204T.[54] Tr. 3848-49, 3920. Overmyer communicated with Josephine Tao (Tao) and Victoria Crane (Crane) several times and sent them a detailed memo on June 16, 2009, outlining his concerns because they did not seem to grasp what CBOE was trying to explain to them, which was that "Zelezney's activity appears to be evading 204T that prohibits the inability to legitimately deliver the stock," because no stock was being delivered as a result of his trades.[55] Tr. 3851-64, 3931-33; OPX Ex. 565. Overmyer testified:

> I saw as a problem that you have a fail to deliver, someone does a buy-write, they get assigned on a buy-write, they do another buy-write the next day, assigned, another buy-write, another assignment. It's just continual. I mean that's, it's a pattern in practice, if you will . . . in my opinion, attempting to avoid a buy-in.

Tr. 3857, 3936-37. Based on information it received from optionsXpress, CBOE told Trading and Markets that optionsXpress did not receive any "CNS buy-ins from DTCC or NSCC" [56] for

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[52] Zelezney is a 1979 graduate of the University of Southern California. He was a stockbroker for sixteen years and worked as a recruiter for several brokerage firms for twelve years. Smith Barney and the Heritage Group both terminated his employment. He has been trading in his accounts for three years. Tr. 4107, 4115, 4153-55.

[53] Stern was invited to the meeting. Tr. 3332; OPX Ex. 72.

[54] Overmyer has two Finance degrees: undergraduate from Quincy University and a Masters from St. Xavier University. He holds Series 3, 4, 7, and 24 licenses. Tr. 3982. Overmyer has worked in the options industry full time for twelve years, including eight years as an options trader and market maker. He joined CBOE in 2007 and left in 2009. Tr. 3811-15.

[55] Tao is an Assistant Director in Trading and Markets. She holds an undergraduate degree in Finance from George Washington University and obtained a Law degree in 1997 from George Mason University. Prior to joining the Commission, approximately twelve years ago, Tao was employed by the Department of the Treasury. Tr. 3581-82.

[56] The options industry, as reflected in the testimony of the witnesses, is not precise in its use of the term "buy-ins." It is used to reference the Accounting Summary that CNS sent to

shares of JOSB, which was the subject of its investigation of Zelezney's accounts. Tr. 4035. CBOE took optionsXpress's response to mean that there were no fails to deliver for Reg. SHO purposes. Tr. 4035-36; OPX Ex. 122.

Overmyer was frustrated because Trading and Markets did not understand CBOE's concerns, and took the narrow view that if there was no failure to deliver by a clearing firm there was no violation of Reg. SHO. Tr. 3859, 3864, 3924, 3929-90, 3961, 3997, 4036. Tao did not understand what Overmyer was attempting to convey, but knew it involved a customer's conduct when her focus was on clearing agents (brokers) subject to Reg. SHO. Tao thinks Trading and Markets told CBOE that a customer cannot violate Reg. SHO, but that there may be fraud involved, and suggested CBOE refer the matter to the Division. Tr. 3644-49.

MacDonald recalls Trading and Markets stating that CBOE needed to look to see if the trading involved fraud, and that, based on the information CBOE provided, optionsXpress did not appear to be involved in a sham close-out in Zelezney's account. Tr. 4036. Overmyer and MacDonald disagreed. They reasoned that the pattern and practice of the buy-writes, where the call was exercised and assigned so that optionsXpress did not have stock to cover the fail to deliver and close out the position, was somewhat of a sham close-out. Tr. 4046-47.

Someone from CBOE spoke with a person in the Division about possible referral of CBOE's investigation to the Division in late July or early August 2009, and on August 5, 2009, Overmyer, with copies to his supervisors, sent a copy of his June 16, 2009, memorandum laying out CBOE's concerns to Eric Ribeline at the Commission. Tr. 3943-45, 3954; OPX Exs. 127, 135.

On September 23, 2009, CBOE issued optionsXpress a Letter of Caution based on activity in the Zelezney accounts from January 1 through February 28, 2009. CBOE found that optionsXpress violated its operational procedures because it called Zelezney before it executed the buy-ins. Tr. 3407-09, OPX Exs. 89, 647. The Letter of Caution stated:

> OptionsXpress apparently violated Exchange Rules 4.2, with respect to the handling of buy-in notices related to three accounts held at OptionsXpress by Mark and Jennifer Zelezney. OptionsXpress conducts buy-ins on the morning of T+4. However, with respect to the Zelezney's a phone call was place[d] prior to the execution of the buy-in, which is a deviation from OptionsXpress's OP's.[57]

OPX Ex. 138. CBOE concluded that there were no Reg. SHO violations in large part because optionsXpress represented that CNS did not report any fails to deliver related to Zelezney's

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participants who have fails-to-deliver on T+3. It could also refer to CNS's formal Intent to Buy-In Notice sent to non-delivering participants. And it is commonly used to refer to what brokers do when customers are short securities in their accounts. Tr. 4089-91.

[57] CBOE Rule 4.2 covers operational procedures and substantive violations. Tr. 3964-65.

accounts. Tr. 4088. According to Strine, optionsXpress changed its procedure and contacted the customer after the buy order was entered and routed, but the evidence shows the pre buy-in calls occurred up until March 2010. Tr. 3410.

On February 3, 2010, Timothy H. Thompson (Thompson), CBOE's Senior Vice President and Chief Regulatory Officer, wrote to Division attorney Jill Henderson (Henderson) concerning Henderson's phone call to Linda Gerdes (Gerdes) at CBOE.[58] OPX Ex. 605. Thompson was disappointed that Henderson was unaware that CBOE had spoken with FINRA or the Commission staff regarding optionsXpress and the Zelezney's activities. Thompson's letter states that in February 2009, CBOE began an investigation regarding optionsXpress and Zelezney's activities and that CBOE was initially inclined to take formal disciplinary action against optionsXpress and to refer the case on the Zelezneys to the Commission until it had a conversation with Commission staff on May 20, 2009.[59] Id.

CBOE Routine Surveillance of Short Sales

In 2009-2010, CBOE conducted surveillance over short sales of options.[60] These were routine surveillances generated by exceptions reports and not comprehensive investigations. Tr. 4018-19. When the automatic surveillance noted that multiple customers were exercising puts or being assigned calls, CBOE sent the clearing broker an inquiry. The routine surveillance identified optionsXpress and thirty-six other firms that had buy-write activity involving deep-in-the-money calls that exceeded the surveillance parameters. Tr. 4702, 4769-70; OPX Exs. 150, 644. On January 20, 2010, CBOE requested that optionsXpress "[p]rovide any fail or buy-in notices . . . received with respect to the securities listed on the attached document" for the period July 1, 2009, through September 30, 2009. Tr. 4761; OPX Ex. 101. On January 28, 2010, CBOE requested that optionsXpress "[p]rovide any fail or buy-in notices . . . received with

[58] Gerdes, Department Head, CBOE Market Regulation (Market Reg.) was MacDonald's superior and reported to Thompson. Tr. 3986; OPX Ex. 605.

[59] Thompson states that persons from Trading and Markets told CBOE that: (1) customers do not have to perform a 'locate' to short a security; (2) as long as the customer does not have a 'fail,' there was no Reg. SHO violation; and (3) the Commission staff felt that the Zelezneys were conducting and maintaining a hedge to their position appropriately. The letter notes CBOE's disappointment that it was unable to pursue this case based on advice from Commission staff and that CBOE stands ready to assist FINRA and the Commission. OPX Ex. 605.

[60] "A short sale occurs in instances in which a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by the appropriate settlement date. If said participant fails to deliver a position to a registered clearing agency, the clearing firm/participant must immediately close out the fail to delivery (sic) position by purchasing or borrowing the security of like kind and quantity." OPX Ex. 644.

respect to the securities listed on the attached document" for the period July 1, 2009, through December 31, 2009. OPX Ex. 164.

Scott Lamm (Lamm), the CBOE investigator in charge of the surveillance operation, believed that the inquiry was satisfied if a clearing firm responded that it had not received any buy-in notices. Tr. 4666-67. On February 11, 2010, optionsXpress informed CBOE that it "[did not receive buy-in notices from CNS for any of the securities identified on the attachment to your letter, dated January 28, 2010," and attached excerpts from its CNS Accounting Summary. Tr. 4668. OPX Ex. 164. Lamm had never seen a CNS Accounting Summary; he did not know whether it had anything to do with a fail to deliver, and did not put much effort into understanding the attachment. Lamm testified, "What does it all matter? They didn't have any buy-ins?" Tr. 4675, 4681, 4695-96.

On February 16, 2010, Lamm sent a request to optionsXpress for the identity of the customers responsible for the trading activity. OPX Ex. 371. In April 2010, optionsXpress responded with a printout that showed numerous buy-writes by Feldman, Gentry, Nielson, and Zelezney from July 2, 2009, through September 17, 2009. OPX Ex. 734. Lamm and MacDonald, his superior, relied on optionsXpress's representation on February 11, 2010, that it did not have any buy-in notifications to close the inquiry. Tr. 4680-81, 4683, 4688, 4690, 4694, 4775. CBOE closed its inquiry because optionsXpress represented no fails or buy-ins were generated. Tr. 4686; OPX Ex. 150. Lamm sent optionsXpress form letters on December 2 and 10, 2010, that no violations were apparent with respect to the materials reviewed in conjunction with this inquiry.[61] Tr. 4682-83; OPX Exs. 151, 152.

Phone Calls with FINRA and the Commission

Yvonne Huber (Huber) and Christina Aylward (Aylward), a FINRA Director and head of the Short Sales Group in Market Reg., and a senior regulatory analyst in Market Reg., respectively, testified that optionsXpress came to FINRA's attention because sweeps showed extended failures by optionsXpress to deliver in three securities - GHL, JOSB, and Sears.[62] Tr. 2680-84, 2802-03.

[61] It appears that there were two inquiries: July 1 through September 30, 2009, and October 1 through December 31, 2009, and optionsXpress responded to both with the February 11, 2010, letter. Tr. 4693; OPX Exs. 150, 644.

[62] Huber holds an undergraduate degree in Business from the University of Richmond and a MBA from Johns Hopkins University. She has been employed by FINRA for over twenty-two years. Tr. 2801. Aylward, a 2007 graduate of Boston College with a concentration in Economics, has worked at FINRA since March 23, 2009, managing from twenty to thirty investigations of broker-dealers for potential violations of Commission and FINRA short sale rules. Tr. 2679-82.

Aylward testified that she contacted optionsXpress because FINRA notifies the dealer when it opens an investigation, assigning the matter a number, and asks questions. Tr. 2692-93. FINRA found the fails to deliver in either JOSB or Sears to be over 120 days, which was among the longer fails that Aylward had seen. Tr. 2685-86, 2696-97. Aylward found that optionsXpress's failure to deliver was caused:

> by an option assignment and when the buy-in was done there would be a subsequent almost simultaneous sale of a deep-in-the-money call option paired to that buy-in. And that deep-in-the-money call option would get assigned at that very day thus perpetuating the fail to deliver position and so it would go on and not close down.

Tr. 2684-85.

On September 23, 2009, while FINRA's investigations were open, Aylward received a phone call from Strine.[63] Tr. 2705, 3411; OPX Ex. 653. Aylward listened and gave no guidance. She did not say "anything along the lines of, keep doing what you're doing," or "anything along the lines that optionsXpress's activities or that of its customers were okay under Rule 204 for closeout provisions." Tr. 2687.

Aylward arranged for a phone call between optionsXpress, herself, and her manager, Jocelyn Mello (Mello), on September 24, 2009. Tr. 2688. Bottini, Hoeh, Stern, Strine, and Victor were on the call.[64] Tr. 3411. Aylward testified that optionsXpress voiced many grievances and she and Mello listened and said they could not provide any guidance. optionsXpress mentioned that it was conflicted because if a customer wanted to sell a deep-in-the-money call and they were obligated to buy-in, it was in the customer's best interest for optionsXpress to execute a buy-write to get the customer the best price; optionsXpress also questioned whether Reg. SHO applied to retail customers versus market makers. Tr. 2712-13, 2729-30; Div. Ex. 233. optionsXpress told FINRA that CBOE looked into the same issue and did not find anything objectionable. Tr. 3415-16. FINRA did not tell optionsXpress to keep doing what it was doing, that what it was doing did, or did not, violate Rule 204, or that it should stop doing the trades.[65] Tr. 2689-90, 2704, 2749, 3351; OPX Ex. 665. FINRA told optionsXpress that it does not comment on whether conduct under investigation is right or wrong, and suggested that optionsXpress reach out to Trading and Markets or FINRA's Office of

[63] There had been communications between optionsXpress and FINRA before the call. Aylward thought the matter changed from a sweep into an inquiry or investigation between March and September 2009. Tr. 2693.

[64] Stern testified Bottini was on the call. Strine did not name Bottini as a participant, but his name appears on Aylward's notes of the second call as one of the optionsXpress names. Tr. 1816-17, 3411; Div. Ex. 233.

[65] Mello's notes are OPX Ex. 665.

General Counsel (OGC) for guidance. Tr. 1728-31, 2725-26. On this call, Victor instructed FINRA to keep communicating with Strine, but to copy Victor and Stern. Tr. 2694.

Stern testified that he happened to be walking in a corridor on September 24, 2009, when he was asked to participate in the call to FINRA by Bottini, Hoeh, Strine, and Victor seeking guidance on its buy-write activity. Tr. 1728-29, 1816-17. It is not clear if Bottini and Hoeh described to Stern then, or earlier when he happened to come upon a discussion around the Execution desk, their idea of bundling optionsXpress's buy-ins and the customer's written calls. Tr. 1817-20. According to Stern, on the earlier occasion, he suggested getting guidance. Tr. 1819-20.

According to Stern, the purpose of the September 24, 2009, phone call to FINRA was to explain to the regulators that optionsXpress was buying in fails on T+1, and to ask whether it was possible to match optionsXpress's stock purchases with the customer's call order in the same account as a buy-write for best execution and to avoid market disruption. Tr. 1651-52. At the time, Stern did not know that FINRA was investigating optionsXpress for activity surrounding buy-writes. Tr. 1730.

On September 24, 2009, Strine called Trading and Markets, which oversees "a number of anti-manipulation rules including the short sell rules, Regulation M and [Rule] 15c2-11." Tr. 3417, 3581; OPX Ex. 579. Tao and Crane called him back and participated in a call with Victor, Strine, Hoeh, and Stern.[66] Tr. 3422. Strine testified that optionsXpress told Trading and Markets FINRA had ongoing inquiries, and that CBOE had decided not to begin an investigation. Tr. 3422-23, 3431. Stern did most of the speaking because he had the most trading experience among the optionsXpress participants. Tr. 1732-33. He described a box spread and explained that a buy-write could only occur when the amounts were equal; when the amounts did not match, the difference was done in a separate transaction. Tr. 1734-35.

Stern recollects telling Trading and Markets that the buy-writes were sent to brokers on the floor and executed in the marketplace. Tr. 1748-49. Stern testified that Trading and Markets told optionsXpress to "keep doing what you're doing – keep closing out," words that appear in Victor's notes, and that they would get back to optionsXpress after they spoke with others about best execution. Tr. 1745-46, 1752-53, 1820-23; OXP Ex. 729. The three pages of Victor's notes appear to be a combination of talking points with comments added. For example, portions of the notes are neatly written. They begin with FINRA and a list of names. The notes state "we buy in @ the open [because] we cannot borrow," with a line to "Robert Kaplan Enforcement Director SEC" over to one side on a slant, which looks like an addition. Later, another line goes from text to "Jocelyn Mellow *Supervisor," which also looks like an addition. Stern testified optionsXpress told Trading and Markets that it was buying customers in on T+1, but this does not appear in the notes. The notes state that, "We got OK from FINRA," "We want to stop activity," "they get assigned every day. * Zelzeny * Feldman," and "we do not fall into the sham

[66] Crane was a branch chief in Trading and Markets. An attorney from the Office of Interpretations and Guidance, perhaps Steve Varholik, was also present. Tr. 3585-86.

transaction – the customer may." Tr. 1826-30; OPX Ex. 729. Stern wrote a portion of what appears on the third page of the notes. Tr. 1855.

Stern does not remember Trading and Markets mentioning that customers might be involved in sham transactions or violating Exchange Act Rule 10b-21, an antifraud provision against short selling. Tr. 1746-47. Stern e-mailed Bottini, with a copy to Victor, on September 24, 2009, that "SEC said to keep doing what we are doing re: the Reg. Sho and short selling. They did not speak on best ex as they did not think that the people in the room were the right ones to comment on best ex[ecution]." OPX Ex. 246. Strine confirmed Stern's account of the conversation.[67] Tr. 3423, 3437, 3440; OPX Ex. 579.

Tao's recollection of the September 24, 2009, phone call is different from optionsXpress's, and she believes that optionsXpress misled Trading and Markets.[68] Tr. 3706. She testified that:

> [E]ssentially what optionsXpress personnel told us is that they had these customers that were engaging in short sales and options as well and as a result were failing to deliver and that the company was having to buy them in or close them out on T plus 4 and it was costing the company some money and was there anything that we could do for them.
>
> . . . .
>
> We said, are you closing them out? Under Reg. SHO, as brokers, are required to close out when there are fails to deliver. And basically the optionsXpress said yes, we are closing them out. We are doing what we are supposed to be doing.

Tr. 3586-88. According to Tao, if the words "keep doing what you are doing" were spoken, they were in the context of optionsXpress continuing to comply with Reg. SHO. Tr. 3617. Tao defined closing out as meaning purchasing securities in a bona fide purchase or borrowing the securities to close out the amount that was failing. Tr. 3591.

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[67] Strine testified that he was surprised at the Commission's response because he was advising optionsXpress not to do buy-writes, not because he thought they violated Reg. SHO, but to avoid further inquiries from regulators that he would have to deal with. He testified, however, that he was not surprised that the people who wrote the rule agreed with optionsXpress that the transactions did not violate Reg. SHO. Tr. 3437-39.

[68] 2008-2009 was a very busy time for Trading and Markets. Tr. 3584. It was a time of financial crisis and new rules relating to short sales. Tao and her staff were inundated with inquiries from brokers. Tr. 3584. Documents show communications with CBOE concerning suspicious trading by optionsXpress in 2009, and optionsXpress had called various people at the Commission. Tr. 3583-86, 3672-73.

Tao's recollection is that optionsXpress had some concerns, but it believed the customers were engaged in a legitimate strategy. Tr. 3587. The customers were engaged in an arbitrage strategy and as soon as they were closed out they would reestablish the hedge through a new short position. Id. optionsXpress said it was closing the customers out as Reg. SHO required. It also said it would like to "throw out" the customers because closeouts created expense for optionsXpress, but it needed help doing so because it might lose in arbitration. Tr. 3587-88, 3675; Div. Ex. 208. Tao testified that she told optionsXpress that Trading and Markets could not help with customer relations, that customers cannot violate Reg. SHO but might be involved in fraudulent behavior in violation of Exchange Act Rule 10b-21, and that optionsXpress had to continue to comply with Reg. SHO as a broker. Tr. 3587-88. Tao testified that she often mentions customer fraud in conversation with brokers to emphasize that they cannot be a part of fraud by a customer. Tr. 3592. optionsXpress mentioned that CBOE had closed an inquiry. Tr. 3714.

Tao testified that on the September 24, 2009, phone call, optionsXpress did not disclose: (1) it had 120 consecutive days of CNS fails in Sears shares; (2) FINRA was investigating its trading;[69] (3) calls were frequently being assigned shortly after being written; and (4) it was not consistently buying customers in at, or close to, the market open. Tr. 3592-93. Tao did not understand buy-writes to be included in the bundling orders optionsXpress mentioned. Tr. 3678-79, 3698. optionsXpress did not mention that it was using buy-writes in closing out a failed position, which would have raised a red flag with Tao. Tr. 3784-85; OPX Ex. 579.

On October 2, 2009, FINRA (Huber) received a return call from Tao and Crane.[70] Tr. 2806-07, 3594-95; Div. Exs. 237, 238. FINRA informed Trading and Markets that when optionsXpress bought in customers that had short positions as a result of assigned deep-in-the-money calls, the customers would simultaneously, or close to the buy-in, sell additional deep-in-the-money calls, and the process kept repeating. Tr. 2810-11; Div. Ex. 237. Trading and Markets learned from FINRA that optionsXpress's situation:

> [W]as more like some of the cases we had brought in the past which is where they would – rather than being closed out and re-establishing the position, they would actually have a false closeout so the closeout was instead a – they would purchase the stock, which is what you're required to do, and then they would have a deep-in-the-money call immediately to offset the purchase. So as a general proposition the purchase was net flat. There was no economic change in position.

[69] Trading and Markets would probably have told optionsXpress at the outset that it did not want to get involved if it knew FINRA had pending investigations. Tr. 3708.

[70] The call was motivated by an inquiry from Huber to Trading and Markets about whether optionsXpress had sought guidance as it represented it would. FINRA's Short Sales Group is in frequent contact with the Commission. Tr. 2814-15, 2826.

Tr. 3599. Tao and Crane told FINRA that optionsXpress failed to mention to them that FINRA was investigating its activities, that the sales of the call options were occurring at virtually the same time as the buy-ins, that the options were deep-in-the-money, and represented that the customers did not want the options assigned. Tr. 2812-13, 2838-40; Div. Ex. 237. Tao and Crane also told FINRA that it had told optionsXpress that on the facts optionsXpress presented, the activity would not be considered a violation of Rule 204. Tr. 2843; Div. Ex. 237. However, FINRA knew different facts and Trading and Markets would contact optionsXpress and state that Trading and Markets was not going to provide guidance. Tr. 2815-19, 2843; Div. Exs. 237, 238, 241.

Trading and Markets called optionsXpress on October 2, 2009. Tr. 3441. Stern recalls participating in another call with Trading and Markets approximately one week after the September 24, 2009, call. He does not remember that in a brief, heated conversation, Crane and Tao stated that optionsXpress misled them in the prior conversation, FINRA had found an entirely different set of facts, and he admits that Tao and Crane would not answer questions. Tr. 1753-55, 3595-96.

On October 2, 2009, Tao e-mailed Huber:

> We just told Hilary Victor that we have spoken to you and that we now understand there are additional facts and different facts from what they told us, and as a result, we can provide no comfort and decline to get involved. She tried to say she had told us there were 'three FINRA inquiries' (and acted like she didn't know which one we were talking about) and we made it clear she had not mentioned FINRA at all. She started to ask about the different facts and we said she has to talk to you. She was a bit flustered.

Tr. 3708-09, 3743; Div. Ex. 241. Tao sent similar information on October 2, 2009, to Kaplan in the Division, King, Associate Director, Trading and Markets, and two Commission personnel who had referred inquiries from optionsXpress to Tao. Tr. 3602-04; Div. Ex. 208.

On October 2, 2009, optionsXpress (Victor, Hoeh, Stern, and Strine) called FINRA (Huber, Mello, and Jim Nixon (Nixon))[71] and stated that, "[s]ince the SEC can't give us guidance we are coming to you." Tr. 2806-08, 2853; Div. Ex. 238; OPX Ex. 668. FINRA advised optionsXpress to put its request in writing to FINRA's OGC, but Huber does not know that optionsXpress ever did so. Tr. 2809. Stern does not recall that on October 2, 2009, FINRA told optionsXpress to submit a written request to it or the Commission. Tr. 1755-56.

On January 14, 2010, Gene DeMaio (DeMaio), a FINRA Senior Vice President who heads the Market Reg. Options Regulatory Team (ORT), which provides options surveillance and investigation services to FINRA and SROs, participated in a call with optionsXpress's

[71] Nixon was an attorney in FINRA's Market Reg. Tr. 2854.

Compliance personnel and Stern.[72] Tr. 2894, 2911. FINRA's ORT was consulting with the Short Sales Group when DeMaio, Danny Moleto, Jeff Chan, Huber, and perhaps others from FINRA participated in a phone call with optionsXpress's Compliance personnel and Stern. Tr. 2912. The call occurred because FINRA was concerned about the possibility of Reg. SHO violations by optionsXpress. Tr. 2914. optionsXpress's activities were similar to what DeMaio had seen in cases that FINRA brought involving standard options and buy-writes.[73] Tr. 2914-18. DeMaio testified that it was unusual for a member firm's CFO to be on this type of call. Tr. 2911.

DeMaio co-authored AMEX's Reg. 2007-35: Applicability of Regulation SHO to Certain Market Maker Transactions (Reg. 2007-35), issued August 9, 2007. Div. Ex. 384. This 2007 regulation stated that Reg. SHO was designed to prevent and deter abusive short selling; it provided enhanced restrictions applicable to securities in which a substantial number of fails to deliver have occurred; and that:

> Regulation SHO prohibits 'a broker-dealer from engaging in 'sham close outs' by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a failure to deliver position and the broker-dealer knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another failure to deliver position.' (footnote omitted) A broker-dealer that engaged in such 'sham close outs' would be liable for violating Regulation SHO and could be liable for fraud under Amex and SEC rules. . . . a purchase of stock paired with one or more short term option transactions such as, for example, a one day in-the-money FLEX option, or a married put (footnote omitted) or buy write transaction whereby the short stock position is only temporarily covered and does not result in actual delivery of the shares in question may not satisfy the Regulation SHO close out requirement and will invite regulatory scrutiny of both sides of the transaction . . . .
>
> . . . .
>
> (Footnote 11) Other transactions that can result in an improper 'reset' of an aged fail include, but are not limited to, married puts, buy writes, conversions, flexes, or other delta neutral short term strategies matching options with stock.

Tr. 3066-68; Div. 384 at 1-2, 4 n.11. DeMaio testified that he never told optionsXpress that the activity discussed on the phone call complied with Reg. SHO, or to keep doing what it was doing. Tr. 2918-19.

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[72] DeMaio earned degrees in Accounting and Law from Fordham University and an LLM from New York University. Tr. 2895. In 2003, DeMaio joined AMEX, later NASD, and now FINRA. Prior to 2003, DeMaio was an options market maker. Tr. 2894-95.

[73] As of September 19, 2012, nine FINRA cases were final that involved options and buy-writes and some of them involved married stock options or buy-writes and standard options. Tr. 2897.

On January 22, 2010, Huber, Aylward, and Mello called CBOE (Larry Bresnahan (Bresnahan) and Mike LaJioia) and CBOE stated that it did a routine exam of optionsXpress in August 2008 and did not find any problems with Rule 204T. Tr. 2731, 2863-65; OPX Ex. 408. Aylward's notes from the conversation state, "Larry said [description of activity] was similar to the pattern reviewed by the examiners and those examiners spoke with the Commission (SEC). Larry said that the SEC said it was OK." Tr. 2734-35; OPX Ex. 408. Mello's notes of the call state, "2009 exam – preliminary findings – no Reg. SHO concerns." Tr. 2738-39; OPX Ex. 409. Aylward understood that CBOE had spoken to the Commission, the Commission did not think it had a case against optionsXpress, and that customers could not violate Reg. SHO. Tr. 2744-45; OPX Ex. 408.

Mello's notes of a conversation with Tim MacDonald at CBOE on January 22, 2010, state, "SEC agreed defnty (sic) 'smelled' but not officially violating a rule. (customer) Didn't think had case against firm b/c customers engaging in activity." OPX Ex. 675. "[A]lso spoke with Josephine Tao & Tony Crane, who said "stinks" but needs to circle wagons and maybe amend rule." Tr. 2747-48; OPX Ex. 675. Huber testified that no one at FINRA ever told optionsXpress to continue or to stop doing what it was doing, or that its activities were compliant with Reg. SHO, and optionsXpress never requested written guidance from FINRA. Tr. 2822, 2867. Ultimately, FINRA deferred its investigation when it learned that the Commission had a similar investigation. Tr. 2696, 2792-93, 2821, 2828.

Stern testified that at some point Bresnahan told him, with respect to the buy-writes, to "keep doing what you're doing as long as you meet your obligations." Tr. 1842-43, 1857.

Stern's Involvement

Stern testified he did not know anything about optionsXpress's conduct in buy-ins before optionsXpress received a letter of caution from CBOE about Zelezney's trading in September 2009. Tr. 1637-38, 1668-69. However, Stern also testified that he was very much involved in buy-ins for a couple of weeks when Rules 204T and 204 took effect September 18, 2008, and July 31, 2009, respectively, and that he worked on responsive buy-in procedures with David Fisher, CEO of optionsXpress Holdings, Bennett, and Hoeh. Tr. 1623, 1644, 1672, 1680, 1688-89, 1833-34. In addition, Stern testified that Hoeh consulted him on buy-in procedures because as a senior officer, he was relied upon in helping make decisions for the firm, and that he knew that some portfolio management customers participated in box spreads and were part of a "buy-in process." Tr. 1635-40.

In August 2009, after optionsXpress stopped allowing customers to buy themselves in, which Stern did not think was allowed by Reg. SHO, Stern spent a few days observing to make sure that optionsXpress's buy-ins occurred at the opening of the market.[74] Tr. 1668-73, 1675-77, 1680. As part of its post-letter of caution procedures, Stern and Bottini had Operations send the

[74] The time sequence is out of synch with the new procedures in August 2009, said to be prompted by the letter of caution in September 2009, but testimony is what it is.

list of fails to the Trading Desk for execution. Tr. 1690-92. During a two-to-three week period when he was very involved in the buy-in process, Stern looked to see that buy-ins occurred within two to three minutes of the market opening. Tr. 1682-83. While looking over Tortorella's shoulder, Stern saw CNS's list of fails to deliver, and he noted that traders were submitting buy-ins near the market open. Tr. 1690, 1694, 1706.

Stern had Tortorella send him copies of buy-in notices sent to the Trading Desk, and he does not recall seeing the same customer names on the buy-in notices. Tr. 1697, 1702. Operations was not his job, but Stern was involved in making sure that Tortorella's area transmitted e-mails to the Trading Desk prior to the market opening, and that orders were put in and executed. Tr. 1673, 1677. Stern admits to having conversations concerning the definition of persistent fails, but he did not know of persistent failures to deliver in Sears and MJN shares. Tr. 1721-24.

Stern believes that optionsXpress complied with Reg. SHO if it covered a fail to deliver position on the morning of T+4 as close to the opening of the market as possible. Tr. 1650-51, 1719. Stern testified that there is no guidance or prohibition against bundling the purchase of stock and sale of a call as a buy-write for best execution. Tr. 1694. Stern testified that he did not believe the buy-in was linked to the assignment. Rather, optionsXpress was doing a buy-in prior to the opening, and when the customer saw that his account was buying stock and getting long, he would enter his desire to sell calls. Tr. 1735, 1817. Stern's professed practice is to check with regulators. If a regulator raised a question, he would have stopped the activity until he could get a definitive answer, but he believes there is still no definite answer today. Tr. 1695. If a regulator did not tell him to stop the conduct described, he took that to mean it did not object. Tr. 1771.

Stern only spoke with Feldman once briefly when Feldman visited optionsXpress's office. Tr. 1635-36, 2623.

Employees of optionsXpress gave varying answers on Stern's role. Coronado thought Stern oversaw the daily operations of the firm. Tr. 607. Molnar would learn from Stern what trading activity raised optionsXpress's capital requirements at DTCC or NSCC; Molnar does not recall Stern being involved with buy-ins. Tr. 348-49. Tortorella does not recall discussing the buy-in process or compliance with Reg. SHO with Stern. Tr. 504. Tortorella's discussions with Stern were in connection with the calculation of the DTCC settlement figure.[75] Strine testified that Stern's responsibilities for Reg. SHO were relatively limited, that people consulted him because of his industry experience, and he was the face of the firm with regulators, but that Strine and the CCO signed off on responses to CBOE and FINRA. Tr. 3464-68.

Feldman's Trading Strategy

[75] In general terms, failure to deliver to CNS impacts the amount of collateral that DTCC required. Tr. 424, 504.

Feldman's three-way strategy at issue here was to buy a call and sell a put (steps one and two) with the same strike prices and same expiration date (synthetic long), and simultaneously sell a call (a hedge against the synthetic long) (step three). Tr. 2111-12, 2118-19. As he described it to Kolocouris, "We are trying to ACTUALLY short the stock, offset by a 'synthetic long' position (sell puts, buy calls) . . and locking in the profits created by the overpriced puts." Tr. 2216-17, 2622; Div. Ex. 266. Feldman traded standard American options with Saturday following the third Friday of the month expiration dates and typically wrote buy-writes when his call options were assigned, which was almost daily in some cases.[76] Tr. 1241, 2150, 1291, 2595; OPX Ex. 915.

Feldman was candid about what he was doing; he did not engage in deceptive conduct or make any misrepresentations or omissions to the clearing brokers he dealt with, and he took whatever actions they required of him. Tr. 269, 331, 335, 451-52, 478, 637-39, 893, 1221-22, 1311, 1809, 2060-61, 3458-59. Feldman never represented to optionsXpress that he had the ability to deliver shares, and he purchased shares every time optionsXpress required him to do so. Tr. 337, 482, 639, 1221, 1809-10.

Feldman testified that he looked to take advantage of mispricing in every activity in life. Very early on, Feldman realized that the skew between the price of the put and the call was due to the borrowing costs of the stock. Tr. 2210, 2214-15, 2218-19; Div. Exs. 63, 259. The fact that optionsXpress did not charge hard-to-borrow fees on stock provided him with what he considered to be an arbitrage opportunity, and he estimates that he made approximately three to four million dollars from all transactions at optionsXpress in this fifteen month period. Tr. 2107, 2119, 2318-19, 2359; Div. Ex. 349. Feldman testified:

> And the only way I was able to make money on any of these trades was profiting off of the business model of the companies [that chose] not to charge their customers hard-to-borrow fees. That is the crux of this entire matter, and that is how the profit was made.

Tr. 2390-91. In addition, the strategy required being able to do buy-writes when his deep-in-the-money calls were assigned. Tr. 2652. Feldman first used a buy-write on May 29, 2009. Tr. 3093.

Feldman did not want to be assigned on the calls that were the third leg of his strategy because when he was assigned, it cost him money and diminished his profits to reestablish the hedge. To reestablish a hedge using a buy-write, which was the cheapest method, Feldman was charged commissions and he had to pay over parity for the stock which meant he was paying the counterparty to take the trade. Tr. 1199, 1207-08, 1257, 2181. Feldman had no guarantee when he wrote a deep-in-the-money call or in-the-money call that it would be exercised, assigned, or that he would be bought in; however, prior experience, the level of open interest, the strike price,

[76] American style options can be exercised on any day between purchase and maturity. OPX Ex. 915 at 6.

and the information he gleaned from constant communications with dealer personnel, provided him with an indication of whether certain options would be assigned. Tr. 342, 2180, 2184, 2197-04.

Assignments were sometimes daily depending on the security and the strike price. Tr. 2156. In an Instant Message exchange on June 30, 2009, Feldman wrote, "it almost doesn't matter, JUL or SEP, as u get assigned that night anyway," and "I just figured I'd get assigned, except maybe I'd buy an extra day or two." Tr. 2158-60; Div. Ex. 246. In an Instant Message on November 16, 2009, Feldman stated, "it doesn't really matter since they will get assigned and become part of the daily roll," meaning buy-write, and on November 24, 2009, he messaged, "They get assigned 100% every night. . ." Tr. 2164-67; Div. Ex. 25 at 12, 32.

Every morning Feldman would receive an e-mail from optionsXpress, and then phone traders to reposition if he had to reestablish hedge positions. Tr. 2076. Early on when he received a buy-in notice, before he thought of using buy-writes, Feldman would not reestablish a hedge but take a risk and remain long. He thought of buy-writes in early May 2009, and executed the first one on May 4 or May 29, 2009. Tr. 2407-08, 2421-25, 2440-42; OPX Ex. 916A, 916B. The buy-write was Feldman's idea, no one at optionsXpress suggested the buy-write or the trading strategy to Feldman. Tr. 2619. optionsXpress, however, assured Feldman on many occasions that there was nothing wrong with buy-writes. Tr. 2459-60.

When he received a buy-in notice on an assigned call option, Feldman would often trade a buy-write that included a deep-in-the-money call at a cost of a penny over parity per share to accomplish the transaction, plus commissions and other fees.[77] Tr. 2133, 2140-43, 2145. Even though they always cost him money, the buy-writes made economic sense from Feldman's perspective because by selling the call he reestablished his hedge and removed the market risk. Tr. 1200, 2460. Initially, the buy-writes could be done during the course of the day, but eventually they had to be done earlier. Tr. 2135-36. Feldman testified that he controlled the time the three-ways were entered, and it was tedious and took hours to get the orders filled. Tr. 2453-54. Feldman testified that the buy-write did not guarantee that his strategy would be profitable. 2460-61.

Feldman testified that his purpose in the buy-writes was to maintain his delta neutral position. Tr. 2268-69. In an e-mail on June 26, 2009, Feldman wrote that he had done a buy-write the day before for more than one million shares of stock and more than 10,000 contracts and that "[t]hese trades are losers for me, and are merely to try to maintain a position I have and cover 'buy-ins'." Tr. 2153; Div. Ex. 271. Feldman believed that he did not have market, meaning directional, risk as long as he had a hedge. Tr. 1197. Delta neutrality could also have been achieved by borrowing the shares or closing out the position. Tr. 2149-51.

[77] Parity as used here is the stock price on the buy minus the strike price on the call. Tr. 2140. Feldman testified that optionsXpresss wanted him to call them with orders so, while he sent e-mails outlining his plans, he tried to call optionsXpress every day. Tr. 2136-39.

Feldman was extremely price sensitive; he would refuse to pay two cents for liquidity on the buy-writes and negotiated for $0.125 or less, and he tried to get reduced commissions. Tr. 1287-88, 2152-53. Feldman placed large orders and pushed to increase the size of his trades. Tr. 1182, 1326. Stella testified the Feldman was very aggressive; he "generally pushed to get more and more leverage so he could trade more of these boxes, because he thought they were riskless." Tr. 1183. Stella vaguely remembers telling Feldman that this might be a grey area so he should keep his trades to a manageable size. Tr. 1186-87.

Feldman knew that some internet message boards such as Yahoo Finance were reporting mystery trades in Sears, some people noticed the volume spikes and speculated why trades were happening every day. Tr. 2265-68. On an internet web page on June 9, 2009, Feldman posted the following:

> I have been in this Citi/Preferred Arb trade for 3 months now..While I somewhow (sic) am not paying the 'cost to borrow' fees (don't ask me how), the risk of 'buy0in' (sic) is huge. . . . I went 2 months with zero buy-ins (miraculously), but the past 2-3 weeks the buyins (sic) have been fast and furious. However, whenver (sic) I get a buy-in (I'm talking hunderds (sic) of thousands of shares sometimes), I recreate the position by selling in-the-money calls, which of cousrse (sic) then get reassigned, leaving me short again.[78] It's a viscious (sic) cycle, ut (sic) worth the [transaction] ciosts (sic) (and the .01-.02 loss per round turn) in order to make the .785/share profit (now closer to .50 as the gap narrowed yesterday).
>
> . . .
>
> It is notable that this 'anomaly' exists with many hard-to-borrow stocks, (I can name 10-15 of them right now) and the common can always be bought for less thruu (sic) synthetics on those cases.

Tr. 2325-36; Div. Ex. 383 at 4. Feldman did not answer the question from another blogger: "[I]f you get assigned on the short call, you have to deliver stock. How do you do this?" and "My understanding is that if you do nothing, you will get bought in (by your clearer) to make delivery on the assignment. Fascinated to hear if/how you get around this." Tr. 2331-33; Div. Ex. 383 at 5.

On July 28, 2009, Feldman sent Coronado, Molnar, Payne, Tortorella, and others copies of a news article about arbitrage trading in Citi in which he is quoted as stating he used "synthetic short options by selling short deep in the money call options," and "he used several types of sophisticated trades to arbitrage."[79] Tr. 479-81, 640-42, 2066; OPX Ex. 866.

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[78] Feldman testified that this statement told people he was doing buy-writes. Tr. 2335.

[79] Arbitrage is defined as "profiting from differences in price when the same security, currency, or commodity is traded on two or more markets." Finance & Investment Handbook 197.

Feldman maintains that he relied on optionsXpress to follow the rules and he understood that the obligation to deliver stock was with the broker. Tr. 2125, 2402, 2493-94. From the materials he received from optionsXpress: computerized generated notice of assignment, buy-in notice from Payne or an associate, a notice showing his stock purchase to cover and notice of sold to open call (buy-write), and the Daily Positions Recap that did not show stock ownership, Feldman believed he had delivered stock to cover his short position as optionsXpress instructed him to do. Tr. 2602-18; OPX Ex. 919, 920, 921. His customer agreement provided:

> All orders for the purchase and sale of securities and other property will be authorized by you and executed with the understanding that an actual purchase or sale is intended and that it is your intention and obligation, in every case, to deliver certificates to cover any and all sales or to pay for transactions upon our demand. If we make a sale of any securities and/or other property at your direction, and if you fail to deliver to us any securities and/or other property that we have sold at your direction, we are authorized to borrow or otherwise obtain the securities and other property necessary to enable us to make delivery, and you agree to be responsible for any cost or loss we may incur, including the cost of borrowing and obtaining the securities and other property.

Tr. 2126-28; Div. Ex. 98.[80] optionsXpress never claimed that Feldman failed to deliver a security. Tr. 2473.

Feldman testified that on or about September 23, 2009, Bottini told him that optionsXpress sought to limit the size of his positions because the Commission had a concern about his trades, including buy-writes, but that the Commission said everything was fine on a phone call. Tr. 2509-11, 2253-61, 2636-40; OPX Ex. 887. Feldman never sought an independent legal opinion on whether his trading was legal, and he thought it would have been bizarre for him to have asked the Commission about its concerns, and whether, in fact, those concerns were resolved. Tr. 2626-38, 2648. Feldman maintains that he relied on optionsXpress's representations that his trading was legal. Tr. 2638. Bottini sent Feldman a link to the Hazan settlement and Feldman distinguished his situation. Tr. 2512-13; OPX Ex. 888.

Feldman's strategy would not be profitable without buy-writes, as shown by the fact that he stopped using the strategy at optionsXpress in March 2010, when optionsXpress stopped allowing buy-writes where the buy was to satisfy a Reg. SHO delivery obligation. Tr. 1696-97. Feldman did not acknowledge this fact, but admitted that his trading strategy would be a lot riskier without buy-writes and that both parts of the buy-write had to be executed as part of the same trade to get the best price. Tr. 2273-74.

[80] Feldman signed an agreement with Penson on October 27, 2009, that contained similar language. Tr. 2131-33; Div. Ex. 99. Penson never claimed that Feldman violated the agreement. Tr. 2474

Effective February 17, 2011, Feldman entered a Stipulation and Consent to the Issuance of an Order to Cease and Desist, Order No. DC 11-014, with the United States Office of Thrift Supervision under which he paid $230,000 in restitution. Tr. 2320-22; Div. Ex. 118.

Penson Financial Services, Inc. (Penson)[81]

In late October 2009, Feldman transferred some of his positions, including his position in Sears, from optionsXpress to another broker-dealer, Terra Nova Financial Group, Inc. (Terra Nova), an arrangement that lasted from about November 12 to November 25 or December 2, 2009.[82] Tr. 297, 302, 319, 904, 2130, 2236, 2284-85; Div. Exs. 133, 375 at 33 n.32. Terra Nova cleared Feldman's account at Penson, Dallas, Texas. Tr. 764-65. As the introducing broker, Terra Nova was Penson's contractual client. Penson dealt directly with Terra Nova about Feldman. Tr. 800-01. Feldman entered a new account agreement and margin agreement with Penson. Tr. 869. Penson required Feldman to maintain margin for his account. Tr. 772, 897.

When a portion of the account was being transferred to Terra Nova, Molnar described Feldman's account activity as: "Each day the account sells deep-in-the-money calls, and he gets assigned the following day. Each day we have been buying the account in for the number of shares he gets assigned." Tr. 299; Div. Ex. 133.

Wallin e-mailed Feldman on October 28, 2009, about problems in making the transfer:

> [T]he difficulty that we are running into is that options settle T+1 but stock is T+3 and you are getting assigned everyday so you constantly have a (sic) unsettled stock position which makes things very difficult to move.

Tr. 2286-87; Div. Ex. 26. Feldman was not troubled by unsettled trades, which he thought were to be expected with daily trading and a transfer, and he inquired whether he could get a couple of "free days" in transit, meaning days without assignments or buy-ins. Tr. 2289-91.

Penson's policy was to satisfy its CNS fails on an ongoing basis. Tr. 798-99. Robert Crain (Crain), former Penson Vice President Risk, testified that the interaction of the OCC and the NSCC was such that a CNS delivery obligation had to be satisfied regardless of what occurred in the options market and buy-writes. Tr. 798. When a call option that Feldman sold was assigned, Penson was obligated to deliver stock to CNS and to post collateral until the stock was delivered. Tr. 853-54, 867. Assignment notices were received at night and sent out the next day, T+1. A purchase on T+1 to cover the assignment could settle three days later on T+4. Tr.

[81] Penson experienced an erosion of net capital in 2007-09, and was forced to borrow funds to meet its capital obligations. It ultimately was acquired by another firm. Tr. 834-35.

[82] Lapertosa contacted Feldman looking for business, but when he learned he was not an institutional client he referred Feldman to Andrew Wallin (Wallin), a sales representative at Terra Nova, because On Point could not handle trades for retail clients. Tr. 1283-86, 2285.

851-53. The same broker-dealer, but not necessarily the same buyer and seller, was the counterparty each day on Feldman's Sears buy-writes.[83] Tr. 816-17, 826, 841.

Terra Nova and Penson disagreed on the fees Penson charged the Feldman account. Tr. 805-12, 844-45; Div. Exs. 296, 343, 347. A relationship manager at Terra Nova agreed that Terra Nova would buy-in Feldman's account on the day there was an assignment, and that it would not charge Feldman hard-to-borrow fees; however, Penson borrowed stock and charged its customers, including Feldman, hard-to-borrow fees.[84] Tr. 891-92, 902-911, 2291-93, 2306-08, 4364. Penson considered hard-to-borrow fees appropriate because of the perpetual short position in Feldman's account, i.e., the buy-writes were assigned daily so the delivery obligation was ongoing, which Feldman did not cover. Tr. 806-07, 882; Div. Ex. 296. For the period November 10 to December 7, 2009, Penson charged Feldman's account $268,258, or net $183,473, in hard-to-borrow fees. Tr. 812; Div. Ex. 347. Feldman's account came to Crain's attention because it was the reason that Penson's collateral requirement at OCC increased significantly. Tr. 764-65. The increase in collateral that Penson had to post was significantly higher than the hard-to-borrow fees. Tr. 854.

According to Sruli Schorr (Schorr), Vice President Sales Worldwide, Penson was told that Feldman was assigned late in the day and covered the next morning and Penson agreed not to assess hard-to-borrow fees. Only later did Penson learn:

> [s]o what happened is the customer does cover every morning, but he also puts on new trades every day. So, that while the assigned position may get covered, a new assignment opens the position again, therefore the position is continuously on the books. In other words, his, quote, cover, never removes the position, because a new assignment recreates it, and in the CNS world it is the same position continuously open on the books.

Tr. 906-07; Div. Ex. 211.

In describing a buy-in by Feldman on MJN shares for about $20 million, the relationship manager at Penson described Feldman's trading strategy as getting assigned every day and covering the following day.[85] Div. Ex. 212; OPX Ex. 719. The Penson customer representative who made the original agreement with Terra Nova questioned why Penson was buying in shares to satisfy CNS when Feldman covered the short. Tr. 894-95; Div. Ex. 296. The reason was that

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[83] Feldman's expert testified that Feldman did not execute any buy-writes in Sears while his Sears account was at Terra Nova. Tr. 3094; OPX Ex. 915, Exhibit 16.

[84] Feldman testified that Terra Nova reimbursed him for hard-to-borrow fees ultimately. Tr. 2378.

[85] The security was MJN. It is not clear how this happened since Feldman supposedly only transferred his Sears trades to Terra Nova. Tr. 802; Div. Ex. 212.

Penson did not consider that a buy-write covered its CNS delivery obligation. Tr. 796-97, 908-09. Crain testified that Feldman's buy-writes did not "sufficiently satisfy the delivery obligation or the requirements to deliver those short shares on an ongoing basis given the nature of the strategy." Tr. 778. From Crain's perspective, the buy-write did not satisfy Feldman's original short position and it did not cause shares to be delivered to the marketplace. Tr. 905-06, 911. Crain testified:

> Ultimately it comes down to shares have to be delivered, and because it was rolled or because we saw this strategy a day after day, there were never going to be shares available to make that delivery unless the strategy stopped or unless something else occurred to what was taking place.

Tr. 779.

On November 30, 2009, Penson's COO, commenting on the firm's CNS delivery obligation, wondered if the firm could "[g]ive the customer the choice (cost of borrow vs risk of market impact of large buy in. (sic)" Tr. 803, 844; Div. Ex. 212; OPX Ex. 719. The buy-in was for about $20 million. OPX Ex. 719. Later, after being asked what to do if Feldman had already bought himself in, Penson's COO instructed the relationship manager, "They can't roll the positions and have to cover. We will have to cover the positions if they don't, assignment or not." Tr. 861-62; Div. Ex. 212; OPX Ex. 719. Penson concluded that Feldman's account was causing it to violate Reg. SHO. Tr. 900.

Crain testified there was agreement within Penson that the firm should not clear for Feldman's account because of the high volume of activity in the account, the size of the positions, the risk, and associated capital requirements. Tr. 770-73, 825, 835-36, 899. Crain testified further that any large share purchases executed in a short time, as was happening in Feldman's account, could impact the marketplace. Tr. 802-03. On December 4, 2009, Penson's CFO and FINOP, stated that, "We are not talking about a trivial amount of fees that we have incurred to finance this activity." Tr. 864-65; OPX Ex. 726. Stern testified that Penson's CEO, Mr. Pendergraf, told him that Penson could not carry Feldman's account because the capital requirement was so large, but did not indicate any concerns about the legality of Feldman's trading strategy. Tr. 1866, 1849. Stern did not share with Penson that Trading and Markets stated that Feldman might be engaged in sham transactions. Tr. 1862

Wallin told Feldman on November 19, 2009, that Terra Nova was going to have to move a portion of his position back to optionsXpress because Terra Nova had to post large amounts of collateral for unsettled trades because his positions were so large. Tr. 2232-35, 2304-05; Div. Ex. 25 at 22. Wallin also told Feldman that a regional FINRA representative told Penson that it needed to borrow the stock. Tr. 2304-05. Wallin sent Feldman an Instant Message on November 19, 2009, "I see where you are going but I don't think this will solve the heart of the solution which is a (sic) unsettled trade of 100 [million] constantly rolling in which OCC and NSCC will want assets pledged against." Tr. 2232-33; Div. Ex. 25 at 22.

On November 23, 2009, Bottini informed Feldman that optionsXpress could not accept the transfer of "a failed short positions." Tr. 2237; Div. Ex. 312. On December 1, 2009, Wallin

told Feldman that he had only a week, more or less, to move his position out of Penson, and he doubted optionsXpress would take his position back because CBOE was getting heavy on them about this activity. Tr. 2301-03, 2310.

On or about December 2, 2009, Crain read an article announcing that on August 5, 2009, the Commission settled two proceeding against broker-dealers who allegedly violated the Reg. SHO rules by selling puts and buying calls, while simultaneously selling short the underlying security and circumventing their obligation to close out their fail-to-deliver obligation on the short stock sale by using sham reset transactions.[86] Tr. 821-24, 898; Div. Ex. 374. It was distributed within Penson. Tr. 898. Crain believed that the settlements described Feldman's trading strategy, but Penson had already informed Terra Nova that it did not want Feldman's account. Tr. 823-24, 899

When Feldman transferred his accounts from Terra Nova back to optionsXpress in December 2009, optionsXpress increased the fees it charged him for buy-ins and gave having to spend more time interacting with regulators on the issue as one reason for the increase. Tr. 2311-12.

E*TRADE

Feldman was a customer of E*TRADE since 1996; he opened a portfolio margin account at E*TRADE in April 2011.[87] Tr. 4802, 4831. E*TRADE does not charge hard-to-borrow fees because it does not have the facility to track and pass them on to customers. Tr. 4799-4800. E*TRADE does not allow customers to short stock. Tr. 4800. If a customer is assigned an option on a hard-to-borrow security and E*TRADE cannot borrow the shares, it requests that the customer close out the position or it closes the position out for the customer on T+1. Tr. 4800-01. In August or September 2011, E*TRADE became aware that, almost daily, Feldman was short due to an assignment, and he would enter a buy-write or cover and write a deep-in-the-money call later in the day. Tr. 4803-05. E*TRADE did not have any fails to deliver because of Feldman's trades, but E*TRADE did not consider that Feldman met his obligation when he was assigned by doing buy-writes or buying shares in the morning and selling calls later the same day. Tr. 4847. To meet its delivery obligation, E*TRADE made delivery from its inventory or borrowed securities. Tr. 4848.

E*TRADE had concerns about meeting its delivery obligations where the customer was engaging in another options assignment, as well as strains on its system and potential Reg. SHO violations. Tr. 4806-08, 4841. Roderick Mikus, E*TRADE Financial's Vice President of Securities Lending Operations and former COO for E*TRADE Clearing, testified:

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[86] TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke, Securities Exchange Act Release No. 60440 (Aug. 5, 2009), 96 SEC Docket 19529; Hazan.

[87] The Wells Notice in this proceeding was issued on October 28, 2010. optionsXpress Inc., Administrative Proceedings Rulings Release No. 710 at 4 (July 11, 2012).

> [I]t's not always the customer's trading activity that is going to satisfy any delivery obligations. There are other customers that trade. There are other transfers that occur. There are other activities that occur in customer accounts or between different counterparties whether it's securities lending or anything else that all works into this net settlement system. Again, this is generally speaking.
>
> However, when a customer is potentially disrupting the apple cart and continually engaging in a trading activity around a security that may or may not be available to facilitate delivery, a general conservative approach would be to shut down or to stop that type of trading activity.

Tr. 4796-97, 4843-44. E*TRADE took a very conservative position because Feldman's trades caused strain on its system, and it told him to close out his positions after a couple of months. Tr. 2645, 4807-08. In addition to E*TRADE, after optionsXpress Feldman began doing buy-writes in connection with buy-ins at TD Ameritrade, which did not assess borrowing costs on hard-to-borrow shares. Tr. 2277-80. TD Ameritrade stopped these transactions after one to three months. Tr. 2277-80, 2645-46.

Two Expert Witnesses for the Division

Dr. Lawrence Harris (Harris) appeared as a Division expert and sponsored Div. Exs. 310, with Exhibits 1-35, 382, with eight pages of tables, and 497, with six pages of tables. Harris holds the Fred V. Keenan Chair in Finance at the University of Southern California (USC) Marshall School of Business.[88] Harris gave expert opinions on Feldman's trading strategies and the resulting gains and losses to Feldman, optionsXpress, and other market participants. Div. Ex. 310 at 3-4. He agreed that Feldman profited by using a non-directional trading strategy. The fact that Feldman was not charged loan fees did not enter his analysis, and he did not retract his position that Feldman was engaged in a strategy "for the sole purpose of evading the requirement to borrow stock to settle short sales, and in particular, for extending his short positions without delivering stock as required." Tr. 1535-36; Div. Ex. 310 at 9. Harris found no evidence that optionsXpress paid to borrow Sears and other hard-to-borrow stocks. Tr. 1606.

Harris analyzed trades in the twenty-five securities named in the OIP in Feldman's accounts at optionsXpress and Terra Nova from February 19, 2009, to March 30, 2010. Div. Ex. 310 at 26. Harris found that:

> Feldman generally opened positions with synthetic trades or sold puts, both hedged with short sales of stock or with sales of deep-in-the-money call options.

[88] Harris earned a B.A., M.A., and Ph.D. at the University of California and the University of Chicago. He has taught at USC since 1982, was the Commission's Chief Economist and Director of the Office of Economic Analysis in 2002-2004, has written extensively, and testified previously. Div. Ex. 310, Ex. 1-2.

> Assignments to the call options and repeated buy-writes soon followed. As the synthetic stock expired, Feldman renewed the positions either by rolling them forward with collars or by exercising the expiring synthetic stock and buying new synthetic stock.[89]

Id. at 31-32. Later, he restated this somewhat with findings that:

> [F]or most of the stocks that Feldman traded which appear in the OIP, Feldman first bought synthetic long stock positions that he hedged by selling deep-in-the-money calls (three-leg trades) or by selling stock short (reverse conversions). . . .
>
> I also found that Feldman sold straddles involving deep-in-the-money puts and deep-in-the-money calls. . . .
>
> Additionally, I found that Feldman sold deep-in-the-money covered puts which consist of short stock sales and sales of deep-in-the-money puts.

Id. at 38-39.

It is Harris's position that Feldman might have violated Reg. SHO, which seeks to: (1) prevent abusive naked short sales; (2) address concerns about people pushing prices down without having borrowed stock; and (3) ensuring market integrity by having trades settle on T+3 when they are supposed to. Tr. 1486, 1488-89, 1535; Div. Ex. 310 at 14. He concluded that Feldman engaged in a parasitic trading strategy "designed to collect the economic equivalent of [hard-to-borrow stock loan fees] without owning the stock and without any significant risk exposure."[90] Div. Ex. 310 at 5. Harris disagreed that Feldman used an option hedging strategy, which he defined as using the market to reduce risk elsewhere. Tr. 1483. In Harris's opinion, Feldman and optionsXpress converted stock sales contracts into the economic equivalent of undated stock futures contracts, thus undermining market integrity. Div. Ex. 310 at 5, 14. He testified that Feldman obtained a short position that he did not settle on. Tr. 1486. Harris conceded that selling deep-in-the-money calls is not the same as selling stock short but it is a way of becoming a short seller. Tr. 1414-15, 1423.

Harris testified that the CNS Accounting Summary indicated whether there is a settlement failure, and when there is a failure, a buyer has not received shares. Tr. 1544. Harris found that during the relevant period, in the stocks named in the OIP, optionsXpress was responsible for sixty-four percent of all shares that failed to settle in CNS. Div. Ex. 310 at 13.

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[89] In options trading, a collar is selling an out-of-the-money call and buying an in-the-money put, thus limiting both upside and downside. Finance & Investment Handbook 286.

[90] Harris defined the term parasitic trading strategies to mean strategies that extract value from other traders. Tr. 1416, 1572, 1596. Feldman testified that "every time an option trade is made, which is millions of times of the day, it's a parasitic trade, because one trader is making money off the other trader." Tr. 2364.

Harris also found that the deep-in-the-money calls that Feldman sold were regularly exercised on the day they were purchased. Id. at 7-8. Harris testified further that Feldman's sales failed to settle in a timely manner so that his short sales became naked short sales. Tr. 1442-46; Div. Ex. 310 at 6. According to Harris, a trade fails to settle when delivery is not made on T+3 and the CNS reports show that optionsXpress did not deliver stock, presumably because it did not have it. Tr. 1446, 1449, 1452.

Harris contended that Feldman's stock sales failed to settle so that buyers did not receive shares and thus could not profit from high stock loan fees. Tr. 1425-26; Div. Ex. 310 at 6-7. It is not clear whether Harris claims that purchasers were defrauded because they expected to receive securities on delivery and did not due to the scheme that Feldman and optionsXpress employed. Tr. 1495-96, 1573-74. He admitted, however, that his analysis showed that delivery occurred within a few days of T+3; 96.2 percent of all failures to deliver settled within five days of T+3 and ninety-eight percent of people received their shares within ten days. Tr. 1422, 1488.[91] Also, in a textbook he authored, Harris stated that, "Clients generally do not know whether their brokers have lent their securities, and they generally do not receive any lending fees." Tr. 1427.

Harris noted that Feldman engaged in very large trades, trading as much as $80 million in transactions, and that his three-part strategy consisted of reverse conversions, which are particularly profitable if loan fees are avoided. Tr. 1543; Div. Ex. 310 at 8, 19. For example, on December 31, 2009, Feldman was assigned a deep-in-the-money call on Sears that forced him to sell short 557,300 Sears shares valued at $47 million. Div. Ex. 310 at 8. The loan stock fee, or hard-to-borrow-fee, on December 31, 2009, was 17.2 percent so the borrowing cost would have been approximately $22,000 per day. Id. at 8, 13. On the same day, Feldman entered a buy-write for 516,600 shares of Sears valued at $43 million, which represented thirty-two percent of the Sears shares traded in the United States on December 31, 2009. Id. at 8. Harris opined that if the 516,000 shares had been sent to the market without being paired with the sold call, it would have caused a disruption and raised prices by five to ten percent. Id. According to Harris, Feldman's Sears buy-writes had a maximum daily value of $84.6 million, and the buyers of the calls exercised them the day of purchase or the next day, presumably to obtain the stock to deliver to Feldman. Id. at 8-9.

Harris acknowledged that only one of the stocks at issue paid dividends, and while he claimed that purchasers were harmed because they could not vote the stocks, he did not know what, if any, voting opportunities purchasers of the securities missed during the relevant period. Tr. 1427-28; Div. Ex. 310 at 5.

Harris's analysis showed that for all buy-writes in all accounts mentioned in the OIP, sixty-six percent of the time the buy occurred after 10:00 a.m. ET. Tr. 1563-64; Div. Ex. 310 at 52, Ex. 26. The analysis did not specify the day on which the buy occurred. Tr. 1564. Harris found that buy-writes were executed, on average, an hour and a half after the market opened and they had little effect on market prices in the underlying stock market. Div. Ex. 310 at 12.

[91] Harris relied on CNS data for delivery information. Tr. 1574.

In Harris's opinion, the only benefit to the customer of these buy-write transactions was to affect the settlement status of the customer's earlier trades.[92] Tr. 1609. Harris found that Feldman's strategy violated Reg. SHO because it was designed solely to evade the requirements to borrow or purchase stock to settle short sales, and it allowed naked short positions to continue. Harris testified that Feldman's trading strategy would not have been profitable if optionsXpress required Feldman to pay hard-to-borrow fees. Div. Ex. 310 at 9. Harris determined that Feldman's buy-writes were regularly exercised on the same day they were sold and that the exercise restored Feldman to a short position for which he had not borrowed stock. Id. at 7-8. Harris found no legitimate economic purpose in writing a deep-in-the-money call and buying the stock at the same time. Id. at 24.

Harris determined that Feldman engaged in 390 buy-write trades on 386 days out of a total 395 trading days in the period June 2009 to March 18, 2010.[93] Id. at 32. Many buy-writes occurred one trading day after a previous buy-write in the same security. Id. at 34. On average, the strike prices of the calls were fifty-seven percent lower than the closing prices of the underlying stocks on the day of the sale so as to be very deep-in-the-money. Id. at 32. Very often the call was sold and assigned on the same day at the same size. Id. at 32-34, 37. The vast majority of buy-writes were closed by assignment. Id. at 36. Feldman executed buy-writes in Sears on fifty consecutive trading days. Id. at 35. Using last in, first out (LIFO), forty-nine percent of Feldman's calls on securities mentioned in the OIP were assigned one hundred percent on the day of the trade, while this occurred sixty-three percent of the time for all of the accounts and all of the securities mentioned in the OIP. Tr. 1511-15; Div. Ex. 382, Ex. A3, Panels C, E.

Harris found that the buy-writes cost Feldman $1.23 on average per contract, and in addition, he paid an average commission of $0.88 per contract to trade them, plus additional commissions when the call options were assigned to him and he sold the stock. Div. Ex. 310 at 37-38. Harris opined that since the buy-writes were costly and essentially risk-free, Feldman's purpose was to extend his settlement failures on short positions. Id. at 38.

Harris determined that the securities mentioned in the OIP were hard-to-borrow securities with average loan fees from eleven percent for TXI to eighty-one percent for Citi from June 2009 to March 18, 2010. Id. At the time, the typical stock loan rate was about 0.30 percent. Id. The largest harm that Harris quantified is the loss of hard-to-borrow fees, which would be paid to those with securities to loan, likely large broker-dealers. Tr. 1431.

[92] According to Harris, after the deep-in-the-money call was assigned, Feldman could have taken other measures to return to equilibrium but they were expensive. Tr. 1610-11.

[93] It appears that if two stocks traded on the same day the result was two trading days, which might be the reason why the number of days between the specified dates is higher than would be expected.

Averaging three different methods, Harris estimated that Feldman's gross trading profits were $4,560,202.[94] Id. at 11-12. Harris calculated that optionsXpress avoided paying stock loan fees of $7,227,851 or $7,214,977 on the customer accounts referred to in the OIP during the relevant period. Id. at 13, 53, Exs. 22, Panel B, 28. He calculated that the accounts named in the OIP paid commissions to optionsXpress of $1,908,744, of which buy-writes accounted for $1,574,599. Id. at 13.

Harris testified that the theory of best execution is inapplicable to Feldman's buy-writes. Tr. 1476. He agreed that it is cheaper to trade the purchase of stock and the sale of call options in combination rather than in separate transactions, but he is unaware of best execution being applied to anything other than market orders in individual securities. Tr. 1479-81. Harris agreed that a buy-write mitigated the market disruption caused by large stock sales. Tr. 1482.

Harris disagreed with Respondents' experts that Feldman employed an arbitrage strategy, which occurs when securities are mispriced. Tr. 1365, 1367, 1395-96. Harris insisted that the securities were properly priced, the loan fees accounted for the price difference, and the use of FIFO for identifying the frequency of assignments was inappropriate. Tr. 1362-63. According to Harris, so-called parity arbitrage does not arise often, and when it does electronic traders react immediately. Tr. 1364. If Feldman's strategy was true arbitrage, the price of the synthetic and the price of the underlying asset would move closer to one another. Tr. 1365. This did not happen. Tr. 1366.

Harris denied that the Division cherry picked the evidence to prove the allegations. Tr. 1397-99. Harris agreed with the Division's position that Feldman's written calls were highly likely to be assigned. Tr. 1387. Harris did not consider the buy-writes to be bona fide transactions because, considered together, the purpose was to extend short positions and avoid either borrowing or buying securities. Tr. 1402-04. Harris considered the use of buy-writes to be similar to the flex options in Hazan because trades were used to extend short positions in both situations. Tr. 1404-05.

On rebuttal, Harris sponsored a series of tables that responded to Respondents' criticism of the originals. Div. Ex. 497.[95] He took issue with optionsXpress's expert, and contended that

[94] The expected trading profit method showed a net profit estimate of $2,656,377; the stock loan fees avoided method showed a net gain estimate of $1,883,068; and the net asset value accounting method showed a net profit estimate of $2,835,872. Tr. 1549-51; Div. Ex. 310 at 40-46, 48, Exs. 20-23.

[95] Div. Ex. 497, Ex. 20-R: Total Expected Profits for the Purpose Trades, after December 1, 2009; Div. Ex. 497, Ex. 21-R: Costs for Buy-Write Trades, After December 1, 2009; Div. Ex. 497, Ex. 22-R: Panel A: Estimated Stock Loan Fees not Paid Based on Fails as Evidenced by the Aggregate Buy-Writes, After December 1, 2009; Div. Ex. 497, Ex. 23-R: Estimated Feldman Account Net Asset Value Profits, After December 1, 2009; and Div. Ex. 497, Ex. 26-R: Time Since Market Open of Various Events for the Buy-Write Trades.

Feldman did not take advantage of true arbitrage opportunities. Rather, the cost of doing these trades legally included paying hard-to-borrow fees, which Feldman did not pay. There was no mispricing. Tr. 4869-70, 4883. Harris determined that the price of the synthetic long is consistently lower than the price of the underlying hard-to-borrow stocks because of stock loan fees, and this price difference is persistent in hard-to-borrow shares. Tr. 4877, 4882-83. Harris viewed Feldman and other customers as traders taking advantage of not paying loan fees to make money on the difference between buying synthetic shares and selling the equivalent of the common stock. Tr. 4882.

Harris's review of CNS data convinced him that optionsXpress did not deliver shares to close out its CNS fails to deliver. Tr. 4894-95. To Harris, delivery meant a transfer of ownership through the clearing system to the purchaser and ultimate registration on the books of the corporation. Tr. 4897. Harris disagreed with optionsXpress's expert that a purchaser who does not receive shares in a timely manner is not damaged in terms of dividends and voting rights. Tr. 4897-98. He testified that the customer will not have the right to vote the shares, will receive a payment in lieu of dividends, and the customer's broker will not have the shares to loan. Tr. 4897-98. Harris testified that the trading at issue had no direct impact on stock prices or market efficiency. Tr. 4918. He viewed assignments as an uncertainty but not a risk. Tr. 4919.

In rebuttal, Harris calculated that before August 20, 2009, optionsXpress executed ninety-seven percent of 1,173 buy-writes after 10:00 a.m. ET. Tr. 4923. After August 20, 2009, it executed fifty-one percent of 1,105 buy-writes after 10:00 a.m. ET. Tr. 4924; Div. Ex. 497, Ex. 26-R. Before August 20, 2009, ninety-eight percent of the buy-write orders were inputted after 10:00 a.m. ET, and after August 20, 2009, four percent of the buy-write orders were inputted after 10:00 a.m. ET. Div. Ex. 497, Ex. 26-R. Before August 20, 2009, ninety-nine percent of the buy-write orders were modified after 10:00 a.m. ET, and after August 20, 2009, seventy-three percent of the buy-write orders were modified after 10:00 a.m. ET. Tr. 4923-26; Div. Ex. 497, Ex. 26-R.

In rebuttal, Harris recalculated the Feldman data from December 1, 2009, that he had offered on direct: $2,616,420 for gross expected profits based on spreads;[96] $2,498,689 for stock loan fees avoided;[97] and $3,207,558, for net asset value profits.[98] The average of the three is $2,774,222. Tr. 4926-31; Div. Ex. 497, Exs. 20-R, 22-R, 23-R.

Harris calculated the same numbers on a net basis as $1,389,442 for total expected profits based on spreads; $1,318,093 for stock loan fees avoided; and $2,026,962, for net asset value profits. The average of the three is $1,578,166. Tr. 4931-35; Div. Ex. 497, Exs. 20-R, 21-R, 22-

[96] The figure assumes one hundred percent delivery failure which is not accurate. Tr. 4982.

[97] The figure represents loan fees associated with trades, understanding that optionsXpress did not charge Feldman hard-to-borrow fees. Tr. 5004.

[98] The $2,774,222 is highly suspect. Tr. 4929-30; Div. Ex. 382, Ex. 23-R

R, 23-R. Harris could not explain why data for AIG that occurred before December 1, 2009, was included in Div. Ex. 497, Ex. 23-R. Tr. 4991-92. He conceded that he had concerns about some of the numbers and was not as confident as he would like to be in them. Tr. 4997, 5005-08. He characterized the net asset value profits as probably the least reliable estimate. Tr. 5008-09.

Harris understands that Reg. SHO is to prevent continuous CNS fails. He testified there are many reasons why a clearing broker can have CNS fails and not violate Reg. SHO. Tr. 4966-67.

Brendan Sheehy (Sheehy) appeared as a Division expert sponsoring Div. Exs. 375, with Exhibits 1-7, and 378-81.[99] Sheehy was asked to examine trading records, evaluate and describe trading strategies, and discuss economic aspects of the trading, including Feldman's three-way trades, other transactions, and associated buy-writes. Div. Ex. 375 at 2-3. Among other things, Sheehy considered whether these transactions make economic sense. Tr. 941; Div. Ex. 375 at 2-3.

Sheehy studied Feldman's transactions in Sears for the period from September 16, 2009, to March 21, 2010, and found that Feldman executed 113 buy-writes on 107 days, over a period of 121 business days. Tr. 703-04; Div. Ex. 375 at 3, 23 n.22, 33 & n.32, 34-35. Sheehy characterized Feldman's transactions as huge. Tr. 749. Sheehy testified that Feldman generally engaged in an option strategy that involved three-way trades in hard-to-borrow Sears stock by simultaneously selling puts and buying calls at the same strike price and expiration date and selling deep-in-the-money calls, all for the same number of contracts. Tr. 1010; Div. Ex. 375 at 4. When stock is hard-to-borrow, the price of puts goes up and the price of calls goes down. Tr. 935. If the deep-in-the-money call was not assigned until expiration, Feldman kept the difference between the price of the put and the call. Tr. 956. If Feldman's deep-in-the-money calls were assigned, they became short positions that Feldman had to cover. Tr. 957-59. Sheehy testified that Feldman entered buy-writes to circumvent borrowing shares.[100] Tr. 729, 958-59; Div. Ex. 375 at 4-5.

According to Sheehy, Feldman's buy-writes involved daily share purchases, which gave the impression that he closed his short position, but he simultaneously sold deep-in-the-money calls for the same number of shares, effectively canceling the purchase he had just made. Div. Ex. 375 at 4-5, 34. "To incentivize the counterparties to buy the deep-in-the-money calls, the customer sold the calls under parity to the stock, guaranteeing the counterparties a profit (and

[99] After graduating from Indiana University in 1993, Sheehy began an eighteen-year career trading options. He has been employed by O'Connor & Associates LLP/Swiss Bank Corp., Refco, Inc., Cornerstone, LLP, and PEAK6 Investments, LLP. Div. Ex. 375 at 1, Ex. 1.

[100] The obligation to cover short shares arises when the call option is assigned, not when it is written. Tr. 728-29. Sheehy testified that the deep-in-the-money calls that Feldman sold as the third part of the three-leg trading strategy would be immediately exercised by the counterparties. Div. Ex. 375 at 4.

guaranteeing the customer a loss on the buy-write)." Div. Ex. 375 at 34 (emphasis in original). Sheehy found that counterparties that bought the deep-in-the-money calls that were part of the buy-writes generally exercised them right away. Id. at 33-34. When this occurred, Feldman entered into another buy-write transaction. Id. at 34.

Sheehy testified that: (1) Feldman was assigned on his deep-in-the-money calls almost immediately; (2) Feldman was assigned on ninety percent of the buy-writes on the first day; (3) Feldman was assigned on his buy-writes nearly every day for ten or fifteen consecutive trading days; and (4) he increased his position by almost fourfold. Tr. 1096. Sheehy also testified that on September 23, 2009, the counterparties exercised one hundred percent of the deep-in-the-money calls that were part of the buy-writes that Feldman wrote the prior day. Tr. 1100-01; Div. Ex. 375 at Ex. 5. Sheehy acknowledged that Feldman's deep-in-the-money calls were not immediately exercised one hundred percent of the time, and that his opinion that they would be immediately exercised is based on his experience and not trading records. Tr. 1011-22.

Sheehy's experience has been that most people who borrow hard-to-borrow stocks pay a negative or extremely expensive rate to do so. Tr. 659, 731, 740, 979; Div. Ex. 375 at 19, 21-24. Sheehy believed that Feldman's buy-write strategy allowed him to profit because he was able to maintain a short position without having to pay for borrowing hard-to-borrow shares. Div. Ex. 375 at 5. Sheehy did not know that optionsXpress did not charge customers a fee to borrow stock. Tr. 725. He believed that anyone who shorts stock is required to borrow the stock or buy in, and that by entering an options contract, Feldman was agreeing that he would deliver shares, if assigned. Tr. 726-27, 737-38.

Sheehy posited that if Feldman had borrowed shares to maintain a short stock position, his trades would not have been profitable because of expensive borrowing fees. Div. Ex. 375 at 17. Sheehy opined that Feldman was trying to take advantage of the pricing differential between the price of the put and call, which is essentially the fee to borrow stock. "When the borrowing fee is very high, the short rate will be a large negative rate."[101] Id. at 18, 23. From September 16, 2009, to March 21, 2010, the short rate on Sears ranged from -2% to -18.7% for an average of -13%. Id. at 23 n.22.

Sheehy claimed that if traders were able to avoid settling short sales and maintain short positions in hard-to-borrow stock without paying the large negative short rate, then the price of the put would move back to parity with the price of the call and the arbitrage opportunity would disappear. Id. at 24. He believed that arbitrage opportunities exist only for seconds in the options markets. Tr. 695.

Sheehy was of the opinion that the twenty-five securities at issue in this proceeding were hard-to-borrow securities during the relevant period. Div. Ex. 375 at 31-32. He concluded that in these circumstances, a rational retail customer would not initiate a three-way trade in Sears, a hard-to-borrow security, unless he never planned to deliver the shorted stock if he was assigned

[101] Sheehy used the term "short rate" to refer to the negative interest rate to borrow hard-to-borrow stocks. Div. Ex. 375 at 18. See supra note 19.

the deep-in-the-money calls. Id. at 32. The reason being that if he delivered the shorted stock, he would have to pay the high negative short rate and the cost would eliminate the profit from the difference between the put and call options. Id.

Sheehy concluded that few of the deep-in-the-money Sears calls sold as part of the buy-writes were intended to hedge an existing long delta position (to hedge Feldman's directional risk in the price of Sears stock), rather they were done in conjunction with the purchase of stock.[102] Id. at 36-37. According to Sheehy, this is shown by the fact that the calls were sold at exactly $0.01 to $0.02 under parity to the stock bought. Id. Sheehy testified that Feldman's daily buy-write transactions made no economic sense. Id. at 37.

Sheehy believed Feldman's deep-in-the-money calls were virtually certain to be exercised and assigned to him. Id. at 39. This is because, first, if the purchaser did not exercise, he would have to hedge the directional risk by shorting Sears stock at an expensive short rate. Id. Second, Feldman's deep-in-the-money calls had a low open interest. Id. The open interest for call option contracts on stock where the short rate is negative because of high borrowing costs is usually very low because it is optimal for holders of the calls to exercise immediately rather than shorting the stock to hedge the position and have to pay the short rate. Id. at 25. In that environment, the seller of a deep-in-the-money call had a high likelihood of being assigned. Tr. 1093; Div. Ex.. 375 at 39-40.

Sheehy found that: (1) Feldman sold an exceptionally high percentage of the total daily volume of Sears call options sold; and (2) between 87.9% and 94.5% of the deep-in-the-money calls that Feldman sold were assigned overnight. Tr. 674; Div. Ex. 375 at 40. From the material he reviewed and from Feldman's actions, Sheehy believed that Feldman understood that his calls would likely be assigned. Div. Ex. 375 at 40-41.

Between September 16, 2009, and March 21, 2010, Feldman initiated fifty-five three-way trades in Sears that generated positive cash flows of $1,289,970, and executed 113 buy-writes, buying 30,824,400 shares of Sears and selling 308,244 calls, that resulted in losses of $412,051. Id. at 34-35, Exs. 4-5. His net profit in the roughly six-month period was $877,919. Id. at 35.

Sheehy concluded that:

> (1) Feldman's trading in Sears was implemented to avoid delivering shorted shares. Feldman knew the deep-in-the-money calls he sold would be assigned putting him back into a short position;

[102] Delta is a measure of the relationship between an option price and the underlying stock price. For a call option, a delta of 0.50 means a half-point rise in premium for every dollar that the stock rises. For a put option, the premium rises as the stock prices fall. Finance & Investment Handbook 336-37.

(2) Feldman and other optionsXpress customers followed similar strategies trading hard-to-borrow securities;

(3) A rational retail customer would not initiate a three-way trade in a hard-to-borrow stock unless he never planned to deliver the stock when the deep-in-the-money call was assigned;

(4) Feldman's three-way strategy would not have been profitable if Feldman had borrowed the shares and paid the expensive interest rate to do so;

(5) optionsXpress and Feldman knew or should have known that the deep-in-the-money Sears calls that Feldman sold would be exercised immediately, putting Feldman into a short position. This is because open interest associated with the deep-in-the-money calls that Feldman sold was relatively low, signaling a great chance of being assigned. Feldman continued to increase the size of his position in Sears and enter more three-way transactions after the pattern of daily assignments occurred; and

(6) Through optionsXpress, Feldman executed his buy-write strategy for a guaranteed locked in loss, generally from $0.01 to $0.02 per share. Sheehy had "never seen a buy-write written up by a brokerage firm traded under parity (i.e., for a loss)." The only economic reason Sheehy could think of for Feldman's buy-writes was "to maintain his short position and avoid paying the expensive short rate." Div. Ex. 375 at 5-6, 35-36.

Sheehy testified that industry norms do not allow writing successive buy-writes on the same stock. Tr. 924-26. A trader would likely be fired if he told his superiors that he entered into buy-writes repetitively on the same option because he was assigned and did not want to, or could not, borrow stock. Tr. 924-30.

Expert Witness for optionsXpress

Dr. Atanu Saha, Ph.D. (Saha) appeared for optionsXpress and sponsored OPX Ex. 248, with Exhibits 1 - 13B and Appendices A and B, and OPX Exs. 1007-1012.[103] optionsXpress charged Saha to review the allegations in the OIP as an economist. Specifically, Saha was asked to evaluate whether: (1) the transactions had a legitimate economic purpose; (2) calls were exercised and assigned on the same day they were sold; (3) customers had any economic motive

[103] Saha is Senior Vice President and head of Compass Lexecon's New York office. He holds a M.A. from the University of Alberta, Canada, and a Ph.D. from the University of California, Davis. His academic concentration was applied economics and econometrics and he has over twenty years of experience in economic consulting. In 1995, Saha chose to become a private sector economist rather than a tenured professor at Texas A&M University. He has published extensively and was awarded the Graham Dodd Award for financial research. Tr. 4368-76; OPX Ex. 248 at 1, Appendix A.

"to perpetuate an open short position;" (4) optionsXpress fulfilled its delivery obligations under Reg. SHO; and (5) the trading drove down stock prices. OPX Ex. 248 at 3.

Saha found the transactions at issue to be box-spreads or three-ways. Id. at 13. He concluded that the buy-write transactions at issue in the proceeding had a legitimate economic purpose; they were an integral part of a hedged option-trading strategy, which was not a short selling scheme. Id. at 4. This strategy was fundamentally different from shorting or naked shorting because a drop in the underlying stock price did not enhance the potential profit from the strategy. Id. Saha argued that the Division's position that the purpose of the buy-writes was to perpetuate a failure to deliver is inconsistent with the statement in the OIP that the purpose of selling the deep-in-the-money calls through buy-writes was to hedge the downside risk of the synthetic long position, a legitimate economic purpose. Id. at 19-20. According to Saha, the options strategy used by Feldman and other customers had a legitimate economic purpose because it had a capped profit potential and risk of loss, the hallmark of any legitimate economic strategy. Tr. 4408, 4414; OPX Ex. 248 at 13-15. Saha disagreed with other witnesses and claimed that writing a deep-in-the-money call to hedge was the only viable means of hedging a synthetic long position. Tr. 4418-20.

Saha sought to debunk the Division's position that the buy-writes were nonsensical because they cost the customer money by analogizing them to home insurance, which is also costly. OPX Ex. 248 at 20. He asserted that the legitimate economic purpose of the buy was to meet the delivery obligation created by the assignment and the write was to re-initiate the hedge of the three-way or box spread strategy. Id. Saha presented a list of twelve funds or asset management firms that use buy-writes. Id. at 20-22.

According to Saha, contrary to the OIP, neither optionsXpress nor its customers could have known that deep-in-the-money calls were virtually certain to be assigned because data showed that more than two-thirds of the deep-in-the-money calls were not fully assigned on the same day they were written. OPX Ex. 248 at 4-5. Saha's data showed that of the twenty-five securities identified in the OIP, five had between 14.5 percent and 39.1 percent (Sears) of their written deep-in-the-money calls fully assigned on the day they were written.[104] Id. at 25, Ex. 5. Saha's statistical analysis showed that none of the twenty-five securities in the six customer accounts covered by the OIP were one hundred percent certain of being assigned. Id. at 25-26. Saha claimed this evidence and additional analysis contradicts the Division's position that deep-in-the-money calls are highly likely to be assigned. Id. at 25.

Of the twenty-five securities noted in the OIP, the five with the highest volume of buy-writes were AIG, AMED, C, MNKD, and Sears. Open interest in deep-in-the-money calls in these securities as a percentage of open interest in all calls, excluding out-of-the-money calls, ranged from 1.9 percent to 7.3 percent. Id. at 28. To Saha, this showed that deep-in-the-money

[104] Saha acknowledged e-mails and expert testimony showing daily assignments to these customers, but says daily assignments are not what is significant. "[W]hat portion of the calls that were written was getting assigned. That is the question." Tr. 4573.

calls exist for a wide range of stocks, not just the twenty-five identified in the OIP. Id. at 27. Saha believed that the random assignment of calls contradicts the Division's claim that optionsXpress and its customers should have known that each of their calls would be assigned. Id. at 27-28.

Saha maintained that, contrary to the Division's position, the buy part of the buy-write met the delivery obligation created by the assignment of the calls, which is to say, the purchases closed out the short position and cured the fails to deliver. Id. at 5, 29-30. Thus, the buy-writes were not schemes to profit by circumventing the delivery requirements of Reg. SHO. Id. at 5.

Saha also maintained that the Division is wrong that shares of stock bought in a buy-write transaction would not be delivered "on settlement" because as long as shares are bought within three days following the day of assignment, the short stock position is covered and the shares are delivered on settlement. Id. at 24. He contended that shares were delivered the day the buy-write occurred, but settlement of the shares occurred three days later. Id. Saha rejected the argument that calls that were part of the buy-write negated the purchases that were part of the buy-write because all of the calls were allegedly fully assigned on the same day they were written.[105] Id. According to Saha, account-level data showed more than 99.3 percent of the short stock positions resulting from assignments "were cured within the T+3 window through legitimate purchases of stocks by the customers." Id. at 32.

Saha opined that the data shows the Division is wrong that the buy-writes were sham transactions that gave the impression that shares were purchased to close out a fail to deliver position. Id. at 29-30. I believe Saha is making the point that fails to deliver addressed by a transaction at the opening of the market on T+4 in compliance with Reg. SHO would not settle for three days. Also, the CNS fail to deliver number changes daily and includes old and new assignments. Saha's figure showing optionsXpress's trade balance and CNS fails to deliver in Sears surged dramatically in the period September 2009 to March 2010. Id. at 31.

Saha opined further that the data showed that arbitrage opportunities exist in option trading. Id. at 36. He contends that the Division is wrong to state that certain transactions were profitable because customers did not incur costs associated with borrowing or purchasing shares to cover short sales. Id. at 33-34. He referred again to data that shows 99.3 percent of customers' short stock positions created by assignments were covered by stock purchases within T+3. Id. at 34. Saha asserted that the Division wrongly believes that customers chose hard-to-borrow securities to implement their strategy because that is where mispricing occurred. Id. at 34, 37. He noted several web sites advertising opportunities in mispriced options and presented what he believed to be "Directional Mismatch between Changes in Option Price and Underlying Price."[106] Id. at 34-36. Saha opined that arbitrage in the trading world is very different from the description of academics and that this proceeding is an example of customers trading on

[105] Saha's testimony is about full option assignments, whereas the Division's evidence is on any size assignments.

[106] The record establishes that option trading presents opportunities for profits.

arbitrage opportunities in the marketplace. Tr. 4535-36. Saha testified that his analysis shows that "there was mispricing thirty percent of the time." Tr. 4535-36.

Saha maintained that if the Division's theory that Feldman's trading strategy was "a complex short selling scheme" was correct, customers would have sought to be assigned, but his data established that the higher the frequency of assignments, the lower the potential profit. OPX Ex. 248 at 5. Further, faced with a delivery obligation as the result of an assignment, a customer had "essentially two rational choices: unwind the strategy and potentially suffer a loss, or enter into a buy-write transaction." Id. Later, Saha outlined three logical optionsXpress customer choices: (1) buying shares; (2) buy-write; or (3) unwind the strategy. Id. at 17-18. The first choice is not economically rational and early unwinding could lead to losses. Id. at 18, 22. The buy-write served two purposes: the buy side of the transaction met the stock delivery obligation created by the assignment and cured the fails to deliver, and the write reestablished the customer's hedged position, which was part of his option strategy. Id. at 9.

Saha believed that the OIP's statement that the strategy was to hedge the customers' synthetic long position contradicts the claim that customers' investment strategy was a short selling scheme. Id. at 37-40. He asserted that buy-writes were different from shorting stock in "economic essence and in effect." Id. at 38. The basis of his statement was that: (1) stock prices for the five securities that had the heaviest trading of the twenty-five securities named in the OIP rose during the relevant period; and (2) "[r]igorous statistical analysis of the share price movements of the twenty-five stocks at issue also demonstrates that stock prices did not fall as a result of the buy-write transactions." Id. 37-40.

Saha's application of the Capital Asset Pricing Model showed no statistically significant changes in the risk reward profiles of the securities identified in the OIP during the period when most of the buy-writes happened so they had no discernible market impact. Tr. 4429-31. Also, data analysis showed the options-spread strategy and the buy-write transactions did not depress prices of the twenty-five securities identified in the OIP. OPX Ex. 248 at 6.

Saha strongly disagreed with the opinion of Harris that shares purchased in buy-writes were not delivered. He noted that Harris found that for stocks named in the OIP, 98.4 percent of the CNS fails to receive were resolved within five trading days. Tr. 4512. Saha was critical of Harris's calculation that only thirty-three percent of the trades occurred before 10:00 a.m. ET because Harris did not state whether the day was T+4. Saha found that for the period October 1, 2008, through March 31, 2010, short positions created by assignments in the accounts at issue for the named securities were covered from ninety-five percent on T+1 up to 99.8 percent on T+4. Tr. 4387-91. Saha found that Harris's characterization of naked shorts was not applicable because delivery was timely. Tr. 4392-93. He made the point that a buy-write on day four, or T+3, to close a CNS fail would not settle until T+6 (the third day after the buy-write), so three days of CNS fails can happen with Reg. SHO compliance. Tr. 4394-97.

Saha believed the number of days of CNS fails is an irrelevant number in addressing the issues in the proceeding, citing a statement on the Commission's website that the age of fails cannot be determined by looking at the CNS number. Tr. 4399-4400; OPX Ex. 248 at 31. Saha took issue with Harris's claim that customers and clearing brokers were hurt by failures to

deliver, noting that customers are credited the stock on the trade date, which would entitle them to voting rights and dividend benefits. Tr. 4479-81. He also disagreed with Harris that Feldman's trading strategy did not have significant risk exposure. Saha found Harris's theories and damage calculations invalid. Tr. 4433-36. If optionsXpress is found liable, any damages assessed should be calculated based on total commissions earned from the trades at issue, and the percent of fails uncured as of the end of T+3. Tr. 4434-35. If you assume the commissions were $2 million, and .7 percent were not covered on T+3, the amount is about $14,000. Tr. 4434-36.

Expert Witness for Stern

John Ruth (Ruth) appeared for Stern and sponsored OPX Ex. 250 with Exhibits 1-10. Ruth opined that: (1) the option market has grown dramatically so that even regulators do not always appreciate its complexity; (2) Reg. SHO does not address non-directional hedging strategies that use standard options; (3) the buy-writes at issue were bona fide transactions and were appropriate for closing out optionsXpress's Rule 204 obligations; and (4) to the extent that he knew buy-writes were being used, Stern was not reckless in not demanding that they stop.[107] OPX Ex. 250 at 5-20. Ruth did not see it as a problem, or causing any harm to the system, when someone does not receive shares on the day they are entitled to them because the CNS delivery system works, and over ninety-five percent of shares are delivered in three days. Tr. 4327-28, 4354. He noted that a CNS fail to deliver can include shares covered by transactions that have not yet settled. Tr. 4328-29. In addition, he testified that someone owed shares has a long position on their broker-dealer's books and records, the shares are settled trades, and the purchaser has all the benefits of ownership. Tr. 4348.

According to Ruth, Reg. SHO does not address economically legitimate non-directional trading strategies that employ standard option products, including deep-in-the-money standard options. OPX Ex. 250 at 7-11. Ruth did not know how an assignment or frequency of assignments would be an indicator of a Reg. SHO violation. Tr. 4243-44. Ruth thought it was significant that Feldman was not attempting to maintain a short stock position and that his position was not any more profitable if the stock price went down. Tr. 4173-74. According to Ruth, Feldman made money by minimizing risk and cost – not by shorting the stock. OPX Ex. 250 at 7-11.

Ruth testified that the buys would always have to net against the writes for buy-writes not to be bona fide stock purchases, and this was highly unlikely. Tr. 4264-65; OPX Ex. 250 at 11-14. Ruth maintained that in order for a buy-write to fail to close out optionsXpress's Rule 204 obligation, "an option would have to be purchased, exercised, and assigned on the exact same

[107] Ruth has an undergraduate degree in Economics from Indiana University and a M.B.A. from the Kellstadt Graduate School of Business, DePaul University. He holds series 4, 7, 10, 24, 55, and 63 licenses. From 2000 through March 2012, Ruth was Vice President and Managing Director of Goldman Sachs Execution & Clearing L.P. From 1993 through 2000, he was an independent floor trader at the Chicago Board of Trade, and from 1997 through 2000, he was a partner at Century Group Holdings LLC, an introducing futures broker. OPX Ex. 250 at 1-2.

day and completely assigned to the seller . . . in order to net-out against the purchases of stock made on that day." OPX Ex. 250 at 13. The evidence is that options were not exercised that rapidly. Id. Ruth acknowledged, however, that on October 6-7, 2009, when Feldman did a buy-write and received an assignment in the same security, the net effect of his trading was zero. Feldman's purchases were offset by the assignment. Tr. 4265-66.

Ruth contended that the data indicate that deliveries were made and new fails created daily. OPX Ex. 250 at 14. Ruth denied the OIP's allegation that the buy-writes were married stock/option trades designed to give the appearance of a long position. Id. He distinguished this situation from situations where FLEX options were used and where married stock/option trades between prearranged parties were done for the sole purpose of resetting the obligation to deliver stock on a short position. Id. Ruth claimed that the calls at issue here were not likely to be exercised on the same day they were sold and that these calls had an economic purpose other than avoiding a delivery obligation and re-setting the close-out period. Id. at 14-15, 17. Ruth considered trades done only to reset the holding period to be of no economic substance; however, the trades at issue here were done to re-hedge a position and eliminate the market exposure created by the assignment or short stock position and thus had an economic purpose. Tr. 4340.

Ruth's position is that if a clearing firm believes its actions are appropriate, it does not know of a rule that defines the activity as inappropriate, and regulators did not tell the firm to stop the activity, the firm should not be held to a higher standard. Tr. 4281. Ruth did not know of a rule that gave guidance on whether a broker could meet its CNS delivery obligation by buying in and selling a call option at the same time. Tr. 4333. Ruth contended that it was appropriate for optionsXpress to continue its activities even knowing that Trading and Markets refused to give it comfort because CBOE did not tell it to stop; he considered Reg. SHO's application to options unclear. Tr. 4292-94, 4345-46; OPX Ex. 250 at 16. Ruth testified that CBOE's failure to find Reg. SHO violations in connection with Zelezney's transactions and to prohibit exchange members from similar conduct sent the message to optionsXpress to keep doing what it was doing. Tr. 4272-73, 4281.

Ruth's position is that optionsXpress was reasonable to continue its activities even with investigations pending, until it was told to stop. Tr. 4277, 4280-81. Ruth suggested that if the law was as clear as the Division suggests, regulatory authorities would have launched investigations. He was unaware when he prepared his testimony that optionsXpress's use of buy-writes was noted by CBOE and FINRA surveillance. Tr. 4267. Even so, Ruth stands by his testimony because the exchanges continued to accept buy-writes in connection with fails to deliver. Tr. 4267, 4279. In his opinion, if a regulator thought optionsXpress's conduct was a problem, it should have told it to stop. Tr. 4295.

Ruth was unaware that the International Securities Exchange found that Wolverine Trading, LLC had violated Rule 203(b) and ISE Rule 400, in the period January through June 2008, for using buy-write transactions to improperly address its close-out obligation while maintaining its short position in certain securities. Tr. 4245. Ruth was also unaware that the NASDAQ OMX PHLX reached a settlement with Keystone Trading Partners and its general

partner on July 7, 2011.[108] It appears that between August 1, 2006, and July 17, 2009, the named persons violated Rule 203(b)(1) and (b)(3) of Reg. SHO by:

> routinely effecting short-term, paired transactions of stock and options that made it appear that they had purchased threshold securities and had satisfied their close-out obligations on the books and record of Keystone's clearing firm. In reality, however, these paired transactions yielded no economic benefit to Respondents and did not close out their short positions.

Tr. 4256-57; Div. Ex. 428. Keystone did not involve FLEX options or collusion. Tr. 4246-47, 4258-59.

Ruth considered a sham transaction, or an improper reset under Reg. SHO, to be a transaction used to avoid a closeout; he contended that a transaction with an economic purpose is not a sham. Tr. 4333-34. Ruth did not consider optionsXpress's situation to come within the language of AMEX Circular Reg. 2007-35, the Wolverine, or Keystone situations because there was no arrangement, the buy-writes had an economic purpose, the options were not short term, and no market maker was involved. Tr. 4334-40.

Ruth testified that the Division is seeking to establish an untenable requirement that a firm be aware from the frequency of assignments that "it will continue to be in a fail-to-deliver position even though it may be satisfying its [Reg. SHO close-out obligations]." Tr. 4167; OPX Ex. 250 at 18. In Ruth's opinion:

> [I]t also was reasonable for optionsXpress to believe – after having received no guidance to the contrary despite having been investigated, audited, subjected to surveillance by, and having repeatedly sought advice from, its regulators – that the buy-writes were an appropriate way to cover short positions while allowing its clients to remain hedged.

OPX Ex. 250 at 18. Ruth faults the Commission for not alerting optionsXpress of its seemingly new position that Reg. SHO prohibits a firm from using buy-writes for options customers in meeting the firm's close-out obligations. Ruth believes that as CFO, Stern could not be expected to know details of the firm's trading policies and procedures, and it was reasonable for Stern to rely on Bottini and Hoeh to provide him with information about buy-writes. Ruth concluded that Stern acted reasonably in that he had no authority for how the firm complied with Reg. SHO. Id. at 19-20.

Ruth believes Harris's and Sheehy's analyses are flawed in many respects: (1) they did not know that optionsXpress did not charge hard-to-borrow fees; (2) they mistakenly thought

[108] NASDAQ OMX PHLX Disciplinary Action No. 2011-04 (June 8, 2011), Press Release, Notice Pursuant to Exchange By-Law 18-2, of Disciplinary Action Against Keystone Trading Partners, Member Organization, and Timothy D. Lobach, Associated Person of Keystone (July 7, 2011). Div. Ex. 428.

Feldman was attempting to maintain a short strategy; (3) they were mistaken that Feldman was virtually certain to be assigned because that would require an arrangement and none existed; and (4) they took too narrow a view of arbitrage, because many arbitrage opportunities exist for extended time periods. Tr. 4173-94.

Expert Witness for Feldman

Dr. Erik Sirri (Sirri) appeared for Feldman. He examined Feldman's trading at optionsXpress for the relevant period and sponsored OPX Exs. 915, with one Appendix and sixteen Exhibits, and 924, with fourteen slides.[109] Sirri offered the following opinions: (1) Feldman overwhelmingly engaged in reverse conversions and three-ways, well-known option trading strategies;[110] (2) these strategies, including the buy-writes, had the economic purpose of taking advantage of securities' mispricing; (3) Feldman had no obligation to deliver shares to CNS or to optionsXpress; (4) it was appropriate for Feldman to rely on optionsXpress to deliver shares; (5) Feldman's written calls were not certain to be exercised and assigned on the day they were written and there was considerable variation in the rate of assignments; (6) the time periods and stocks specified in the OIP are not representative of Feldman's trading strategies; and (7) knowledge that Reg. SHO motivated the close-out requests Feldman received from optionsXpress does not mean that Feldman believed executing buy-writes might cause his broker to violate Rule 204. OPX Ex. 915 at 3-4. Sirri used the term "relative mispricing" to mean that these securities provided an arbitrage opportunity to make a profit by trading a combination of the puts, calls, and the stock. Tr. 3033-35. Sirri described arbitrage as a trading opportunity that has a very high probability of being profitable. Tr. 3035.

Sirri did not cite any support for his belief that a trader can cover a short position with a buy-write. Tr. 3059-63; OPX Ex. 915 at 13. According to Sirri, a buy-write enables a trader using a three-way strategy who is forced to purchase stock by his broker to preserve the essence of his strategy.[111] OPX Ex. 915 at 13. He opined that a buy-write is the only strategy that a trader employing a reverse conversion can employ when faced with a buy-in that continues the economic purpose of the strategy, which is to achieve trading profit without significant directional market risk. Tr. 3072; OPX Ex. 915 at 15.

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[109] Sirri holds degrees from the California Institute of Technology and the University of California. He is currently a professor at Babson College. Sirri was the Commission's Chief Economist, 1996-1999, and Director of Trading and Markets, 2006-2009. He has written many published works and testified in many litigated proceedings. OPX Ex. 915 at 1-2, Appendix A.

[110] A synthetic long (buy a call and sell a put) hedged typically by selling the underlying stock short is a reverse conversion. OPX Ex. 915 at 8.

[111] When a reverse conversion is subject to a buy-in, a trader can do many things, including execute a buy-write, or alternatively: (1) buying the stock and not replacing the hedge; (2) unwinding the entire position; or (3) buying the stock and then selling short again soon thereafter, however, Sirri presumes that a broker would not want to permit a customer to short sell again the same day. Tr. 3054-55, 3069-70; OPX Ex. 915 at 15.

Sirri assumed for purposes of analysis that a trading strategy had a legitimate economic purpose if it was designed to make trading profits without using deceptive means. OPX Ex. 915 at 30. He found that the economic purpose of Feldman's three-way trading strategies was "not to avoid delivering shares or to help his clearing broker give the appearance of compliance with Regulation SHO," and Feldman's buy-writes had the clear economic purpose of maintaining a hedge, an integral part of his trading strategy. Id. at 33-34.

Sirri found that Feldman's trading did not generate any obligation for him to deliver shares to optionsXpress. Tr. 3024; OPX Ex. 915 at 35. Sirri contended that the assignment of a written call created a delivery obligation for the clearing broker, but buying stock offset that obligation. According to Sirri:

> If a Clearing Member uses a customer's buy-write transaction as a source of shares to comply with its Rule 204 closeout requirement and the written call is not exercised and assigned the same day, the buy-write would resolve the Clearing Member's fail to deliver in the CNS system, as envisioned by Reg. SHO. On the other hand, if the written call is exercised and assigned on the same day the buy-write was executed, the settlement of the option assignment would occur on the same day as that of the stock purchase, the two components would offset each other, and the stock purchase would not change the Clearing Member's net delivery position at CNS.

OPX Ex. 915 at 36. Sirri testified that his present view is that it is an unresolved issue whether a buy-write, where both transactions are executed on the same day, causes a broker to violate Reg. SHO because Rule 204 requires the broker to borrow or buy securities, but it does not require that the broker bring its CNS failed position to zero.[112] Tr. 3176-87, 3214.

Sirri asserted that Feldman's trading records do not support the Division's allegation that the buy-writes represented sham resets. Sirri testified that even if Feldman knew, or had reason to know, that his call that was part of the buy-write was virtually certain to be exercised and assigned on the same day, he would have had to be in communication with his broker to know whether the buy was for the purpose of satisfying the broker's delivery obligation to CNS. OPX Ex. 915 at 37. Sirri found that from five to fifty-five percent of Feldman's written calls on fifteen of the stocks named in the OIP were assigned, in part, on the day of issue. Id. at 38, Ex. 13. This is contrary to the general economic theory that a deep-in-the-money call is not expected to be exercised prior to maturity, let alone immediately. Id. at 37.

Sirri disagreed that Feldman knew, or had reason to know, that most of the calls that were part of his buy-writes would be exercised and assigned on the day they were sold. Id. at 38-39.

[112] According to the July 31, 2009, Adopting Release for Rule 204, to meet its close-out obligation the broker must also be able to demonstrate that on the applicable close-out date it is flat on its books and records. Tr. 3214-15.

A visual display of all Feldman's transactions showed trades in and outside the relevant period that did not involve buy-writes. According to Sirri, the periods of high buy-write activity are not typical of Feldman's trading strategies. Id. at 38-39, Ex. 16. According to Sirri, Feldman did not have sufficient information to know whether optionsXpress was complying with Reg. SHO, and it was reasonable for him to assume that acceptance of his buy-write orders meant they complied with applicable rules. Id. at 40-42.

In rebuttal, Sirri denied Harris's assertion that Feldman was required to deliver securities, that he violated Reg. SHO, and that he would have had to pay borrowing fees if he did not engage in buy-writes. Tr. 2978-85; OPX Ex. 924, Slides 5-9. According to Sirri, a broker can obtain securities by various means, but if it borrows stock and pays a fee, it decided whether or not to charge the customer, which is most often negotiated and depends on the customer. Tr. 2980. Sirri considered Harris's damage calculation flawed for numerous reasons; for example, it assumed Feldman should have borrowed stock when borrowing is a particularly expensive choice among a number of alternatives, and the method of calculation is not linked to the theory of liability. Tr. 2987-97; OPX Ex. 924, Slides 10, 11.

Arguments

The Division

The Division argues that optionsXpress violated Reg. SHO Rule 204 by failing to deliver securities by market open on T+4. Div. Brief at 15. According to the Division, CNS records demonstrate that optionsXpress had failures to deliver for at least twenty-five securities for significant periods of time between October 2008 and March 2010, and these failures to deliver "dwarfed" other firms' failures to deliver. Id. The Division argues that the buy-write transactions executed by optionsXpress, which consisted of purchasing securities on the close-out date and simultaneously selling deep-in-the-money calls, did not satisfy its delivery obligation. Id. at 1-2, 15. The Division argues that there was no economic purpose for the buy-write transactions; the customer's economic purpose was to make a profit by extending its short position without delivering shares and optionsXpress knew that these rolling fails to deliver meant that shares were not being delivered to CNS. Id. at 15-16.

The Division argues that even if the Court accepts optionsXpress's argument that the buy-write transactions satisfied optionsXpress's delivery obligation, optionsXpress still violated Reg. SHO by failing to close out its failure to deliver positions at market open. Id. at 20. The Division points to evidence that for the 1,205 buy-writes executed before August 20, 2009, a time when optionsXpress only required its customers to be bought in on T+4, ninety–seven percent of the buy-writes were executed after 10:00 a.m. ET. Id. at 20. The Division contends that optionsXpress knew that Rule 204 required the transactions to be entered into at market open and knew that this was not being done. Id. at 20-21.

With respect to Feldman, the Division argues that Feldman's offer and sale of options contracts with no intention of delivering securities when assigned was fraudulent and manipulative conduct because market participants were deceived about the volume of trading in the securities at issue and about whether they would receive their shares in a timely fashion. Id. at 26. The Division contends that Feldman's use of buy-writes allowed him to avoid delivery,

and Feldman knew that his trades were not settling and were deceiving market participants. Id. at 28. The Division points to contemporaneous communications by Feldman to brokers and his friends as evidence that he understood the call options he sold would be exercised and assigned on a daily basis and stock would not be delivered in settlement. Id. at 28-29.

At a minimum, according to the Division, Feldman negligently relied on optionsXpress to ensure compliance with the law by failing to do due diligence on the legality of his trading in the face of numerous red flags that should have tipped him off to the violations. Id. at 33-36. The Division argues that Feldman also violated Exchange Act Rule 10b-21 by selling call options on hard-to-borrow securities knowing that they would be promptly exercised and assigned when Feldman did not intend to make delivery but would instead execute buy-writes, which Feldman knew would not result in actual delivery. Id. at 36-38.

The Division argues that optionsXpress caused and willfully aided and abetted Feldman's violations by allowing Feldman's trading to continue when it knew from discussions with regulators that its customer's transactions may be a sham. Id. at 38-39.

The Division charges Stern with causing and willfully aiding and abetting optionsXpress's violations of Rule 204 and causing and willfully aiding and abetting Feldman's fraud. Id. at 40-42. The Division argues that Stern was optionsXpress's primary regulatory liaison, was intimately familiar with Feldman's trading, and participated in the calls with the regulators during which concerns were raised about the trading. Id. The Division claims that Stern was closely involved in optionsXpress's 'perpetual fail' policy, which the Division asserts "institutionalized optionsXpress's Reg. SHO-circumventing conduct." Id. at 40.

optionsXpress

optionsXpress argues that it did not violate Rule 204 because the buy portion of the buy-writes satisfied its delivery obligation "virtually 100% of the time." OPX Brief at 7. optionsXpress believes that you must look to its books and records, and not its position at CNS, to determine whether it complied with Rule 204 because: 1) Rule 204 only required it to "buy shares of like kind and quantity," not flatten its position at CNS; and 2) the CNS data is a combination of new and past fails and therefore a fail may exist even if a previous purchase cured the fail. Id. at 9-13. optionsXpress argues that the Division did no analysis to determine whether the buy-writes were traded on T+4, or whether they were traded on T+1, T+2, or T+3, in which case the buy-write could be executed after 10:00 a.m. and still comply with Rule 204. Id. at 24-26. To the extent that there were isolated instances where buy-ins occurred after market open on T+4, optionsXpress believes that those instances were due to technology glitches or reasons beyond its control. OPX Proposed Findings of Fact (FOF) at 48-49.

optionsXpress argues that the buy-writes weren't sham close-outs prohibited by Rule 204(f) because the counterparties to the trades were unknown and the Division has admitted that neither optionsXpress nor its customers had an arrangement with any counterparty. OPX Brief at 7-9. It argues that footnote 82 to Rule 204's July 31, 2009, Adopting Release, which prohibits purchasing or borrowing securities on the applicable close-out date and on that same date engaging in sale transactions to reestablish the fail position if the transaction does not have a

legitimate economic purpose, has no legal effect because it is not contained in Rule 204 itself, and that sanctioning optionsXpress for conduct that violates footnote 82 would violate its due process rights. Id. at 13-16, 28-29. In any event, optionsXpress believes that its customers had a legitimate economic purpose for executing the buy-writes, namely, curing the fails to deliver and reestablishing the hedged position, and optionsXpress points out that regulatory guidance issued by CBOE has condoned the pairing of stock and options purchases. Id. at 21-23.

optionsXpress sets forth, at great length, its interactions with CBOE, FINRA, and the Commission as evidence that it acted in good faith to comply with Reg. SHO. OPX FOF at 15-39; OPX Brief at 36-40. It argues that it sought guidance from the regulators and was never told to stop trading the buy-writes, that CBOE investigated the trading on several occasions and never found any substantive violation, and that it stopped trading buy-writes when asked to do so by the Division in March 2010. OPX FOF at 15-39; OPX Brief at 36-40.

With respect to the aiding, abetting, and causing securities fraud and Exchange Act Rule 10b-21 charges, optionsXpress argues that because there was no primary violation of Reg. SHO or the antifraud violations, there can be no aiding and abetting liability, and that optionsXpress did not act with the requisite scienter. OPX Brief at 33-36. optionsXpress believes that Feldman was open and forthcoming about his trading strategy and did not make a misrepresentation to anyone. Id. at 34-35. optionsXpress argues that there was no evidence that any market participant was harmed by the trading nor was there any evidence of market manipulation. Id. at 34.

Feldman

Feldman maintains that throughout the relevant period he was open and honest with his brokers, made no misrepresentations or omissions of material fact, and did not seek to deceive anyone. Feldman FOF at 2; Feldman Brief at 19. Specifically, Feldman argues that he made no representations to optionsXpress or anyone else about his intention or ability to deliver securities, and therefore the Division's claim pursuant to Exchange Act Rule 10b-21 fails. Feldman FOF at 26; Feldman Brief at 37-39. Feldman argues that he openly discussed his trading strategy, and his strategy involved "absolutely no deception," which is fatal to the Division's fraud claims. Feldman Brief at 18.

Feldman argues that his trading could not have caused a violation of Reg. SHO because, as a retail investor, he had no delivery obligation under Rule 204, and delivery into the CNS system is on a net basis and there is no evidence that his specific trades caused any failures to deliver at CNS. Feldman FOF at 11-12; Feldman Brief at 13. Feldman contends that, in any event, Reg. SHO does not require a broker to clear its failure to deliver position at CNS. Feldman FOF at 15.

Feldman does not believe that there is anything inappropriate about executing a buy-write after receiving an assignment because the buy satisfies the purchase requirement and the write reestablishes a legitimate hedge. Id. at 16. Feldman argues that Rule 204(f) is the only provision of Reg. SHO addressing when a purchase of shares will be deemed not to comply with Reg. SHO, and it is inapplicable to this case because it requires an arrangement with another party,

which he did not have. Id. at 16-17; Feldman Brief at 26. Feldman agrees with optionsXpress that footnote 82 to Rule 204's July 31, 2009, Adopting Release has no legal effect, and points out that there was no evidence that he was ever warned about, or had knowledge of, footnote 82. Feldman FOF at 32; Feldman Brief at 9-10. Feldman argues that even if footnote 82 did apply, the buy-writes had a legitimate economic purpose, i.e., to deliver the required securities and reestablish the hedged position. Feldman FOF at 64-65; Feldman Brief at 10.

Feldman argues that even if optionsXpress did violate Reg. SHO, he had no knowledge of any of the alleged violations because he reasonably relied on optionsXpress, a well-established broker, to comply with the securities laws, and he received daily confirmations that the share purchases he made were executed and delivered. Feldman FOF at 31, 36, 48; Feldman Brief at 25-26, 30. Feldman states that he reasonably relied on the representation made by optionsXpress in fall 2009 that the Commission had reviewed his trades and did not find them problematic. Feldman FOF at 36; Feldman Brief at 26-30. Feldman argues further that the Division has demonstrated no harm because the trades had no impact on market integrity, no investors were deceived because shares were delivered, and there was no evidence that any investors lost their voting or dividend rights. Feldman FOF at 66-67; Feldman Brief at 14-17.

Finally, Feldman raises again his contention that these proceedings violate Section 929U of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), codified at Section 4E of the Exchange Act.[113] Feldman Brief at 49.

Stern

Stern agrees with the arguments made by optionsXpress and Feldman as to why the Division failed to prove any primary violations of Rule 204 or the fraud provisions and incorporates their proposed findings of fact and briefs by reference. Stern Brief at 3 n.2, 17-21. Even if the Division had proved primary violations, Stern argues that the Division has failed to prove that he aided and abetted or caused the alleged violations because, as the CFO and FINOP, he was only responsible for monitoring optionsXpress's capital position and filing financial reports with regulators; he was not responsible for deciding how optionsXpress would comply with Rule 204 or whether its customers could engage in buy-writes. Id. at 1, 4-5. Stern states that he relied on Hoeh and Bottini, who were in charge of compliance and trading, to make those decisions. Id. at 1.

Stern contends that he did not oversee the day-to-day operations at optionsXpress, and during the time he was at optionsXpress, he had only "one brief, non-substantive conversation with Mr. Feldman." Id. at 6, 13. Stern admits that he participated in some of the calls with FINRA and the Commission in September and October 2009; however, he contends that his role was limited on these calls to "diagramming" the trades or providing examples of the trading. Id. at 32. Stern argues that the Division has not proven that he acted with the requisite scienter for

[113] This issue has been raised and ruled on in connection with Feldman's Motion for Summary Disposition, filed June 4, 2012; Motion for Issuance of Subpoena, filed August 13, 2012; and Motion for Reconsideration, filed August 22, 2012. I also heard arguments from Feldman's counsel and the Division during the first day of the hearing on September 5, 2012. Tr. 13-28. I rejected Feldman's arguments in each instance.

the causing and aiding and abetting claims, pointing out that the trading of buy-writes was widely known to optionsXpress's legal and compliance teams and the regulators themselves had difficulty determining whether the buy-writes violated Reg. SHO. Id. at 23-24.

Legal Conclusions

I reject Feldman's claim that this proceeding is in violation of Section 929U of Dodd-Frank, codified as Section 4E of the Exchange Act, which provides:

> (1) *In General.* Not later than 180 days after the date on which Commission staff provide a written Wells notification to any person, the Commission staff shall either file an action against such person or provide notice to the Director of the Division of Enforcement of its intent to not file an action.

15 U.S.C. § 78d-5(a)(1).

The Declaration of Deborah A. Tarasevich (Tarasevich Declaration) submitted by the Division on June 18, 2012, as part of its Response to Feldman's Motion for Summary Disposition, sets forth the timeline of events:

October 28, 2010:	The Division issued written Wells notices to Respondents and the initial 180-day period begins running. Tarasevich Declaration at 1-2.
April 8, 2011:	Prior to the expiration of the first 180-day period, the Division's Director extends the filing deadline for an additional 180 days after determining that the investigation was "sufficiently complex." Id. at 2. The second 180-day period is set to expire on October 21, 2011.[114]
October 13, 2011:	The Division's Director received approval from the Commission for an additional 180-day extension, extending the filing deadline to April 17, 2012. Id.[115]

[114] The Division appears to include in its time calculation the day of the act from which the designated period of time begins to run, which may explain why the Division and Feldman arrive at different expiration dates for the second 180-day period. Compare Tarasevich Declaration at 2 ("extended the filing deadline to October 21, 2011") with Feldman's Prehearing Brief at 49 ("before the expiration of the second Dodd-Frank deadline on October 24, 2011). This dispute does not affect my conclusion.

[115] The Tarasevich Declaration states that the Commission authorized the institution of litigated administrative proceedings against Respondents on October 20, 2011, and on April 12, 2012.

October 20, 2011:	The Commission authorized the institution of litigated administrative proceedings against Respondents. Id.
April 16, 2012:	The Commission instituted litigated administrative proceedings against Respondents. Id. at 3.

Feldman argues that the statute was violated because the Commission staff was required by law to file the action before the second 180-day extension expired on October 21, or October 24, 2011. Feldman Brief at 49. According to Feldman, neither the Division nor the Commission could rely on the additional 180-day extension granted on October 13, 2011, because the Commission authorized institution of the proceeding on October 20, 2011, before the expiration of the second 180-day period. Id.

Feldman does not point to any new authority or raise any new arguments that I have not considered in my previous rulings on this issue. The evidence is that the Division's Director acted in accordance with the statute when he received an extension of time from the Commission on October 13, 2011. The statute provides for additional extensions in "complex actions," and it is obvious from the seventeen days of hearing held in this case that this is a complex matter. See optionsXpress, Inc., Administrative Proceedings Rulings Release No. 710 (July 11, 2012), 104 SEC Docket 56315, 56321. I do not read the statute as containing the same requirement that Feldman does, and to do so would limit the Division's ability to seek an extension, which appears contrary to the drafters' intent. All indications are that the Division and the Commission acted reasonably in following the language of the statute. Tr. 28. For these reasons, I reject Feldman's argument that this proceeding violates Section 4E of the Exchange Act.

I. optionsXpress willfully violated Rules 204 and 204T of Reg. SHO.[116]

Rule 204 and Rule 204T are strict liability provisions and scienter is not required for a violation. Tr. 3726. Stated simply, CNS participants are required to deliver shares to CNS to meet their delivery obligations for sales by customers on T+3. When the participant has a "fail to deliver" on T+3, Rule 204 requires that the fail be closed out no later than the beginning of regular trading hours on T+4.[117] The preponderance of the evidence is that optionsXpress violated Rule 204 on at least two levels.

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[116] Willfulness does not require an intent to violate the law, nor does it require "deliberate or reckless disregard of a regulatory requirement." Jacob Wonsover, Exchange Act Release No. 41123 (Mar. 1, 1999), 69 SEC Docket 694, 711, aff'd Wonsover v. SEC, 205 F.3d 408 (D.C. Cir. 2000). To commit a willful violation, a respondent need only have intentionally committed the act which constitutes the violation. See Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976); James E. Ryan, 47 S.E.C. 759, 761 n.9 (1982); Tager v. SEC, 344 F.2d 5, 8 (2d Cir. 1965).

[117] Rule 204(g)(2) defines regular trading hours as having the same meaning as in Rule 600(b)(64) of Regulation NMS, which defines the term as "the time between 9:30 a.m. and 4:00 p.m. ET, or such other times as is set forth in the procedures established pursuant to § 242.605(a)(2)."

A. First level - Delivery of securities by settlement date (T+3). Failures to deliver on T+3 are commonplace and have no independent significance. However, for a violation of Rule 204, there first must have been a failure to deliver securities on T+3.

The preponderance of the evidence is that during the relevant period, optionsXpress received a significant number of Accounting Summaries showing fails to deliver on T+3, and that it was able to determine that Feldman and other customers employing similar trading strategies caused some of the fails to deliver. Respondents insist that fails to deliver cannot be traced to specific customer accounts; however, that assertion is not true in this case where the evidence is that optionsXpress's Clearing personnel knew, at least as to these hard-to-borrow securities, which customers were responsible for the fails to deliver. The testimony and e-mails of several optionsXpress employees or former employees and data establish these facts.

For example, Tortorella, a credible witness, acknowledged that optionsXpress's Clearing had IT problems in October 2008 in dealing with the Accounting Summaries. It did not get the information to him in time for him to e-mail Payne and the Trading Desk, by market open, which accounts optionsXpress needed to buy-in to comply with Rule 204. However, the IT problems were fixed, and most of the time, Tortorella was able to send the list of customers with accounts that were short securities to Payne and the Trading Desk before the market opened. Tortorella intended that the Trading Desk would close out the fails to deliver by executing trades before the market opened, to comply with Rule 204. Tr. 394. During the relevant period, optionsXpress was responsible for sixty-four percent of all shares that failed to settle in CNS. Div. Ex. 310 at 14. An Accounting Summary on March 4, 2010, showed that optionsXpress had been short Sears shares to CNS for 228 days. Tr. 53, 57, 96-97; Div. Ex. 18.

The Facts contain many examples of securities shown on Accounting Summaries that optionsXpress received that were in Feldman's and other customers' accounts. Tortorella was able to determine which accounts were short these securities and he would put those accounts on the buy-in list. Further evidence that optionsXpress experienced fails to deliver on T+3 is that on January 4, 2010, the Accounting Summary showed a total of 942,566 fails to deliver in Sears shares for all participants and 938,139, or 99.5 percent, of the Sears fails to deliver were at optionsXpress.[118] Tr. 3479-83; Div. Exs. 18, 417.

I reject optionsXpress's position that the fails to deliver listed on the Accounting Summary it received were inaccurate because fails to deliver may have been closed out by transactions that had not yet settled on T+3 due to the three-day settlement cycle. The odds of this scenario happening for every security on every Accounting Summary is implausible and other evidence detailing when and how some of the fails to deliver were resolved establishes that Clearing and the Trading Desk believed optionsXpress had fails to deliver on T+3 that it had to close out at the opening of the market on T+4. Tr. 366.

[118] Some of this information was on the Commission's website but was taken from the Accounting Summaries. Tr. 3476.

It is beyond dispute that a close-out can happen any time before T+4 without a Reg. SHO violation. optionsXpress's argument that adoption of the T+1 policy establishes that there were no fails to deliver on T+3 during the relevant period is unpersuasive. Nine months of the relevant period occurred before optionsXpress adopted the T+1 policy in August 2009. And, there is evidence that after August 2009, optionsXpress did not close out all fails to deliver on T+1. On January 12, 2010, at 11:21:21 a.m. ET, Feldman executed a buy to cover and a sell to open (a buy-write) for 147 contracts and 14,700 shares of CSKI, which was related to a reverse conversion he entered on January 6, 2010. optionsXpress notified Feldman that the buy-write was completed at 11:21:21 a.m. and 11:20:38 a.m. ET.[119] Tr. 4577-89, 4598-99; Div. Ex. 432. The reverse conversion included a written call for 204 contracts that resulted in an assignment on January 6, for 147 contracts. Under a T+1 policy, covering the short would have occurred on January 7, but Feldman executed the buy-write on January 12, which allowing for the weekend, occurred on T+4.

Saha's assertion that his data show that 99.3 percent of trades occurred before the end of T+3 is an acknowledgement that there were many fails to deliver because seven-tenths of an enormous number of trades is a very large number. Tr. 4389.

I conclude that the record shows that optionsXpress had fails to deliver on T+3.

B. "No later than the beginning of regular trading hours." The parties agree that "at the beginning" of trading means prior to 10:00 a.m. ET on T+4. Tr. 4866-67. The enormous amount of evidence, in the form of testimony and e-mails cited in the Facts, establishes that optionsXpress's efforts to close out its fail to deliver positions frequently occurred after 10:00 a.m. ET on T+4 during the relevant period. Some examples are Risley's acknowledgement that Clearing had trouble getting buy-in information to the Trading Desk; Tortorella's acknowledgement that before August 2009, he occasionally could not get the list of who had to be bought in to the Trading Desk before the opening of the market, and evidence that after August 2009, Tortorella sent two lists, one after the market opened. Div. Ex. 204.

Tortorella and Molnar had concerns that the Trading Desk, over which they had no control, was not executing buy-ins promptly. In fact, the Trading Desk was not doing so. Payne, Coronado, and Stella were playing fast and loose with the rules and allowed Feldman, Zelezney, and certain other customers to decide how to cover the shorts in their accounts, which took time. Stern testified that he did not know that traders were queuing up buy-in orders rather than sending them to the exchange, and he did not know that some buy-in orders were being executed a half hour after the markets opened. Tr. 1693, 1706. Coronado and Stella did not insist that On Point process buy-writes at market open, and sent many buy-write orders to On Point after 10:00 a.m. ET. As detailed in the Facts, when Lapertosa apologized for delays in processing the buy-

[119] Respondents elicited testimony that optionsXpress's notices to customers might show times later than when the trade was executed, but there is no persuasive evidence that the documentation was inaccurate. Tr. 4591-93.

writes, Coronado replied, "I need to get them done as close to the open as possible, but if you are swamped I understand. I know its tedious work." Tr. 575, 1271; Div. Ex. 91.

The record shows that optionsXpress did not close out many of its fail to deliver positions at the beginning of regular trading hours on T+4.

C. "Immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity." There is nothing unlawful about buy-write transactions. The issue here is whether optionsXpress's use of buy-writes to close out its fail to deliver positions on T+4, as described in this record, violated Rule 204.

Feldman's transactions did not involve the standard definition of short selling, i.e., selling shares of a security not owned by the seller, but they had the same effect. Whenever the deep-in-the-money call options that Feldman wrote were assigned to him, Feldman ended up in a short position. Feldman did not go to the market with a naked short position, but he ended up with one when he was assigned. Tr. 3436; OPX Ex. 248 at 9. This would have been true for any trader. What was different for Feldman and certain other customers was that it was not an infrequent or unplanned occurrence, rather it was their deliberate and consistent trading practice.

Saha draws a distinction between when a customer initiated a short stock position and must borrow or locate stock, as opposed to an assignment which creates a short position over which the customer has no control. Tr. 4406-07. That difference is inapplicable to this situation. The record is replete with statements by Feldman, Zelezney, several optionsXpress personnel, experts, CBOE personnel, and data that all show frequent, sometimes consecutive, assignments to Feldman and Zelezney that caused their accounts to be short securities because of option assignments. From reading testimony of Feldman and Zelezney, Saha concluded they hoped they would not be assigned because it cut into their profits, "but [they] went into the trade knowing fully well and expecting that some portion [would] be assigned." Tr. 4571. Further examples include Molnar's November 2008 statement: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle." Tr. 4574; Div. Ex. 41. On July 6, 2009, Feldman, in an exchange with a person in optionsXpress's Margin department observed, "it's a part of my daily routine. Brush teeth, get coffee, [reset the margin requirements for Citigroup and cover buy-in on Citigroup]." Tr. 2178-80; Div. Ex. 247. Depending on the terms of the option, Feldman acknowledged that he could have a one hundred percent expectation of being assigned on a specific day. Tr. 2205. I accept as valid Sheehy's analysis of data for the period September 16, 2009, through March 21, 2010, which shows Feldman engaged in huge transactions that followed the same pattern and resulted in consistent assignments and buy-writes. Div. Ex. 375 at 33, Ex. 5.

Finally, based on the character of the calls, publicly available information on the level of open interest, and past experience, Feldman and optionsXpress knew that his deep-in-the-money calls on Sears and other securities would likely be exercised and assigned to him. To say that Feldman and optionsXpress had no control over, and were unaware of, the likely creation of short positions in Feldman's account, is not being candid.

optionsXpress's counsel argues strenuously that shares were delivered by the buy portion of the buy-write. I disagree for the following reasons. Use of a buy-write transaction comes within the Commission's definition of a naked short sale. When it adopted Rule 204, the Commission repeated that the goal was to address "abusive 'naked' short selling in all securities." 74 Fed. Reg. 38266 (July 31, 2009). According to the Commission, "[a]lthough abusive 'naked' short selling is not defined in the federal securities laws, it refers generally to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three-day settlement cycle."[120] Feldman and optionsXpress knew a short sale would occur if Feldman's deep-in-the-money calls were assigned because Feldman did not own shares and had no intention of delivering them. By allowing customers to execute buy-writes to cover short positions in their accounts, optionsXpress did not close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity. To put it bluntly, no one had any skin in the game. In other words, by not performing its responsibility and closing out fail to deliver positions, optionsXpress allowed Feldman and others to continue what, in effect, was naked short selling.

Permitting Feldman an inexpensive way to reestablish a hedge for his synthetic long position, which disappeared when his deep-in-the-money call was exercised and assigned, is not an economic purpose that validates the buy-write for optionsXpress.

I find support for my position in the views of the Division's experts and others. optionsXpress's primary regulator, CBOE, in the persons of Overmyer, an investigator with experience as an options trader and market maker, and his immediate superior, MacDonald, an experienced regulator, believed strongly, after a thorough examination, that a pattern and practice of this type of options trading was illegal, harmed option market makers, and that regulatory action was needed. Overmyer testified:

> I believe anyone can violate Reg. SHO. You can't hide behind a customer and market maker. If you're skilled enough to trade options and put these positions on and carry this kind of capital, you're skilled enough to know what you're doing in my opinion. And if you can hide behind a customer, let me know.

Tr. 3929. CBOE's Thompson, Senior Vice President and Chief Regulatory Officer, expressed disappointment at not bringing a regulatory action. Penson's former Vice President of Risk, Crain, did not believe the buy-writes satisfied Feldman's original short position or caused shares to be delivered to the marketplace. Tr. 905-06, 911. DeMaio, the head of FINRA's Options Regulation team, considers buy-writes a concern because "they can be used as a tool to give the artificial appearance that Reg. SHO has been complied with." Tr. 2914.

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[120] Naked Short Selling Antifraud Rule, 73 Fed. Reg. 61666, 61667 (Oct. 17, 2008) (adopting Exchange Act Rule 10b-21) (citing 2007 Regulation SHO Final Amendments, 72 Fed. Reg. 45544 (Aug. 14, 2007) and 2006 Regulation SHO Proposed Amendments, 71 Fed. Reg. 41710 (July 21, 2006)); see also Amendments to Regulation SHO, 73 Fed. Reg. at 61707-08.

There is no evidence that any clearing broker except optionsXpress used buy-writes to satisfy its CNS fail to deliver positions. After the relevant period, in 2011, E*TRADE required Feldman to close out his margin account position. It was E*TRADE's position that by doing buy-writes, or buying shares in the morning and selling calls later the same day, Feldman did not meet his obligation to satisfy the short in his account created when he was assigned. Tr. 4847. On January 20, 2012, TD Ameritrade determined that Feldman's "current strategy of trading hard to borrow issues (e.g. GRPN, CFX, SHLD, and TZOO) via options [would] no longer be permitted." Div. Ex. 416. In an e-mail to Feldman on January 20, 2012, TD Ameritrade stated:

> The strategy that continues to be executed creates operational risk, market risk, and potential regulatory risk for the clearing firm. The nature of the frequent assignment of the short calls creates an obligation for delivery of shares that lags the closing transaction of the short position by one day. In several instances over the last two months, these fails have continued to age as new calls are written simultaneously with the closing transactions. As a result of these frequent sizable and aged fails to deliver, the firm has absorbed significant market, economic, and regulatory risk to allow this activity to continue. At this time, we will be facilitating closing transactions only.

Id.

Zelezney has stopped transacting deep-in-the-money calls and buy-writes because optionsXpress does not allow them any longer, it is not cost effective because the costs are a lot higher at other firms, and he is only selling shares short that are available to sell short. Tr. 4163. When optionsXpress eliminated buy-writes to cover assignments in March 2010, it also eliminated actions in customer accounts "that would, or could be reasonably expected to, result in another short sale, or short position, in this security." OPX Ex. 485.

optionsXpress's defense that its actions were based on assurances from regulators, as stated by Stern, to continue doing what it was doing with respect to "Reg. SHO and short selling" does not bear scrutiny. OPX Ex. 246. First, regulated entities are responsible for knowing the rules and cannot rely on informal conversations with government employees as a defense for their actions. See Stephen J. Horning, Exchange Act Release No. 56886 (Dec. 3, 2007), 92 SEC Docket 207, 221 & nn.24-25 (citing William H. Gerhauser, 53 S.E.C. 933, 940 (1998) (finding applicants liable "even had there been an NASD audit that found no violations"); Richard R. Perkins, 51 S.E.C. 380, 384 n.20 (1993); Rita H. Malm, 52 S.E.C. 64, 75 n.40 (1994) (rejecting applicant's "contention that, because the NASD noted no markup, pricing or other 'exceptions' during its audit . . . NASD was subsequently precluded from bringing markup or supervisory charges")).

Second, the evidence is that regulators did not give the guidance that optionsXpress claims it relied upon. Tao's e-mails to FINRA and persons at the Commission, sent on October 2, 2009, support her version of the September 24 and October 2, 2009, telephone

calls.[121] Tr. 3604-05; Div. Ex. 243. Also, Crane's notes of the September 24, 2009, telephone call do not mention any FINRA investigations. Tr. 3676; OPX Ex. 579. Strine acknowledged at the hearing that the Commission made it clear to optionsXpress on October 2, 2009, that it could not get involved and optionsXpress was professed to be looking to FINRA for guidance for this reason. Tr. 3557-60. All this is persuasive that Trading and Markets' version of what transpired on the calls is accurate.[122]

Ruth's expert opinion is based on three erroneous assumptions. The first is that a firm can continue a questionable business practice until a regulator tells it to stop. The second is that optionsXpress acted in good faith to determine the legality of how the rules impacted its business practice, and the third is that Rule 204 is confusing. None of these assumptions are accurate. Regulated entities are required to know the applicable rules and to operate accordingly. See Robert L. Burns, Advisers Act Release No. 3260 (Aug. 5, 2011), 101 SEC Docket 44807, 44826 n.60 ("we have repeatedly held that ignorance of the securities laws is not a defense to liability thereunder.") (citing Marc N. Geman, 54 S.E.C. 1226, 1260 (2001), aff'd 334 F.3d 1183 (10th Cir. 2003)). In Geman, the Commission held "securities professionals . . . are part of a highly regulated industry and, as such, required to know the law that is applicable to their conduct within that industry." 54 S.E.C. at 1260.

There is considerable evidence that optionsXpress was not fully forthcoming with Trading and Markets, CBOE, and FINRA and did not operate in good faith. From the issuance of guidance by FINRA and CBOE, settlements, and decisions, optionsXpress knew that the subject was of regulatory concern. However, optionsXpress did not make a written request for guidance, setting forth all of the facts, to FINRA's Office of General Counsel, as Huber, Nixon, and Mello recommended in a telephone call on October 2, 2009. Tr. 2859-60. Strine does not deny that on October 2, 2009, FINRA recommended that optionsXpress submit a written request for guidance to FINRA's Office of General Counsel and to the Commission, and that optionsXpress did not do so. Tr. 3560; Div. Ex. 238. optionsXpress called various people at the Commission and had two disputed telephone conversations with Trading and Markets, but there is no evidence that it submitted a written request for an opinion, setting forth all of the facts, to anyone at the Commission. On April 30, 2009, optionsXpress mentioned buy-writes to cover a customer's short position to Overmyer in connection with CBOE's investigation of Zelezney's trades. Tr. 3830-35; OPX Ex. 124. However, optionsXpress knew its short selling had triggered two CBOE surveillance reports, and there is no evidence that it described its use of buy-writes to cover fails to deliver in connection with those surveillance reports or requested an opinion from CBOE on whether it was legal to do so.

[121] Elizabeth King, an Associate Director in the Office of Market Supervision, was another person who referred a communication from optionsXpress to Tao. Tr. 3604.

[122] Trading and Markets' failure to understand CBOE's position led to a high level of frustration between regulators.

Persons at optionsXpress knew of the July 20, 2007, Brian A. Arenstein decision, where respondents used a variety of transactions, including, "without limitation, buy-writes, and two-day FLEX options" to circumvent their delivery obligation." Brian A. Arenstein, AMEX Disciplinary Panel, Case No. 07-174, Exhibit A, Stipulation of Facts and Consent to Penalty at 4 n.12. Brian A. Arenstein was decided prior to the adoption of Rule 204, and found violations of Rule 203(b) which: (1) contained an exemption from the locate requirement for market makers engaged in bona-fide market making activities in a particular security; and (2) required clearing firms to close out fail to deliver positions in "threshold securities" that lasted thirteen consecutive settlement days. Id. at 2, 4. Brian A. Arenstein resulted in a settlement that censured the respondents, ordered them to disgorge $1.8 million, fined them $1.2 million, and suspended Brian A. Arenstein from AMEX membership and association or employment with any AMEX member or member organization for five years.[123]

> Respondents did not want their fail to deliver position from the reverse transaction to be bought-in since Respondents or their clearing firm would be forced to make large open market purchases of a Reg. SHO threshold security with little or no control as to execution price. Additionally, a buy-in would result in an unhedged synthetic long stock position (long calls and short puts) from the original reversal transaction. This would expose Respondents to directional market risk, which could negatively impact the profit from the reverse conversion transaction.
>
> In order to avoid being bought-in, Respondents entered into a series of transactions that circumvented Respondents' obligation to actually deliver securities to close out their short position pursuant to Reg. SHO. Specifically, Respondents, utilizing the services of a floor broker, executed a series of complex transactions that appeared to close out their fail to deliver position by purchasing securities of like kind and quantity.
>
> In an example of one type of such a transaction[124], Respondents executed a married put using a one-day FLEX option[125] that had the effect of temporarily resetting the buy-in date.
>
> . . .

[123] The decision resulted from a review by AMEX's Disciplinary Panel Chair who determined that the parties' Stipulation of Facts and Consent to Penalty was acceptable.

[124] (Footnote in original) Respondents utilized a variety of different types of transactions to circumvent their delivery obligations under Reg. SHO. Examples of other types of transactions utilized by the respondents include, without limitation, buy-writes and two-day FLEX options.

[125] (Footnote in original) A FLEX option is an exchange traded equity or index option, that enables an investor to specify within certain limits, the terms of the options, such as exercise price, expiration date, exercise type, and settlement calculation.

> Respondents repeatedly engaged in these or other types of transactions after receiving a Reg. SHO Buy-In Notification from their clearing firm and these transactions caused the buy-in date to be reset.

Brian A. Arenstein, Exhibit A, Stipulation of Facts and Consent to Penalty, at 4-5.

optionsXpress's efforts to distinguish Arenstein, Hazan, and TJM, from its conduct are shallow, self-serving, and unpersuasive. The differences - a standard option as opposed to a FLEX option, optionsXpress's non-market maker status, and other characteristics - do not outweigh the fact that the purpose of the transactions in Arenstein, Hazan, and TJM was to make it appear that delivery had been accomplished. That is exactly what optionsXpress attempted to do here, make it appear that it had delivered shares when it did not do so. Tr. 3361-66.

In an e-mail on November 13, 2008, Risley responded to Bottini, who sent him a Wall Street Journal article about how short sellers in Sears were circumventing the "SEC cover rule," with the comment, "[t]hey're definitely doing this."[126] Tr. 211; Div. Ex. 255. Strine, wrote to Hoeh, Bennett, Victor, and Kahn on August 6, 2009, after reviewing Hazan and TJM:

> The troublesome part is that the SEC characterized, and found as a violation, the fail-to-deliver close-out process used by both firms as "sham reset transactions." In both cases, the firms would either use married-put or buy-write transactions to close-out their Reg. SHO fails-to-deliver. Our customers have been engaging in buy-write transactions, or simply selling deep-in-the-money calls after we process buy-ins in their accounts. The end result in all situations is similar: the shares are bought-in, but the subsequent exercise or assignment of the option that night results in a continuation of the fail.

OPX Ex. 678.

Despite the fact that optionsXpress's conduct vis-à-vis Feldman and a few other customers was similar in many respects to the conduct in Arenstein, Hazan, and TJM, optionsXpress did not obtain an authoritative written opinion from any regulator or any independent source that Reg. SHO permitted optionsXpress to use buy-writes to satisfy its fail to deliver obligation. Moreover, no one at optionsXpress communicated with the individuals named to answer questions in AMEX's Reg. 2007-35: Applicability of Regulation SHO to Certain Market Maker Transactions, issued August 9, 2007, or CBOE Regulatory Circular

[126] At the hearing, Risley testified that he did not mean that customers were doing the type of trading referred to in the Wall Street Journal article titled, "Tactic Lets Traders Dodge Rule on Short Selling." Tr. 213; Div. Ex. 256.

RG08-63, Regulation SHO (Short Sales), issued May 19, 2008.[127] Tr. 3501-04; Div. Exs. 129, 384. The evidence does not show that optionsXpress made a good faith effort to determine whether its use of buy-writes to close out its fails to deliver was lawful. Moreover, CBOE and FINRA personnel made clear at the hearing that those regulatory bodies would not have approved optionsXpress's conduct, if optionsXpress had been candid and made a good faith effort to secure an opinion.

When Payne raised concerns about the use of buy-writes, optionsXpress's reaction was to require two separate transactions. When Coronado was unwilling to do buy-writes after reading Hazan and noting the similarities, he was quickly told to continue. In neither situation, did optionsXpress show good faith. optionsXpress's claim that the doctrine of best execution required buy-writes is unpersuasive. As noted by Harris, best execution is inapplicable to this situation. Tr. 1476. It borders on chutzpah for optionsXpress to claim best execution, an accepted standard for handling customer orders, caused it to violate a securities regulation.

Finally, I disagree with Ruth that Rule 204 is confusing. Its purpose to address persistent fails to deliver and abusive naked short selling has been clear since day one. The formal title is Reg. SHO - Regulation of Short Sales. Furthermore, portions of Ruth's testimony cause me to question his objectivity. For example, Ruth considers a written CBOE letter of censure to be "technical advice" to optionsXpress; he concluded that CBOE cleared optionsXpress's use of buy-writes based on two CBOE form letters with no consideration of the surrounding facts; he concluded that optionsXpress was unable to get definitive guidance from regulators; and he apparently believes that regulated entities can claim that a regulator did not order them to stop committing violations as a valid defense. Tr. 4300-07; OPX Ex. 250, Ex. 5.

D. Second level: optionsXpress's use of buy-writes constitutes a sham transaction. The Division is not claiming that optionsXpress violated Rule 204(f).[128] Reply Brief Against OPX at 18. I reject optionsXpress's contention that there must be a charge that it has violated Rule 204(f) for me to consider whether optionsXpress's use of buy-writes was a sham. OPX Brief at 13-14. The Division has characterized optionsXpress's customer buy-

[127] DeMaio, who was named as a person to answer questions regarding AMEX's Reg 2007-35, participated in a call with optionsXpress in January 2010 at the request of Huber, and Stern was on the phone call. Tr. 2911-12.

[128] Rule 204(f):

> A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this section where the participant enters into an arrangement with another person to purchase or borrow securities as required by this section, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow.

17 C.F.R. § 242.204(f).

writes as sham transactions throughout the proceeding and it is not necessary to charge a Rule 204(f) violation, which requires an arrangement, to consider whether the buy-writes at issue here merit that description. Div. Prehearing Brief at 13-16; Reply Brief Against OPX at 18-21.

optionsXpress was required to close out its fail to deliver position at the opening of the market on T+4. According to CBOE Rule 4, it should have closed out the fails to deliver and bought in customers without giving notice. OPX Ex. 138. However, it gave Feldman and other customers, who had chronic shorts in their accounts, notice before the market opened that they were being bought in and gave them leeway on how the buy-in should be accomplished. After it notified Feldman that he was subject to buy-ins, optionsXpress accepted Feldman's request to do buy-writes and it used the transactions to close or reduce its fail to deliver positions. optionsXpress did not send the buy-writes out to the open market electronically, which could have been quicker. Tr. 1136-37. Instead, Coronado and Stella moved more of the buy-write transactions to On Point, a floor broker, that could locate a counterparty who could take both sides of the transactions on terms Feldman would accept for both the buy and the write. Tr. 1136-37, 1287-88.

Feldman did not know the identity of the counterparty on the buy-writes, but the evidence is that he was heavily involved in them. Tr. 1188-91, 1287-91. On Point could not take orders from Feldman because he was not an institutional client; however, Feldman communicated with Lapertosa, On Point's managing partner, and Coronado and Stella placed the buy-writes orders for him.[129] Tr. 1293. On December 31, 2009, Feldman discussed the terms of a buy-write involving Sears with an On Point employee and asked if the employee could show the offer to the counterparty. The On Point employee, who was not supposed to speak to Feldman, told Feldman to "give it to [Coronado] and I will take care of it for you." Tr. 1293-94, 1303; Div. Ex. 89. Lapertosa told Coronado and Stella that often it was the same counterparty on the purchase and sale. Coronado and Stella knew that On Point was working predominantly with one market maker as the counterparty on the buy-writes. Tr. 1277. In December 2009, Coronado told Feldman that the counterparty to the buy and the write, a market maker, was one and the same. Tr. 581-85.

Strine's testimony that buy-writes are permitted as an exception to the prohibition against sham transactions is implausible. In August 2009, he directed traders and others not to do buy-writes in connection with covering short positions due to assignments. He acknowledged, however, that despite his guidance and instructions, optionsXpress traders continued the practice. Tr. 3510-12. In fact, Stella gave investigative testimony that Strine instructed him to "Google" the Hazan case under sham buy-in. Tr. 1144-45.

Saha stresses that data showing that the customers' deep-in-the-money calls were fully assigned on the day they were written only thirty percent of the time demonstrates that customers were not guaranteed to have their deep-in-the-money calls assigned. Tr. 4573. I reject Saha's

[129] Lapertosa told Feldman he could not communicate with him because On Point was only permitted to do business with institutional clients, but Feldman called Lapertosa at least a half a dozen times and reached out to On Point employees. Tr. 1293-1306, 1312.

belief that only full assignments are relevant because it does not have a logical basis and the very large size of Feldman's calls would impact the likelihood of full assignments.

The evidence is clear that in some time periods, optionsXpress knew that Feldman was getting some portion of his deep-in-the-money calls assigned daily. For example, on December 31, 2009, in an Instant Message with a floor broker, Feldman wrote, "Same trade every day. Get assigned stockk (sic) + sell options." Div. Ex. 89. The floor broker responded, "I see it," and "the numbers are insane." Id. Following a synthetic long and a call in CSKI, and a partial assignment on January 6, 2010, Feldman engaged in consecutive buy-writes and assigned calls in CSKI on January 12-15, 19-22, 25-29 and February 1-5, 8-12, and 17, 2010, that ended with an expired option and assigned put on February 19, 2010. Div. Ex. 310, Ex. 6.

The common meaning of a sham is "a trick that deludes: hoax." Merriam-Webster's Collegiate Dictionary 1073 (10th ed. 2001). optionsXpress was the nominal buyer on the buy side of the buy-write. Because it knew that the shares that were the subject of the buy were shares for Feldman's account that were the subject of simultaneous deep-in-the-money calls, which would be exercised and assigned so that no shares were delivered to CNS, optionsXpress engaged in a sham close-out of its fail to deliver position. CBOE's MacDonald testified that he and Overmyer told Trading & Markets:

> [W]e clearly indicated that they're doing buy-writes and as a result the stock's getting called because they exercise and therefore did not have the stock to cover the short and we felt it was somewhat of a sham closeout. They weren't really closing the position.

Tr. 4046-47. My determination that optionsXpress's use of buy-writes to satisfy its CNS fails to deliver is independent of Rule 204(f). If something looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck.

For all these reasons, optionsXpress did not close out its CNS fail to deliver positions by executing consecutive buy-write transactions and willfully violated Rules 204 and 204T.

II. Feldman willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21.

The antifraud provisions that Feldman allegedly violated provide as follows:

Securities Act Section 17(a)(1)-(3) makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly:

> (1) To employ any device, scheme, or artifice to defraud, or
>
> (2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order

> to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Similarly, Exchange Act Section 10(b) makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Exchange Act Rule 10b-5 makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Exchange Act Rule 10b-21 provides:

> It shall also constitute a 'manipulative or deceptive device or contrivance' as used in section 10(b) of this Act for any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.

Exchange Act Rule 10b-21 requires delivery by the seller. Naked Short Selling Antifraud Rule, 73 Fed. Reg. at 61672. "The rule targets the misconduct of sellers. As discussed above, sellers should promptly deliver the securities they have sold and purchasers have the right to the timely receipt of securities that they have purchased. Thus, Rule 10b-21's focus is on whether or not there is a fail to deliver by the seller, rather than on whether or not there is a fail to deliver in the CNS system." Id.

To establish a violation of the antifraud provisions, the Division must establish that Respondents made material misrepresentations, or materially misleading omissions, or committed a deceptive act as part of a scheme to defraud, in connection with the offer, sale, or purchase of securities, either acting with scienter or negligently. See SEC v. Pirate Investor LLC, 580 F.3d 233, 239 (4th Cir. 2009); SEC v. Morgan Keegan & Co., 678 F.3d 1233, 1244 (N.D. Ga. 2011) (citing SEC v. Merch. Capital, LLC, 483 F.3d 747, 766 (11th Cir. 2007)); SEC v. Steadman, 967 F.2d 636, 641-42 (D.C. Cir. 1992). Violations of Section 17(a)(1), Section 10(b), and Rules 10b-5 and 10b-21 require a showing of scienter. A showing of recklessness is sufficient to satisfy the scienter requirement.[130] See Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); see, e.g., Hollinger, 914 F.2d at 1568-69.

Sections 17(a)(2)-(3) require a showing of negligent conduct. See Steadman, 967 F.2d at 643 n.5 (citing Aaron v. SEC, 446 U.S. 680, 701-02 (1980)). Negligence defined as:

> [t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights

is sufficient to establish a violation of Sections 17(a)(2) and (a)(3). The term negligence denotes culpable carelessness. See Aaron, 446 U.S. at 697, 701-02; Black's Law Dictionary 1056 (7th ed. 1999).

As an initial matter, Feldman's trading strategy did not involve arbitrage.[131] The record supports the notion that there are many mispricing or arbitrage opportunities in the options market, but this situation was not one of them. There was no mispricing in connection with these transactions. optionsXpress made a conscious decision to allow customers to employ a strategy that resulted in frequent assignments of deep-in-the-money calls and to allow customers to use buy-writes to cover their short positions. It made money by doing so. There is no evidence that any other clearing broker allowed optionsXpress's business practice at issue here. I accept as valid Harris's expert testimony that in a true arbitrage situation, the price of the synthetic and the price of the underlying value would move closer. This did not happen as a result of Feldman's strategy. Tr. 1365. Feldman took advantage of optionsXpress's policies, which this Initial

[130] Recklessness is defined as "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1569-70 (9th Cir. 1990) (en banc) (as amended) (quoting Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977)); see also Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992).

[131] The record contains a great deal of evidence on this subject, but it is irrelevant as to whether the transactions were lawful.

Decision finds were in violation of Rule 204. The issue is whether by doing so Feldman violated the antifraud provisions of the securities statutes.

There is no dispute that Feldman was engaged in offering, selling, and buying securities using means of interstate commerce. Fraud involves deception or misrepresentation. In 1896, under a mail fraud statute, the Supreme Court held "to promise what one does not mean to perform, or to declare an opinion as to future events which one does not hold, is a fraud." United States v. Grayson, 166 F.2d 863 (2d. Cir. 1948) (summarizing the holding in Durland v. United States, 161 U.S. 306 (1896)). More recently, the Ninth Circuit held in Reese v. BP Exploration (Alaska) Inc.,

> The failure to carry out a promise made in connection with a securities transaction is normally a breach of contract. It does not constitute fraud unless, when the promise was made, the defendant secretly intended not to perform or knew that he could not perform.

643 F.3d 681, 692 (9th Cir. 2011) (quoting Mills v. Polar Molecular Corp., 12 F.3d 1170, 1176 (2d Cir. 1993)); cf. Capital Mgmt. Select Fund Ltd. v. Bennett, 680 F.3d 214, 225 (2d Cir. 2012) (noting that "[b]reaches of contract generally fall outside the scope of the securities laws," but that a breach of contract can be actionable under § 10(b) when "the promise . . . [encompasses] particular actions and [is] more than a generalized promise to act as a faithful fiduciary") (quoting in part Luce v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986)); 7 Loss, Seligman, & Paredes, Securities Regulation 436-37 (4th ed. & Supp. 2012).

The options market, like other securities markets, operates on the understanding that sellers of securities will settle with delivery on the required date. Feldman's actions constitute fraud because by writing calls he represented to the market as a whole and to purchasers of his deep-in-the-money calls that he was going to make delivery if his calls were exercised and assigned when he had no intention of doing so, and, in fact, by entering buy-writes, he did not cover his short position.

Feldman acted with the very definition of scienter, a mental state embracing the intent to deceive, manipulate, or defraud. Feldman did not mislead those he dealt with at various clearing brokers who knew, directly or indirectly, that he was not going to the deliver securities if his calls were exercised and assigned; however, the market as a whole did not have this knowledge. See Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001) ("To sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith."); Walling v. Beverly Enter., 476 F.2d 393, 396 (9th Cir. 1973) ("Entering into a contract of sale with the secret reservation not to fully perform it is fraud cognizable under § 10(b)."); 37 Am. Jur. 2d Fraud and Deceit § 41 (2013) ("[F]raud may consist of . . . the creation of a false impression by words or acts . . . .).

The record contains numerous statements by persons at optionsXpress and by Feldman that he never intended to make delivery, and intended to, and did in fact, consistently roll his calls when they were exercised and assigned. On October 22, 2009, at 5:26 a.m., Feldman e-mailed Coronado, "Gmorning. Can do the same today re [Sears] as yest re buy writes. Same

applies tomorrow (Fri.) too. Thx." Coronado responded at 11:58 a.m., "Ok I got it." Div. Ex. 303. In an e-mail on October 16, 2009, concerning the transfer of a portion of his optionsXpress account to Terra Nova or Penson, Feldman stated, "So I'd never actually take settlement of the shares, just would cover within the 3 days, and do a buy-write again?" Tr. 2220-21; Div. Ex. 86. In a phone call on November 9, 2009, Feldman stated, "Right, so I can do a buy-write, and I wouldn't settle on the . . . ." Tr. 2226-27; Div. Ex. 94. In an e-mail on November 10, 2009, Feldman wrote, "So how many [Sears] do I have to buy-in today (to avoid settlement)? Just the orig 12,200?" Tr. 2229; Div. Ex. 27. In an Instant Message on November 18, 2009, Feldman stated, "Ok. Not 100% sure what u mean but u can explain later. (I don't settle the stock @all so what diff wld t+2 be?)." Tr. 2231-32; Div. Ex. 25 at 20.

It is noteworthy that in June 2009, after he blogged about his trading, Feldman did not answer the following question from a fellow blogger, "if you get assigned on the short call, you have to deliver stock. How do you do this?" and "My understanding is that if you do nothing, you will get bought in (by your clearer) to make delivery on the assignment. Fascinated to hear if/how you get around this." Tr. 2331-33; Div. Ex. 383 at 5.

Feldman never sought an independent opinion as to the legality of his activities despite receiving a number of warnings and the existence of several red flags. Tortorella sent Feldman a copy of Rule 204 on August 3, 2009, and Payne sent him an excerpt from Rule 204 and a link to it on August 20, 2009. Div. Ex. 278; OPX Ex. 875. Bottini provided Feldman with a link to the Hazan settlement, which Feldman read, and various people told Feldman that regulators were looking at short selling and specifically his trades. Tr. 2253, 2258; Div. Exs. 58, 278. For example, Payne told Feldman on August 6, 2009, "Basically all these rules are to curb short selling." OPX Ex. 871. Bottini told Feldman that optionsXpress wanted to limit the size of his positions because the Commission had inquired about his trades. Tr. 2256-57.

There are many ways of accomplishing legitimate delivery but buy-writes executed to avoid a buy-in and a CNS fail with one's clearing broker is not one of them. The expert for one of the Respondents does not disagree that the net effect of the buy-writes that Feldman executed on three consecutive days in October 2009 was zero in that the amounts of the purchases were offset by the amounts of the assignments. Tr. 4265-66.

Feldman emphasizes that he relied on optionsXpress as a reputable clearing broker to know the rules and to follow them. This defense is inapplicable in this situation. Feldman is a sophisticated options investor; he was employed as a Vice President of a bank where he was the Chief Lending Officer; and he has a Master's degree in computer science. Sophisticated traders cannot do transactions that they knew, or were reckless in not knowing, were illegal and then blame their broker who they knew had a substantial financial interest in continuing the transactions.[132]

[132] Feldman complained to Kolocouris about the size of optionsXpress's charges and reminded optionsXpress how much it earned from his trades. Div. Ex. 249; OPX Ex. 875.

Feldman's statements are damning evidence that he knew he was causing confusion among market participants. Feldman told Lapertosa that a finance message board had noted that fifty to seventy-five percent of the daily volume in Sears occurred in one block trade and people on the message boards had panicked because "they thought it was some kind of either treasury stop or insider stop being, you know, transferred." Tr. 1294-95.

On December 31, 2009, Feldman messaged a trader at the floor broker On Point:

> I'll just go about my merry way, entering + canceling + entering + canceling.
> Nice way to earn a living.
> Lol
> I should hire a bimbo to enter + cancel orders all day. While the strategy is sophisticated, the order entry is like mindless secretarial work.
>
> . . .
>
> Do u realize that w my daily buy writes this year (say example 600k sh of [Sears] @ $58) that's $51[million]/day of 1099! Proceeds. My annual 1099! Will be over $2[billion]!
>
> . . .
>
> See how it happens? Same trade every day. Get assigned stockk (sic) + sell options."

Tr. 1303-06, 2169-70; Div. Ex. 89. The "[s]ame trade every day" referred to buy-writes. Tr. 2170. On January 26, 2010, Feldman informed Kolocouris:

> I read the latest thread on the [Sears] 'volume spikes.' Very entertaining. (Until someone notifies the SEC, and they shut down the strategy!! Then we'll need a real job . . LOL

Tr. 2275; Div. Ex. 29. Feldman testified that he knew the Commission was aware of his trading strategy when he wrote the e-mail and his comment was supposed to be funny. Tr. 2484-85.

When Feldman transferred the positions he had transferred to Terra Nova back to optionsXpress, optionsXpress increased the fees it charged Feldman. Tr. 2311-12. On February 2, 2010, Feldman complained about this treatment to Kolocouris:

Feldman:	Millions of [dollars] inc (sic) commissions,,, yet treat me/us like criminals.
Kolocouris:	I hear you . . .
Feldman:	But, in the big picture..it's still quite the gig. where can you get such mkt-[beating] retuens (sic) consistently?
Feldman:	so, as disgusting as they are, have to bend over and get raped, and take the punishment,,,

Feldman: just imagine how much more could be made w normal margin (PM) ans (sic) no fees.

. . .

Feldman: 'compliance' . . what do they do, ask Joe SLovick every day what to do? This is the exact same trade very (sic) f-day of their lives. I figure thay (sic) re doing 20,000 or so contracts (2[million] shares) total a day among all stocks. so they are collecting $8-10,000 PER DAY that's $2.0-2.5 MILLION per year. that's bullshit, like Jeremy gets paid that per year. you could pay 30 fulltime people, and this isn't 30 peiple (sic), and it's not full time. it's an hour a day maybe of his time.

Feldman: BTW, that's $8-10k on top of the normal commission of probably $15k/day on those.

Tr. 2171-77; Div. Ex. 249.

Under the federal securities statutes, a scheme to defraud under Section 17(a) of the Securities Act does not require proof that any victim suffered actual loss. Securities Regulation 454. SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985), established the same principle for Exchange Act Section 10(b). Harris testified that the buy-writes did not impact the underlying stock price; however, investors and potential investors can be damaged in other ways than by the manipulation of stock prices. Irfan Mohammed Amanat, Exchange Act Release No. 54708 (Nov. 3, 2006), 89 SEC Docket 714, 715 n.3, defines:

> Wash trades are 'transactions involving no change in beneficial ownership.' SEC v. U.S. Envt'l., Inc., 155 F.3d 107, 109 (2d Cir. 1998) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 205 n.25 (1976)), cert. denied, 526 U.S. 1111 (1999). Matched orders are 'orders for the purchase [or] sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale [or] purchase of such security.' Id.

Wash and matched trades have long been considered fraudulent devices proscribed by Exchange Act Section 10(b) and Exchange Act Rule 10b-5. Amanat, 89 SEC Docket at 727; Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11 n.7 (1971) ("Section 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether [they] involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.") Feldman's consecutive use of buy-writes in response to short positions in his accounts raised market concerns among option market makers, CBOE investigators, FINRA, and participants in option internet message boards. Tr. 1294-95, 1553-54, 2275; Div. Ex. 29.

I reject Feldman's explanation that his buy-writes were permitted because they had a legitimate economic purpose, i.e., to reestablish his hedge for the first two steps in his three-way

strategy.[133] Feldman Brief at 10. Reducing risk that results from a trading strategy is not a defense to fraud.

The preponderance of the evidence is that Feldman executed a trading strategy that he knew, or was reckless in not knowing, perpetrated a fraud on the participants in the securities markets and thus willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Exchange Act Rules 10b-5 and 10b-21.

III. Stern caused and willfully aided and abetted optionsXpress's and Feldman's violations.

Causing and aiding and abetting violations of the securities laws requires proof of three elements: (i) a primary violation by another party; (ii) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; and (iii) that the aider and abettor knowingly and substantially assisted in the conduct that constituted the primary violation. See Woods v. Barnett Bank, 765 F.2d 1004, 1009 (11th Cir. 1985); Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir. 1980); Woodward v. Metro Bank, 522 F.2d 84, 94-97 (5th Cir. 1975); Erik W. Chan, Securities Act Release No. 8078 (Apr. 4, 2002), 77 SEC Docket 851, 859-60. A Respondent who aids and abets a violation also is a cause of the violation under the federal securities laws. See Sharon M. Graham, 53 S.E.C. 1072, 1085 n.35 (1998), aff'd, 222 F.3d 994 (D.C. Cir. 2000).

Howard v. SEC, 376 F.3d 1136 (D.C. Cir. 2004), is a leading case concerning the "awareness" or "knowledge" required to support allegations of aiding and abetting. There, the court found that for aiding and abetting, there must be proof that the person was aware or had knowledge of wrongdoing or, in the absence of knowledge, that an aider and abettor had a state of mind close to conscious intent. Id. at 1142-43 (citing Graham v. SEC, 222 F.3d 994, 1006 (D.C. Cir. 2000)). Recklessness is sufficient to satisfy the scienter requirement for aiding and abetting and causing liability. Id. at 1152.

The first element for causing and aiding and abetting liability is satisfied by the conclusions reached as to optionsXpress and Feldman. As to the second and third elements,

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[133] Footnote 82 of the Adopting Release for Rule 204 states:

> [W]here a participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement.

Amendments to Regulation SHO, 74 Fed. Reg. at 38,272 n.82. My conclusion that Feldman's buy-writes were a sham and not a bona fide delivery of securities is independent of footnote 82 of the Adopting Release for Rule 204.

Stern presented his role at optionsXpress as that of a utility baseball player called on occasionally to fill in. Stern Brief at 1. The evidence, however, is that he was more like the smart and savvy clean-up hitter. When a question arose about the credit arrangements optionsXpress granted to Kolocouris, the CFO of optionsXpress Holding stated, "If Tom Stern approved this relationship, I am ok with the credit." Tr. 1641; Div. Ex. 328. Stern's thirty-five years of industry experience and knowledge were extensive. Stern Brief at 1. During the relevant period, Stern had power and responsibility within optionsXpress given his status as CFO, FINOP, member of the Board, and after Morof left, optionsXpress's regulatory liaison. Tr. 1622-24; Stern Brief at 1. Stern had extensive options experience and short selling was a much discussed topic inside optionsXpress and in trading circles during the relevant period. The CEOs of optionsXpress Holding and optionsXpress asked Stern to make sure that buy-ins on T+4 were working and in August 2009, according to Stern, he was the one who suggested that optionsXpress adopt a policy of closing out short positions on T+1. Tr. 1834-37.

When confronted with his investigative testimony, Payne remembered that Stern asked him for information about Feldman over fifteen times in 2009, related to the buy-in lists and the number of shares that needed to be covered in Feldman's account, with particular reference to Sears shares. Tr. 2034-37. In his investigative testimony, Risley stated that Stern was aware of the repetitive buy-ins related to assignments, that he was part of the discussions around Rule 204, and he engaged in discussions with Kevin in his group from time to time wanting to know what the processes were. Tr. 197. Also, "sitting here today" Risley testified that Stern knew of repeated buy-ins for various customers in hard-to-borrow securities. Tr. 200. Tortorella spoke with Stern about fails to deliver and conferred with Stern about optionsXpress's collateral requirement at DTCC. Tr. 424.

Stern was on the telephone calls with Trading and Markets about Rule 204; on the September 24, 2009, call he gave a verbal diagram of the trading that optionsXpress was seeking guidance on, and he passed on to the higher ups at optionsXpress the erroneous information that Trading and Markets told optionsXpress to keep on doing what it was doing, i.e., using the buy-writes to satisfy its fails to deliver. Tr. 1728-29, 1823-25. Stern was also on the call with FINRA's DeMaio, along with persons from optionsXpress's Compliance, but failed to pursue getting a definitive determination on whether optionsXpress's use of buy-writes was lawful. Tr. 2911-12.

Based on this evidence, I conclude that Stern willfully caused and aided and abetted optionsXpress's and Feldman's violations because he knew, or was reckless in not knowing, that he was part of, and gave substantial assistance to, violations of the antifraud provisions of the securities statutes and Rule 204.

IV. optionsXpress caused and willfully aided and abetted Feldman's violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21.

The evidence shows that optionsXpress, acting through Bottini, Coronado, Hoeh, Payne, Stella, Stern, and Strine, caused and willfully aided and abetted Feldman's violations of the

antifraud provisions because, as set out in the Facts, it knew, or was reckless in not knowing, that it was part of, and gave substantial assistance to, Feldman's illegal conduct.

Sanctions

The prerequisites for imposing sanctions, such as notice, opportunity for hearing, and violation of the securities statutes or regulations, have been met. optionsXpress, Stern, and Feldman contend that the Division has not shown that they committed any violations, but if their position does not prevail, they dispute the sanctions the Division seeks.

I. Cease and Desist

Section 8A of the Securities Act and Section 21C of the Exchange Act provide that the Commission may order a person who has violated the statutes or any regulations thereunder, or who was a cause of a violation of the statutes or the regulations due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing the violation or any future violation. 15 U.S.C. §§ 78u-3, 77h-1. KPMG Peat Marwick LLP, 54 S.E.C. 1135, 1192 (2001), reconsideration denied, 55 S.E.C. 1 (2001), petition denied, 289 F.3d 109 (D.C. Cir. 2002), has established that the risk of future violations and the public interest factors cited by the court in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981), are relevant considerations in determining whether Respondents should be ordered to cease and desist.[134]

The Division recommends that: (1) optionsXpress should be ordered to cease and desist from violating Rules 204 and 204T of Reg. SHO, and from aiding and abetting violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21; (2) Feldman should be ordered to cease and desist from violating Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21; and (3) Stern should be ordered to cease and desist from causing and aiding and abetting violations of Rules 204 and 204T of Reg. SHO, Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21. Div. Brief at 45-46; Reply Brief Against optionsXpress at 46-50; Reply Brief Against Stern at 18-21; and Reply Brief Against Feldman at 29-30.

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134 "[T]he egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations."

Steadman, 603 F.2d at 1140; See Joseph J. Barbato, Securities Act Release No. 7638 (Feb. 10, 1999), 69 SEC Docket 178, 200 n.31; see also Donald T. Sheldon, 51 S.E.C. 59, 86 (1992), aff'd, 45 F.3d 1515 (11th Cir. 1995).

optionsXpress maintains that there has been no showing that a cease-and-desist order is needed. It notes that it stopped the buy-write transactions at issue three years ago, and that the Commission's expert did not identify a single victim or an impact on share prices, citing KPMG Peat Marwick LLP, 54 S.E.C. 1135 (2001) and WHX Corp. v. SEC, 362 F.3d 854, 859 (D.C. Cir. 2004). OPX Brief at 48-49. Feldman advances similar arguments, noting that he has not conducted similar trades since TD Ameritrade asked him to stop in early 2012. Feldman Brief at 48. Stern argues that the Division has failed to prove that he had sufficient authority or involvement to have been a contributing or substantial cause of the alleged violations and therefore a cease-and-desist order is inappropriate. Stern Brief at 28-29.

Cease-and-desist orders are needed because the violations were egregious, continued for a minimum of a year, were committed by sophisticated, experienced, well-educated people, who knew, or should have known, that their conduct was improper, and there is nothing in this record that provides any assurance that these Respondents will not commit future violations. There has been no acknowledgment of wrongdoing; rather, the effort has been made to blame regulators who never were told all the facts. Respondents reiterated at the hearing through their testimony and at least one expert that they were justified in believing their actions were lawful because no regulator told them to stop. In this particular situation, however, the Commission, the industry's self-regulators, and most industry participants who did not engage in this type of conduct agree the conduct at issue was improper, and that optionsXpress and its customers were outliers in using buy-writes to satisfy fails to deliver and cover short positions in customer accounts.

The evidence and the demeanor and testimony of Respondents establishes a high likelihood that they will commit future violations if they have an opportunity to do so. A cease-and-desist order is needed to prevent future violations and to convey the message to Respondents and others that the conduct detailed in the Facts is illegal.[135]

II. Disgorgement

Section 8A(e) of the Securities Act and Section 21C(e) of the Exchange Act authorize the Commission to enter an order requiring an accounting and disgorgement, including reasonable interest, in any cease-and-desist proceeding. Disgorgement is defined as "'an equitable remedy designed to deprive [respondents] of all gains flowing from their wrong.'" SEC v. AMX, Int'l, Inc., 872 F. Supp. 1541, 1544 (N.D. Tex. 1994) (citations omitted). A violator is returned to where he or she would have been absent the misconduct. Disgorgement deprives a wrongdoer of

[135] The Commission has held it is proper to use settlements in fashioning a sanction. Robert D. Potts, CPA, Exchange Act Release No. 39126 (Sept. 24, 1997), 65 SEC Docket 1376, 1399 n.59 (citing Belton v. Fibreboard Corp., 724 F.2d 500, 505 (5th Cir. 1984) (admitting evidence of settlements for purposes other than proving liability or the amount of damages does not contravene Rule 408 of the Federal Rules of Evidence)). Feldman executed a Stipulation and Consent to the Issuance of an Order to Cease and Desist with the United States Office of Thrift Supervision, effective February 17, 2011. Jonathan I. Feldman, Order No.: DC 11-014. Div. Ex. 118. Stern submitted a Letter of Consent and consented to the Stipulation of Facts and Findings and Sanction by CBOE on August 12, 2012. Div. Ex. 420.

his or her ill-gotten gains and deters others from violating the securities laws. SEC v. First City Fin. Corp., 890 F.2d 1215, 1230-32 (D.C. Cir. 1989). "The effective enforcement of the federal securities laws requires that the SEC be able to make violations unprofitable. The deterrent effect of an SEC enforcement would be greatly undermined if securities law violators were not required to disgorge illicit profits." SEC v. Manor Nursing Ctrs., 458 F.2d 1082, 1104 (2d Cir. 1972).

The Division recommends disgorgement of: (1) $7,214,977, plus prejudgment interest, from optionsXpress; and (2) $4 million, plus prejudgment interest, from Feldman. Div. Brief at 42.

optionsXpress considers the Division's proposal to use hard-to-borrow fees as a basis for disgorgement "patently absurd" because, among other reasons, Rule 204 does not require that optionsXpress pay borrowing fees. OPX Brief at 45. optionsXpress would limit disgorgement to net profits from commissions earned as a result of the trading at issue, noting that its profit margin was approximately forty-four percent, and that the Division relies on footnote 82 to the Adopting Release of Rule 204 to support its theory of liability, so profits before July 31, 2009, the effective date of Rule 204, should be excluded. Id. at 44-45. It argues that a reasonable approximation of optionsXpress's profits cannot exceed $1,574,999, the amount of commissions Harris calculated were paid to optionsXpress as a result of the transactions at issue. Id. at 44-46.

Feldman characterizes the Division's evidence on disgorgement as entirely specious, speculative, and unsupported. Feldman Brief at 42. Feldman cites Harris's testimony that he would have profited legally if he had an arrangement with optionsXpress not to pay hard-to-borrow fees, and notes that borrowing stock for the entire period would have been the most expensive of the various alternatives available to him if he had not used buy-writes. Id. at 43-44. Feldman questions assumptions Harris used in making his calculations, and he insists that Harris's metric for harm is wrong because it assumes customers were harmed when they did not receive shares on T+3. Id. at 44-46.

Based on the finding of violations in this Initial Decision, optionsXpress and Feldman should be required to disgorge ill-gotten gains from their illegal activities. The case law provides that disgorgement must be a reasonable approximation of profits causally connected to the violations. First City Fin. Corp., 890 F.2d at 1231.

Rule 600(a) of the Commission's Rules of Practice provides that:

> The disgorgement order shall specify each violation that forms the basis for the disgorgement ordered; the date which, for purposes of calculating disgorgement, each such violation was deemed to have occurred; the amount to be disgorged for each such violation; and the total sum to be disgorged. Prejudgment interest shall be due from the first day of the month following each such violation through the last day of the month preceding the month in which payment of disgorgement is made. The order shall state the amount of prejudgment interest owed as of the date of the disgorgement order and that interest shall continue to accrue on all funds owed until they are paid. 17 C.F.R. § 201.600(a).

Based on the innumerable different transactions that occurred, it is impossible to fashion a disgorgement order with the specificity that Commission Rule of Practice 600 envisions. Harris's calculation that the six customer accounts that engaged in the trading strategies described in this Initial Decision paid optionsXpress a total of $1,908,744 during the relevant period, and that $1,574,599 of that amount was for buy-writes, makes the latter the most reasonable approximation of optionsXpress's ill-gotten gains, plus prejudgment interest. Div. Ex. 310 at 13. The Division would prefer the full amount, claiming that the other trades were predominantly reverse conversions and three ways, but it does not point to evidence in the record to support its claim. Reply Brief Against optionsXpress at 47. I reject the Division's recommendation that unexpended borrowing fees should be used as a basis for disgorgement because Rule 204 does not require that optionsXpress pay borrowing fees. Feldman's estimate that optionsXpress was making between $2 and $2.5 million each year in commissions on his trades supports this lower amount. Div. Ex. 249.

The most reasonable approximation in this record of Feldman's ill-gotten gains is $2,656,377, plus prejudgment interest. The $2,656,377 figure is a calculation of Feldman's net profits from his underlying trading – reverse conversions and three ways – that resulted in gross trading profits of more than $4 million at optionsXpress during the relevant period. Div. Ex. 310 at 41-42, Exs. 20, 21; Reply Brief Against optionsXpress at 43. The reasonableness of the $2,656,377 figure is supported by Harris's calculation that Feldman's expected profits in trades conducted between December 2, 2009, and March 18, 2010, only a small portion of the relevant period, was $1,389,422; Sheehy's opinion that Feldman earned $877,919 over a six-month period; and Feldman's statement that his IRS Form 1099 for 2009 would be over $2 billion, all of which support a substantial disgorgement amount. Div. Exs. 89, 375 at 5, 497.

When the government puts forward a figure that reasonably approximates the amount of unjust enrichment, the burden shifts to the respondents to demonstrate that that the figure is not a reasonable approximation. SEC v. Lorin, 76 F.3d 458, 462 (2d Cir. 1996); SEC v. Patel, 61 F.3d 137, 140 (2d Cir. 1995); First City Fin. Corp., 890 F.2d at 1232. Any risk of uncertainty as to the disgorgement amount "should fall on the wrongdoer whose illegal conduct created that uncertainty." First City Fin. Corp., 890 F.2d at 1232. Neither optionsXpress nor Feldman put forth a reasonable disgorgement estimate.

III. Civil Penalties

Section 8A(g) of the Securities Act and 21B(a) of the Exchange Act authorize the Commission to impose civil monetary penalties. 15 U.S.C. §§ 77h-1, 78u-2. The statutes set out a three-tiered system for determining the maximum civil penalty for each "act or omission." See Mark David Anderson, 56 S.E.C. 840, 863 (2003) (imposing a civil penalty for each of the respondent's ninety-six violations). A second-tier penalty is permissible if the violations involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement. 15 U.S.C. § 78u-2(b)(2). A third-tier penalty is permissible for violations that, in addition, "directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission." Id. § 78u-2(b)(3). Section 21B(c) of the Exchange Act specifies the following as public interest

considerations: (1) whether the violations involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm caused to others; (3) the unjust enrichment; (4) prior violations; (5) deterrence; and (6) such other matters as justice may require. Id. § 78u-2(c).

From October 2008 to March 3, 2009, the maximum amount of civil penalty for each act or omission at the second tier was $65,000 for a natural person, and at the third tier was $130,000 for a natural person and $650,000 for any other person. See 17 C.F.R. § 201.1003, Subpt. E, Table III. After March 3, 2009, the maximum amount of civil penalty for each act or omission at the second tier was $75,000 for a natural person, and at the third tier was $150,000 for a natural person and $725,000 for any other person. See 17 C.F.R. § 201.1004, Subpt. E, Table IV.

A circuit court has taken the Commission to task for, among other things, not following the statutory formula: "To impose second-tier penalties, the Commission must determine how many violations occurred and how many are attributable to each person." Rapoport v. SEC, 682 F.3d 98, 108 (D.C. Cir. 2012). Presumably, the court would take the same view about imposition of civil penalties at the third-tier level.

The Division recommends third-tier penalties against optionsXpress and Feldman for each of their multiple violations and a second-tier civil penalty of $75,000 against Stern. Div. Brief at 44-45.

optionsXpress's position is that the "gross deficiencies in the Division's proof is matched only by the gross hyperbole in the penalty it demands – close to $1 billion for a purported and unproven technical and victimless violation of a strict liability rule." OPX Brief at 46. It argues that the Division grossly misreads Section 21B(a) of the Exchange Act to arrive at a third-tier penalty of $725,000 on Reg. SHO violations for twenty-five securities on at least 1,200 occasions for a total of $870 million. Id. at 47. optionsXpress argues that the Division has failed to: (a) prove fraud, manipulation, or reckless disregard of a regulatory requirement; (2) show that market participants were harmed; (3) show market integrity was undermined; or (4) show that optionsXpress greatly profited. Id. at 46-47.

Feldman maintains there is no basis for civil penalties because the Division did not show that Feldman acted with extreme recklessness, he was not charged with willfully aiding and abetting a violation by another person, and the Division did not show the assessment of civil penalties serves the public interest. Feldman Brief at 47-48. Feldman notes that the Division would assess a third-tier $150,000 penalty for each violation, and that it claims Feldman conducted 390 buy-writes, but that the Division did not show which of the buy-writes resulted in a fail to deliver position. Id.

Stern argues that for imposition of a penalty the Division is required to show that he acted with extreme recklessness and it has not done so. Stern Brief at 36.

It is in the public interest to assess civil monetary penalties against: optionsXpress and Feldman at the third tier because they committed willful violations involving fraud, deceit,

manipulation or deliberate or reckless disregard of a regulatory requirement, which resulted in substantial pecuniary gain to each of them; and Stern at the second tier because he committed willful violations involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. Orlando Joseph Jett, Exchange Act Release No. 49366 (Mar. 5, 2003), 82 SEC Docket 1211, 1264 (finding a third-tier civil penalty appropriate for deterrence and because respondent's conduct involved deceit and resulted in substantial pecuniary gain.)

optionsXpress willfully violated Reg. SHO, and acting with scienter it caused and aided and abetted Feldman's fraud. The public interest considerations set out in Section 21B(c) of the Exchange Act show that it is in the public interest to impose a civil monetary penalty on optionsXpress. Despite numerous red flags that warned of possible violations, optionsXpress only ceased the illegal activity when the Commission told it to stop. The fact that a major options broker willfully ignored regulatory mandates to enable customers to commit fraud for its financial benefit should be dealt with strictly to protect the public. The Exchange Act specifies that the need to deter persons from similar conduct is a public interest consideration in assessing the need for a penalty. 15 U.S.C. § 78u-2(c)(5). "'Fidelity to the public interest' requires a severe sanction when a respondent's misconduct involves fraud because the 'securities business is one in which opportunities for dishonesty recur constantly.'" Justin F. Ficken, Exchange Act Release No. 58802 (Oct. 17, 2008), 94 SEC Docket 10887, 10891 (citing Richard C. Spangler, Inc., 46 S.E.C. 238, 252 (1976)).

Civil monetary penalties are appropriate against Feldman because this proceeding was instituted pursuant to Section 21C of the Exchange Act, among others, and he has been found to have violated the antifraud provisions of the securities statutes.[136] The Commission has consistently treated fraud as a serious threat to the investing public. Marshall E. Melton, Exchange Act Release No. 48228 (July 23, 2003), 56 S.E.C. 695, 713 (reasoning that violations of the antifraud provisions have "especially serious implications for the public interest").

The public interest considerations set out in Section 21B(c) of the Exchange Act show that it is in the public interest to impose a civil monetary penalty on Feldman. Feldman continued his illegal activities despite numerous red flags that warned of possible violations. Feldman believes he has done nothing wrong because optionsXpress allowed his trades and no one told him to stop. It is one thing to have the courage of your convictions and to believe you are right, it is another thing to participate in a regulated industry without any independent, knowledgeable basis that supports your position. Feldman does not consider that he is required to have a reasonable belief that his securities transactions are lawful, rather, he will engage in any securities transactions where he believes he has found mispricing that he can find a broker to process. After optionsXpress ceased allowing his transactions at the Commission's request, Feldman continued with other brokers as long as they would allow him to do so. The market was generally harmed by Feldman's transactions. I base this conclusion on a review of all the Facts; in particular, because:

[136] Section 21B of the Exchange Act, which specifies civil monetary penalties, is applicable to any proceeding instituted under Exchange Act Section 21C where certain conditions are met.

(1) his actions misled market participants as noted on the internet message boards;[137] (2) his actions raised concerns among market makers who asked CBOE to investigate similar transactions by Zelezney;[138] (3) Overmyer's testimony that these transactions disadvantaged market participants; and (4) as used by Feldman, the buy-writes were essentially wash trades or matched orders to avoid delivering shares. Tr. 3818, 3913-14, 3969, 4047.

The need to deter persons from violations of the securities laws and regulations is a public interest consideration in assessing the need for a penalty. Given that the securities industry provides so many opportunities for fraud and financial profit, and Feldman's position on allowable conduct, deterrence is a particularly strong reason to impose a civil monetary penalty on Feldman. 15 U.S.C. § 78u-2(c).

The penalties in Section 21B are based on "each act or omission." 15 U.S.C. § 78u-2(b). "optionsXpress violated Reg. SHO in 25 securities on at least 1,200 occasions." Div. Brief at 45 n.17. I agree with optionsXpress that a literal application of the each act or omission language would have an absurd result. The Division did not disagree. OPX Brief at 47. With deference to Rapoport and to a reasonable outcome, I will order optionsXpress to pay a civil monetary penalty in the amount of $2 million, which is $1,667 for each of the 1,200 Reg. SHO violations, exclusive of the causing and aiding and abetting violations that involved scienter. A $2 million civil penalty, along with the other sanctions imposed and new corporate ownership, will, hopefully, but not assuredly, provide some protection to the public.

"Feldman committed fraud in connection with 13 securities over 20 different periods." Div. Brief at 45 n.17. The record shows Feldman executed 390 buy-write trades (counting only the stock purchase legs) from June 2009 to March 18, 2010. Div. Ex. 310 at 32. With deference to both Rapoport and a reasonable outcome, I will order Feldman to pay a civil monetary penalty in the amount of $2 million, which would be $5,128 for each of the 390 fraud violations.

There is no evidence that Stern profited financially from his conduct and a second-tier $75,000 civil monetary penalty that the Division recommends, along with the substantial other sanctions, should protect the public.

IV. Bar

Section 15(b)(6) of the Exchange Act authorizes the Commission to censure, place limitations on the activities or functions of, suspend for up to twelve months, or bar from association or participation, a person who willfully aided, abetted, counseled, commanded,

[137] For example, on December 23, 2009, Kolocouris called Coronado and described the confusion on an internet message board about "big volume jump in Sears that referenced the buy-write activity." Tr. 594-96; Div. Ex. 370.

[138] A CBOE internal document dated June 16, 2009, states: "The complainant felt that the behavior may be disadvantaging the market place, in reference to ones ability to make quality markets." OPX Ex. 565.

induced, or procured violations of the securities statutes while associated with a broker or dealer if it is in the public interest. 15 U.S.C. § 78o(b)(6).

Section 9(b) of the Investment Company Act authorizes the Commission to prohibit, either permanently or for such time as it deems appropriate in the public interest, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter. 15 U.S.C. § 80a-9.

The Division would bar Stern from: (a) associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization; (b) acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor or principal underwriter; (c) participating in any offering of a penny stock, including: acting as a promoter, finder, consultant, agent or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance of trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock. Div. Brief at 46-47.

Stern maintains that the Division is overreaching, there is no showing that he willfully violated federal securities laws, and that he has taken full responsibility for errant responses in his Wells response. Stern Brief at 36. Stern would like to participate in the securities industry as a consultant. Tr. 1795.

This Initial Decision finds that Stern willfully caused and aided and abetted violations of the securities statutes and thus the issue is whether it is in the public interest to impose a sanction. The discussion of the Steadman factors, with respect to imposition of a cease-and-desist order against Stern, is also applicable here in determining whether a sanction is in the public interest.

Stern is charming, extremely knowledgeable, but unfortunately on the matters at issue in this proceeding he was not credible. For example, he falsely informed persons at optionsXpress that Trading and Markets approved the use of buy-writes in connection with closing out fails to deliver. Stern was optionsXpress's regulatory liaison, but he did not initiate contact with CBOE or FINRA to determine whether optionsXpress's conduct satisfied Rule 204, yet he claims no one told optionsXpress to stop. Stern worked on optionsXpress's procedures when Rule 204T became effective in October 2008, when Rule 204 became effective in July 2009, and when the T+1 buy-in policy was initiated in August 2009, yet he testified he did not know anything about optionsXpress's buy-ins before the CBOE letter of caution in September 2009. Finally, Stern claimed he did not know much about Feldman's trades, but Feldman was one of optionsXpress's largest retail customers, Payne testified that Stern asked about Feldman's trading about fifteen times in 2009, Feldman believed that Stern knew who he was when they met briefly in 2010, and Tortorella testified that he spoke with Stern about optionsXpress's requirement to post collateral, which would have been impacted by the huge size of Feldman's margin trading.

On September 25, 2012, CBOE announced that it had censured and permanently barred Stern from acting as a Trading Permit Holder (TPH) or from association with any TPH or TPH organization. Stern's conduct included making false statements or misrepresentations to CBOE on several matters. Div. Ex. 418. Stern submitted a Letter of Consent without admitting or denying the violations. Div. Ex. 419. Based on this evidence, and the opportunities for violations presented by industry participation, it is in the public interest to bar Stern from participation in the securities industry and from serving as an officer or director.

Record Certification

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Corrected Record Index issued by the Secretary of the Commission on May 10, 2013.

Order

I ORDER that, pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934:

> optionsXpress, Inc., shall cease and desist from violating Rule 204 of Reg. SHO, and from causing and aiding and abetting violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rules 10b-5 and 10b-21;
>
> Thomas E. Stern shall cease and desist from causing and aiding and abetting violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, Exchange Act Rules 10b-5 and 10b-21, and Rule 204 of Reg. SHO; and
>
> Jonathan I. Feldman shall cease and desist from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Exchange Act Rules 10b-5 and 10b-21.

I FURTHER ORDER that, pursuant to Section 8A(e) of the Securities Act of 1933 and Section 21C(e) of the Securities Exchange Act of 1934:

> optionsXpress, Inc., shall disgorge $1,574,599, plus prejudgment interest from October 7, 2008;[139] and

[139] This is the date the OIP alleges optionsXpress began allowing customers to conduct the trading strategy this Initial Decision finds resulted in violations. It is also close to the September 30, 2008, date for data that Harris analyzed confirming that other customers used similar strategies as Feldman. OIP at 8; Div. Ex. 310 at 31, 49.

Jonathan I. Feldman shall disgorge $2,656,377, plus prejudgment interest from June 1, 2009.[140] Prejudgment interest shall be calculated at the rate of interest established under Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), shall be compounded quarterly, and shall run through the last day of the month preceding the month in which payment is made. 17 C.F.R. § 201.600(b).

I FURTHER ORDER that, pursuant to Section 8A(g) of the Securities Act of 1933 and Section 21B(a) of the Securities Exchange Act of 1934:

optionsXpress, Inc., shall pay a civil monetary penalty in the amount of $2,000,000;

Jonathan I. Feldman shall pay a civil monetary penalty in the amount of $2,000,000; and

Thomas E. Stern shall pay a civil monetary penalty in the amount of $75,000.

I FURTHER ORDER that, pursuant to Section 15(b)(6) of the Securities Exchange Act of 1934 and Section 9(b) of the Investment Company Act, Thomas E. Stern is

barred from being associated with a broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization or from participating in an offering of penny stock; and

prohibited permanently from serving or acting as an employee, officer, director, member of an advisory board, investment adviser, or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter.

Payment of the disgorgement and civil monetary penalty shall be made no later than twenty-one days following the day this initial decision becomes final. Payment shall be made by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission. The payment, and a cover letter identifying Respondent and Administrative Proceeding No. 3-14848, shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, OK 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of

[140] This is the date the OIP alleges Feldman began his trading strategy, which was confirmed by Harris's analysis. OIP at 8; Div. Ex. 310 at 31, 34.

fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

_____

Brenda P. Murray
Chief Administrative Law Judge