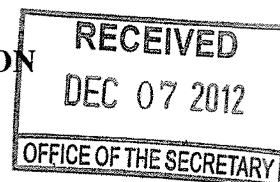
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION



ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

optionsXpress, Inc.,
Thomas E. Stern, and
Jonathan I. Feldman,

Respondents.

DIVISION OF ENFORCEMENT'S POST-HEARING BRIEF

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The Division of Enforcement ("Division") respectfully submits this Post-Hearing Brief.

INTRODUCTION

For all its seeming complexity, this case is about simple, old-fashioned, deceptive securities trading by individual options traders with the assistance of a broker-dealer that failed to comply with its regulatory obligations. Respondent optionsXpress, Inc. ("optionsXpress") facilitated what no other brokerage firm would allow – customers, including Respondent Jonathan I. Feldman ("Feldman"), engaging in day-over-day buy-write trades in the face of uncured failures to deliver – because optionsXpress made money on every trade (nearly $2 million in total over the course of the relevant period). These uncured failures to deliver violated Rules 204 and 204T of Regulation SHO ("Reg. SHO") and Feldman's and the other customers' schemes to profit from the failures to deliver constituted fraud.

Feldman and other optionsXpress customers undertook a complex options trading strategy to make ***millions*** of dollars by trading ***billions*** of dollars of publicly-traded securities, part of which involved selling deep-in-the-money call options with no intention of actually delivering stock when those options were inevitably exercised and assigned. Instead, Feldman and the other customers planned to execute "buy-write" transactions, which involved simultaneously buying stock and selling an equivalent number of deep-in-the-money call options that they knew had a high probability of being exercised and assigned on the same day they were sold, resulting in what optionsXpress recognized early on was a "vicious cycle" of "perpetual" failures to deliver for the firm. These buy-write transactions, "even viewed in the most favorable light," are "nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). In short, the buy-write trades in this case were sham transactions that did nothing more than fraudulently circumvent delivery obligations so that Feldman and the other customers could illegally profit.

optionsXpress – with the approval and assistance of Respondent Thomas E. Stern ("Stern"), its former Chief Financial Officer and regulatory liaison – violated Rules 204 and 204T of Reg. SHO when it allowed its customers to improperly use buy-writes and create a cycle of perpetual failures to deliver. Rules 204 and 204T of Reg. SHO were designed to reduce failures to deliver by broker-dealers like optionsXpress to a registered clearing agency – in this case, the Continuous Net Settlement ("CNS") system at the National Securities Clearing Corporation ("NSCC") – and to curb abusive naked short selling (that is, short selling securities without actually delivering the stock that was sold short). 74 Fed. Reg. 38266 (2009); 73 Fed. Reg. 61706 (2008). To accomplish these goals, Rules 204 and 204T of Reg. SHO require broker-dealers like optionsXpress – the gatekeepers of the settlement system – to deliver shares into CNS no later than three days after the shares are sold (*i.e.*, by T+3). 17 C.F.R. § 242.204(a); 17 C.F.R. § 242.204T(a).

If a broker-dealer like optionsXpress does not deliver shares to CNS by the end of those three days, then it has a failure to deliver position at CNS, and must "*immediately close out* its failure to deliver position" by purchasing or borrowing shares in a bona fide transaction "no later than the beginning of regular trading hours" the following day (i.e., T+4). *Id.* ***It is axiomatic that a broker cannot "immediately close out" a failure to deliver position <u>at</u> CNS without actually making delivery <u>to</u> CNS.*** Yet the records from CNS are unequivocal – optionsXpress facilitated Feldman's and its other customers' buy-writes in response to CNS failures to deliver resulting in shares not being delivered to CNS in an amount sufficient to actually "close out" those failures to deliver. Thus, optionsXpress' failures to deliver did not settle or go long and instead persisted for weeks and months on end.

These persistent, uncured failures to deliver violated Reg. SHO, and optionsXpress is strictly liable for these violations. Notably, however, optionsXpress was aware in 2008 that the trading activity was violating federal securities laws. For example, optionsXpress' head trader emailed the Clearing Department about "an article in the WSJ about how short sellers in [Sears]

are using options ***to circumvent the SEC cover rule***[;] I think we need to review this," to which optionsXpress' head of clearing responded, ***"[The Customers are] definitely doing this.***" DFOF ¶ 132.[1] Likewise, as early as October 15, 2008, less than one month after the Commission issued its emergency order for Rule 204T, optionsXpress employees recognized that the firm's customers had "short positions on hard to borrow stocks where the ***customer has to buy in every day***," adding that customers were "buying back the short and writing in the money calls which are ***assigned on a daily basis***." DFOF ¶ 128. The next month, optionsXpress employees noted that the trading activity was creating perpetual failures to deliver: "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***." DFOF ¶ 131. This vicious cycle of what optionsXpress employees called "perpetual," "chronic," or "rolling" failures to deliver, continued into and beyond August 2009, when an optionsXpress employee confirmed that its customers, including Feldman, persisted in remaining "[a]lways short, cover[] [their] buys by buying [sic] short options deep in the money, so they get assigned. More or less, their trade date position stays constant, ***settled position never closes or goes long***." DFOF ¶¶ 86, 163.

Despite early awareness of the apparent securities violations, optionsXpress did nothing to stop the buy-write activity and instead allowed the vicious cycle and perpetual failures to deliver to continue until March 2010. Tellingly, while optionsXpress and Stern knowingly permitted and facilitated this activity for over a year, ***every other brokerage that confronted identical trading by Feldman promptly stopped it.***

And even if optionsXpress was correct that it was properly "buying in" its customers by allowing them to do buy-writes, the firm would still be liable for violating Reg. SHO because it did not ensure shares were purchased *immediately* at the *beginning* of regular trading hours (*i.e.*,

[1] "DFOF" refers to the Division's Findings of Fact. "Div. Ex." refers to exhibits marked by the Division that were admitted at the hearing. "Resp. Ex." refers to the Respondents' exhibits admitted at the hearing. "Tr." refers to the hearing transcript. The parties have requested that certain corrections be made to the hearing transcript. Thus, the page references might change if an amended transcript is issued.

before 10:00 a.m. Eastern Time), as Rules 204 and 204T require. Here too, while optionsXpress knew as early as October 2008 that the SEC took the timing of buy-ins very seriously and was cracking down on firms for late buy-ins, (DFOF ¶¶ 156, 157), as late as August 2009 the buy-writes still were not taking place until well after market open. Indeed, prior to August 2009, ninety-seven percent (97%) of the buy-writes were executed after 10:00 a.m. Eastern Time. For the entire time period relevant to this case, sixty-seven percent (67%) of the buy-writes were executed after 10:00 a.m. Eastern Time, with the first trade in the buy-write being executed on average approximately 1 hour and 35 minutes after market open.

Despite Respondents' best efforts to suggest otherwise, Feldman and the other customers did not discover some new and novel "arbitrage" opportunity, but instead "discovered" an options trading strategy that could (and did) succeed only in very narrow circumstances. That is, the strategy depended on Feldman and the other customers finding a broker-dealer (optionsXpress) that would willingly neglect its regulatory obligations and allow its customers to repeatedly execute deep-in-the-money buy-writes in hard-to-borrow securities when it had settlement obligations to make delivery, resulting in a vicious cycle of "perpetual," "chronic," or "rolling" failures to deliver. Feldman admits that his trading strategy was executed deliberately and intentionally and bragged in writing that he was not going to make (or wanted to avoid making) delivery to settle his trades: ***"I don't settle the stock@all.";*** "So I could do a buy-write ***and then I wouldn't settle***."; "So how many SHLD do I have to buy-in today (***to avoid settlement***)?" DFOF ¶¶ 218, 219. Feldman's professed "reliance" on optionsXpress was not reasonable, particularly when he testified unequivocally that he is steadfastly skeptical in all of his business dealings and always seeks his own understanding of the true nature of the circumstances he faces. Feldman's supposed reliance on optionsXpress is particularly unreasonable given that ***every other brokerage firm he tried to use promptly shut down his strategy over regulatory concerns***. Moreover, Feldman was personally exposed to numerous red flags about the implications of his trading activity – he was provided a copy of Rule 204 and

Hazan by optionsXpress and communicated with optionsXpress about the regulatory implications of his trading – yet he bragged to a friend about the market and regulatory concerns his trading was having on the trading volume of these stocks: "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. ***(Until someone notifies the SEC and they shut down the strategy!!)***. DFOF ¶ 277.

After seventeen days of hearings, it is time for the Court to do what Feldman rightly predicted – "shut down the strategy!!" – and confirm what was apparent to optionsXpress four years ago – the buy-write trading at issue in this case violated Rules 204 and 204T of Reg. SHO and was a key element of Feldman's fraud. In the process, the Court should find Feldman liable for violating Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 10b-5 and 10b-21 thereunder, as well as Section 17(a) of the Securities Act of 1933 ("Securities Act"). The Court should also hold that optionsXpress caused and willfully aided and abetted Feldman's and other customers' abusive naked short selling, and in the process violated its delivery obligations under Reg. SHO. The Court should further find that Stern's active role as optionsXpress' primary regulatory liaison and in setting optionsXpress' policies and procedures for handling the improper trading aided and abetted both optionsXpress' violations of Reg. SHO and Feldman's violations of the securities laws. For their violations of the securities laws, Feldman and optionsXpress should be ordered to cease and desist, disgorge their improper gains, and pay civil penalties, while Stern should be permanently barred from activity in the securities industry and be required to pay a civil penalty.

BACKGROUND – TRADING OVERVIEW

During the relevant period, Feldman and other optionsXpress customers (hereinafter, collectively, "the Customers") bought ***millions*** of dollars of call option contracts referencing hard-to-borrow securities, giving them the right to buy stock at a certain price on specific hard-to-borrow stocks. *See* DFOF ¶¶ 48, 49; Harris Report (Div. Ex. 310) at ¶ 52; Sheehy Report (Div. Ex. 375) at ¶ 18; Div. Ex. 75 (Feldman's Form 1099 from optionsXpress). At the same

time, Feldman and the Customers sold an identical quantity of put options in the same hard-to-borrow stock – giving a purchaser the right to make Feldman or the Customers buy stock at the same price as the call option they had purchased. DFOF ¶¶ 50, 53, 54. Purchasing the calls and selling the puts were the economic equivalent of buying shares of stock. DFOF ¶ 50. Because the combined transactions mimic owning a stock, this position is known as a "synthetic" long position. *See* DFOF ¶ 50; Harris Report (Div. Ex. 310) at ¶ 101; Sheehy Report (Div. Ex. 375) at ¶ 24.

Because a synthetic long position exposed Feldman and the Customers to potential losses if the stock price went down, just like owning a share of stock outright, they would establish an offsetting short position, *i.e.,* they would "hedge" their synthetic long. *See* DFOF ¶ 53; Harris Report (Div. Ex. 310) at ¶¶ 17, 18, 111, 142; Sheehy Report (Div. Ex. 375) at ¶¶ 46, 49. The profit in this trading came from the difference between the price they *received* from selling the put on the hard-to-borrow security and the price they *paid* to buy the call on the same security (thereby establishing the synthetic long), less the price they would have to *pay* for the initial and all subsequent hedges. *See* Harris Report (Div. Ex. 310) at ¶¶ 137-139; Sheehy Report (Div. Ex. 375) at ¶ 46.

Feldman's and the Customers' short "hedge" positions were established in one of two primary ways: (1) selling stock short; or (2) selling a deep-in-the-money call.[2] The sale of short stock created an immediate delivery obligation, and the sale of the deep-in-the-money call options created delivery obligations after those calls were exercised and assigned to Feldman and the Customers.[3] Because Feldman and the Customers sold deep-in-the-money calls referencing

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[2] The combination of a synthetic long and a short sale of stock is called a "reverse conversion." The combination of a synthetic long and the sale of a deep in the money call is called a "three-way" trade. A call option that is "deep-in-the-money" has a strike price that is far below the market price for the given security. Harris Report (Div. Ex. 310) at ¶¶ 18, 68; Sheehy Report (Div. Ex. 375) at ¶ 19c; Sirri Report (Resp. Ex. 915) at ¶ 24.

[3] An assignment is a notice received by an option writer stating that the option he sold has been exercised by the purchaser of the option. When assigned, the option writer has an obligation

hard-to-borrow securities, the calls were highly likely to be exercised immediately and the obligation to deliver triggered. In fact, the deep-in-the-money call options were regularly and promptly exercised, a scenario, as both sides' experts explained, one would expect of deep-in-the-money call options on hard-to-borrow stock. *See* Harris Report (Div. Ex. 310) at ¶¶ 23, 28, 74, Ex. 32; Sheehy Report (Div. Ex. 375) at ¶¶ 61-64; *see also* Tr. at 4403:16-18 (Saha) (stating "it's a fact" that the "deeper the call is in the money, the more likely it is to be assigned).

Despite having delivery obligations when the call options were assigned, optionsXpress did not deliver stock to CNS by settlement date (T+3). DFOF ¶ 69. Instead, optionsXpress facilitated Feldman's and the Customers' execution of "buy-write" transactions – matched orders to "buy" the amount of stock that was required to be delivered because of the previously-exercised call options and simultaneously sell (i.e., "write") deep-in-the-money call options for the exact same quantity of stock. *See* Harris Report (Div. Ex. 310) at ¶¶ 26, 158; Sheehy Report (Div. Ex. 375) at ¶ 8. The deep-in-the-money call options sold as part of the buy-writes were promptly exercised by the counterparty – as one would expect, for the reasons explained above – resulting in the stock that Feldman and the Customers purportedly "bought" from the counterparty being promptly sold right back. *See* Harris Report (Div. Ex. 310) at Ex. 16; Sheehy Report (Div. Ex. 375) at ¶ 54(a). An example of this trading is set forth below:

- Start day: Feldman/optionsXpress owe delivery to CNS of 100 shares
- 11:00 a.m.: Feldman buys 100 shares, sells 1 deep-in-the-money call on 100 shares (Buy-Write Trade)
- 11:00 a.m.-4:30 p.m.: Deep-in-the-money call exercised
- 10:00 p.m.: Feldman gets assigned and sells 100 shares to satisfy assignment of 1 deep-in-the-money call
- End of Day: Feldman/optionsXpress still owe delivery to CNS of 100 shares

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to complete the requirements of the option contract. If the option was a call option, then the writer would have to sell the underlying security at the pre-determined price and deliver the shares being sold.

This same day purchase and sale resulted in no shares being delivered to CNS for weeks and months on end, which optionsXpress recognized as a "vicious cycle" as early as November 2008.

By entering into buy-writes, optionsXpress and Feldman (and the Customers) avoided paying substantial fees to borrow the hard-to-borrow stocks – as everyone else in the market was doing – and thereby deprived stock owners of borrowing fees they should have received. *See* Harris Report (Div. Ex. 310) at ¶¶ 141-45; Sheehy Report (Div. Ex. 375) at ¶¶ 9, 58-60. While Feldman claims that optionsXpress did not charge him hard to borrow fees, this fact is irrelevant. Feldman testified that he specifically sought out brokers that did not charge hard to borrow fees. DFOF ¶¶ 64, 95. And, optionsXpress never paid to borrow shares to satisfy the firm's and Feldman's delivery obligations.

The buy-writes that optionsXpress and Feldman executed were not bona fide purchases and had no legitimate economic purpose. Rather, they only served to allow Feldman and the Customers to "profit" as a result of extending their "naked" short positions. Indeed, to trade these buy-writes, Feldman and the Customers had to actually ***pay money to*** the counterparty that was purportedly ***purchasing*** the call options from them. *See* Harris Report (Div. Ex. 310) at Ex. 21; Sheehy Report (Div. Ex. 375) at ¶ 9(f). Thus, at the end of the day, optionsXpress and Feldman were still obliged to deliver as many shares as they had been obliged to deliver at the beginning of the day. optionsXpress and Feldman repeated this buy-write process whenever Feldman's deep-in-the-money call options were exercised – as they were virtually certain to be from the outset – until the original put and call options expired or the entire position was unwound. *See* Harris Report (Div. Ex. 310) at ¶ 29; Sheehy Report (Div. Ex. 375) at ¶ 62.

This Court should hold that the "buy" portion of the buy-writes did not satisfy optionsXpress' and Feldman's delivery obligations because the buying (of the stock) and selling (of the deep-in-the-money calls) occurred simultaneously and effectively cancelled each other out resulting in no shares being delivered to CNS. *See* Harris Report (Div. Ex. 310) at ¶¶ 115, 116; Sheehy Report (Div. Ex. 375) at ¶¶ 61-64. That this was the intent and effect of the trades

was apparent to both optionsXpress and Feldman; indeed, an optionsXpress employee explained to Feldman that his positions "are always short. 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***." Div. Ex. 58 (emphasis added). As Feldman himself explained – "***I don't settle the stock@all.";*** "So I could do a buy-write ***and then I wouldn't settle***."; "So how many SHLD do I have to buy-in today (***to avoid settlement***)?" DFOF ¶¶ 218, 219. Notably, every witness with options trading experience who testified at the hearing and was not either employed by optionsXpress or retained as an expert by Respondents testified that this use of buy-writes with deep-in-the money calls is highly unusual and not normal market activity. *See* DFOF ¶ 77.

Despite the assertions by Respondents' experts, the price differential in the puts and calls was not an "arbitrage opportunity" that Feldman (and optionsXpress' other Customers) were the first and only people to recognize; rather, it was a price differential that anyone involved in options trading could readily see and understand. *See* Harris Report (Div. Ex. 310) at ¶ 16; Sheehy Report (Div. Ex. 375) at ¶¶ 37-39. If an entity paid to borrow the stock and charged its customers for borrowing that stock, then there was no profit to be made. optionsXpress did not pay to borrow the stock, and its Customers made money because optionsXpress did not actually "purchase" shares on their behalf when there were failures to deliver. Rather, optionsXpress allowed the buy-writes which enabled the Customers to "profit" from the alleged "arbitrage opportunity."

True arbitrage opportunities in options trading exist for only a matter of moments, unlike the put/call price differential that can and does persist for months in hard-to-borrow stocks. *See* Sheehy Report (Div. Ex. 375) at ¶¶ 30-31. In true arbitrage opportunities (unlike this one), market makers and professional investors running sophisticated algorithms can capitalize on these opportunities quickly, making it virtually impossible for an individual trader like Feldman to profit. *See* Sheehy Report (Div. Ex. 375) at ¶ 30. Tellingly, optionsXpress' website notes the opportunity for retail investors to profit from reverse conversions is extremely limited:

"Individual investors and most other off-the-floor traders don't have an opportunity to do conversions and reversals because price discrepancies ***typically only exist for a matter of moments***. Professional option traders, on the other hand, are constantly on the lookout for these opportunities. As a result, the market quickly returns to equilibrium." DFOF ¶ 99; Sheehy Report (Div. Ex. 375) at ¶ 31.

From October 2008 through March 2010, Feldman and the Customers routinely engaged in these buy-write transactions in at least 25 securities. *See* Harris Report (Div. Ex. 310) at ¶¶ 174-78. As a result of these Customers trading buy-writes, optionsXpress' had continuous failures to deliver in numerous securities that persisted for months. Feldman personally purchased at least $2.9 ***billion*** of securities and sold short at least $1.7 ***billion*** of options through optionsXpress in 2009 alone – making a gross profit over the entire relevant period of more than $4 million – and optionsXpress' other five customer accounts purchased approximately $2.6 ***billion*** worth of securities and sold short approximately $2.3 ***billion*** of options. optionsXpress avoided paying $7,214,977 in hard-to-borrow fees over the relevant period. *See* Harris Report (Div. Ex. 310) at ¶¶ 41, 188, 199.

ARGUMENT

I. OPTIONSXPRESS VIOLATED THE CLOSE-OUT PROVISIONS OF RULES 204 AND 204T OF REG. SHO

A. Reg. SHO Was Designed To Reduce Failures To Deliver

Rules 204 and 204T of Reg. SHO are strict liability regulations designed to reduce failures to deliver and abusive "naked" short selling. Abusive naked short selling refers to selling stock without having stock available for delivery – either in inventory or by borrowing it – and failing to deliver stock within the standard three-day settlement cycle. 73 Fed. Reg. 61667. The adopting release to Rule 204 makes clear that "[s]ellers sometimes intentionally fail to deliver securities as part of scheme to manipulate the price of a security, ***or possibly avoid borrowing costs***

associated with short sales, especially when the costs of borrowing are high." 74 Fed. Reg. at 38267 (emphasis added); *see also* 73 Fed. Reg. at 61707-08.

In an effort to reduce failures to deliver and prevent abusive naked short selling, Rules 204 and 204T require optionsXpress, and other participants of a registered clearing agency (like the NSCC here), to deliver equity securities to their registered clearing agency by settlement date, which is generally three days after the trade date ("T+3"). 73 Fed. Reg. at 61710, 61707 n.8. For short sales, if a participant like optionsXpress does not deliver securities by T+3 and thus has a failure to deliver position at the clearing agency, it must take affirmative action to purchase or borrow securities of like kind and quantity to close out the failure to deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date ("T+4"). 73 Fed. Reg. at 61710-11. Critically, however, where a participant like optionsXpress, that is subject to Reg. SHO's 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. 74 Fed. Reg. at 38272 n.82.

The Commission's concern about market participants using combined purchase-and-sale transactions to circumvent its rules relating to delivery of securities is not new. In 2003, the SEC issued guidance to "disabuse traders of any notion" that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). As the Commission noted back then, "[e]ven viewed in the most favorable light, these married put transactions appear to be nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." *Id.* "The Commission has previously indicated that where transactions involve no market risk and serve no purpose

other than rendering a person an owner of a security in order to accomplish indirectly what was prohibited directly, the activity may violate the federal securities laws." *Id.*

In July 2007, the American Stock Exchange fined several entities and individuals for violating Reg. SHO Rule 203 (which also imposed close-out obligations) based on trading activity similar to what the Customers did here. *In the Matter of Scott H. Arenstein and SBA Trading, LLC* (July 20, 2007); *In the Matter of Brian A. Arenstein and ALA Trading, LLC* (July 20, 2007). In the *Arenstein* cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation of Rule 203. Following the release of the *Arenstein* cases, the Chicago Board Options Exchange ("CBOE") sent a regulatory circular to its members, including optionsXpress, "strongly cautioning" its members that transactions "pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement." CBOE Regulatory Circular RG07-87 (Aug. 9, 2007).

> Short sales of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, for example, including, but not limited to, ***reverse conversions and deep in-the-money long call/short stock,*** are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase.

Id. (emphasis added). CBOE proceeded to explain that while its examples involved market-makers, "the same analysis would apply to similar arrangements between any market participants." *Id.* The following year, CBOE reiterated its caution: "When accompanied by certain option transactions, stock purchases that are intended to effect close-outs of fail to deliver positions may bring into question whether a bona-fide purchase has occurred." CBOE Regulatory Circular RG08-63 (May 19, 2008).[4]

[4] While CBOE noted that it was permissible to re-establish a short position ***the business day following a close-out,*** "if the underlying stock purchase was not bona-fide or did not completely

In August 2007, the American Stock Exchange sent similar guidance to its participants. Div. Ex. 384. This guidance provided that "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 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 . . . ." *Id.* (emphasis added). This guidance further provided that:

> The use of a buy write with a one-day, deep-in-the-money FLEX option to nominally close out a fail to deliver position and then shortly thereafter reestablish or 'reset' the fail to deliver position ***is not the only means by which an aged fail can be reset.*** 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.***

Id. at n.11 (emphasis added).

This guidance was again reinforced when the SEC adopted Rule 204T on October 14, 2008, explaining that "the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement." 73 Fed. Reg. at 61715 n.78. In July 2009, Rule 204T became permanent with the adoption of Rule 204 and the Commission stated:

> [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.

74 Fed. Reg. at 38272 n.82.

Less than a month later, the SEC brought settled enforcement actions against several entities and individuals for violations of Rule 203 based on options trading similar to what the

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satisfy any close-out requirement, a pre-borrow of stock is required for the subsequent establishment of the new short stock position on the following business day until the close-out is satisfied."

Customers did here. *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, Exchange Act Release. No. 34-60441 (Aug. 5, 2009); *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, Exchange Act Release No. 34-60440 (Aug. 5, 2009). In the *Hazan* and *TJM* cases, the respondents engaged in a series of sham reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203.[5]

Simply put, there has been longstanding industry guidance that the use of buy-writes to address failures to deliver is highly questionable and is indicative of attempts to circumvent Reg. SHO's closeout requirements. Indeed, the testimony at the hearing confirmed that ***every other broker dealer*** who encountered Feldman's use of buy-writes considered the trading a regulatory risk and decided they would not allow it. DFOF ¶¶ 77, 97, 216, 283, 285, 286, 288.

B. optionsXpress' Did Not Cure Its Failures To Deliver At CNS

The stock at issue in this case, like most stock traded in the United States today, is settled through the CNS system. 74 Fed. Reg. at 38272 n.35; 73 Fed. Reg. at 61711 n.14. This means that in order to make delivery, a broker-dealer such as optionsXpress must deliver stock to CNS. 74 Fed. Reg. at 38272 ("Because Rule 204 is based on a participant's fail to deliver position at a registered clearing agency, it is consistent with current settlement practices and procedures and with the Regulation SHO framework regarding delivery of securities.").

A review of the CNS Account Summaries for the 25 securities shows that optionsXpress simply did not deliver shares to cure its failures to deliver during the time periods charged in the OIP – that is, it did not deliver sufficient shares to make its closing position go to zero (0) or become a positive number (which would mean optionsXpress would be owed shares from CNS).

[5] Three months later, the SEC brought settled enforcement actions against several other entities regarding similar trading and Reg. SHO violations. *In the Matter of Rhino Trading, Fat Squirrel Trading Group, Damon Rein, and Steven Peter,* Exchange Act Release No. 34-60941 (Nov. 4, 2009).

Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries); Tr. at 64-65 (Colacino) (CNS Account Summary reflects the shares that are delivered to it in the "ALLOC/RECYC" column). Because shares were not delivered, optionsXpress' failure to deliver position remained open for extended periods of time. The CNS records demonstrate that optionsXpress had failures to deliver in at least 25 securities for significant periods of time between October 2008 and March 2010. Indeed, with respect to Sears Holding Corp. ("Sears" or "SHLD") stock, optionsXpress had a failure to deliver position for at least 240 continuous settlement days during the 2009-2010 period. *See* Div. Ex. 18 (Sears CNS Account Summaries); Harris Report (Div. Ex. 310) at Exhibit 32. Moreover, during the relevant time period, optionsXpress' failures to deliver at CNS dwarfed any other clearing firm's failures to deliver. *See* Div. Ex. 18 (Sears CNS Account Summaries); Harris Report (Div. Ex. 310) at ¶¶ 191-95.

C. The Buy-Writes Did Not Have A *Legitimate* Economic Purpose

Where a market participant that is subject to Reg. SHO's close-out requirement, like optionsXpress, 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, the participant will not be deemed to have satisfied the close-out requirement unless they can demonstrate a legitimate economic purpose for the activity. 74 Fed. Reg. at 38272 n.82. Respondents claim that the buy-writes had a legitimate economic purpose and the trading did not violate Rule 204. Respondents assert that the Customers' deep-in-the-money buy-write trading was used to maintain the hedge against their synthetic long positions. Although the deep-in-the-money buy-writes cost the Customers money on every trade (generally $0.01 or $0.02 per share), optionsXpress' expert, Dr. Atanu Saha ("Saha"), testified that doing deep-in-the-money buy-writes was the *only* economical way that Feldman and the Customers could profit from their trading because all other hedging alternatives would consume the put/call price differential in the original synthetic long and might actually lead to a loss.

Just because the Customers had *an* economic purpose – to "make a profit" – does not make it a *legitimate* economic purpose, any more than the same economic purpose – to "make a profit" – legitimizes check-kiting, stock-kiting, or other forms of securities violations. *See, e.g., U.S. v. Jimenez*, 513 F.3d 62, 72 (3d Cir. 2008) (check kiting is fraud); *Graham v. SEC*, 222 F.3d 994, 1001-03 (D.C. Cir. 2000) (stock kiting scheme was securities fraud). Here, the Customers' economic purpose was to make a profit by extending their short position without delivering shares – optionsXpress knew that its "perpetual," "chronic," and "rolling" failures to deliver meant that shares were not being delivered to CNS. The written guidance from the SEC, CBOE, AMEX and decisions in factually similar cases like *Hazan*, *TJM*, *Rhino*, and *Arenstein* – all of which optionsXpress reviewed at the time they were issued – make clear that such an economic purpose is not legitimate. *See* 74 Fed. Reg. at 38267 (explaining that Rule 204 was enacted in part to prevent failures to deliver arising from a trading strategy that is designed "to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high"); *see also* DFOF ¶¶ 111-124.

D. optionsXpress' T+1 Argument Ignores The Trading Patterns In This Case

During the hearing, Respondents argued that virtually all of the buy-write trades were executed on T+1 after August 2009 so there could not be a Rule 204 violation. This argument is without merit.

The "perpetual list" procedures implemented by optionsXpress on August 20, 2009 did not actually result in shares being delivered to CNS – a fact recognized by the procedures themselves which applied only where "the fail is continuously open due to customers being assigned in the money short calls." Div. Ex. 128. The Rules are clear that a failure to deliver could not occur unless optionsXpress failed to deliver shares by close of business on T+3 – two days after the supposed "cover" on T+1 – and a failure to deliver could only be "continuously open" if shares were not thereafter delivered to CNS. As optionsXpress explained to Feldman, "we are experiencing persistent fails. Because of that, we must take action every day . . . 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." DFOF ¶ 225 (quoting Div. Ex. 28). optionsXpress would not have had to clean up a failure to deliver "immediately" unless it was already past T+3. 17 C.F.R. § 242.204. Because the failures to deliver were never cleared up, the buy-writes were not done on T+1, they were done on T+6, T+10, or T+227, for example. *See, e.g.*, DFOF ¶ 69, 81, 84, 96; Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries). Hence, by the time optionsXpress made the decision in August 2009 to purportedly require the Customers to buy-in on what Respondents call "T+1" – and even then, only some but not all of the hard-to-borrow securities at issue – it was not, in fact, "T+1."

Moreover, optionsXpress claims that after August 20, 2009, it was buying in each of the Customers' entire short position in certain hard-to-borrow securities regardless of the amount of the firm's failure to deliver at CNS. If this were true and the purchases were legitimate, the expectation would be that the failures to deliver would be cleaned up quickly because (1) more than the amount of optionsXpress' failure to deliver at CNS was being "purchased," and (2) optionsXpress was making the purchase on "T+1." But the CNS reports demonstrate that optionsXpress' failures to deliver persisted well past August 2009. *See, e.g.*, DFOF ¶¶ 69, 81, 84, 96; Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries). This is because the deep-in-the-money calls that were part of the buy-writes were continually exercised and assigned, resulting in optionsXpress immediately selling back that which had just been bought, again resulting in no shares being delivered to CNS.

There should be no doubt that a Rule 204 or 204T "close-out" of a failure to deliver does not take place when a firm "purchases" securities and then mere seconds or minutes later sells the same amount of those securities. Yet, the Customers' use of buy-writes with deep-in-the-money calls results in that very situation. As would be expected, the deep-in-the money calls were routinely exercised and assigned. The pattern repeated itself, day after day after day. In short, there was never any delivery sufficient to satisfy optionsXpress' failures to deliver at CNS.

Finally, optionsXpress' T+1 argument also assumes the ultimate issue that this Court is deciding – whether the use of the buy-write restarts the failure to deliver clock and thus creates "new fails" that have two more days to settle. This argument is nonsensical and could lead to broker-dealers never settling their trades. This is what Rules 204 and 204T were passed to prevent. 74 Fed. Reg. at 38267 (goal of Rule 204 is to further reduce failures to deliver). There is no reason that the use of buy-writes, if legitimized in this case, would be limited to the circumstances in this case. The legitimization of buy-writes to circumvent the close-out provisions of Reg. SHO would effectively eviscerate Rule 204. It would be the exception that swallowed the rule.

E. optionsXpress Cannot Get Pre-Fail Credit Under Rule 204(e)

optionsXpress' argument that it was closing out its failure to deliver positions on T+1, in excess of what Reg. SHO required, is meritless for another reason. Rule 204 contains a specific provision relating to "early" or "pre-fail" close-outs – *i.e.,* close-outs that occur on T+1, T+2, or T+3. optionsXpress did not meet the requirements of this provision.

Rule 204(e) allows a participant of a registered clearing agency who has not closed out a fail to deliver position by settlement date at CNS, to qualify for a "pre-fail credit" if the broker-dealer purchases or borrows the securities, and if: (1) the purchase or borrow is bona fide; (2) the purchase or borrow occurs on T+1, T+2, or T+3; (3) the purchase or borrow is of a quantity sufficient to cover the entire amount of the ***broker's failure*** to deliver position at CNS; and (4) ***the broker can demonstrate*** that it has a net flat or net long position on its books and records on the day of the purchase or borrow. 17 C.F.R. § 242.204(e). In other words, for optionsXpress to get credit for "buying in" the Customers on T+1, it needs to prove it complied with the pre-fail credit provisions of Rule 204(e) – the burden of proof for the pre-fail credit provision rests with optionsXpress. 17 C.F.R. § 242.204(e). optionsXpress has not met its burden.

First, optionsXpress does not qualify for the pre-fail credit because the "purchases" associated with the buy-writes were not bona fide. *See* supra Section I.C.

Second, as discussed above, the "purchase" did not occur on T+1 (or T+2 or T+3). *See* supra Section I.D.

Third, optionsXpress does not qualify for the pre-fail credit because the "purchase" was not of a quantity sufficient to cover the entire amount of the broker's failure to deliver position at CNS. 17 C.F.R. § 242.204(e). Indeed, the records at CNS showed that optionsXpress never delivered enough shares to "close out" its CNS failures to deliver – that is, it never delivered enough shares to reduce its failure to deliver position to zero (0) – and thus allowed its failures to deliver to persist for long periods of time. *See, e.g.*, DFOF ¶¶ 69, 81, 84, 96; Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries).

Finally, optionsXpress does not qualify for the pre-fail credit because it has provided no evidence that it had a net flat or net long position on its books and records on the day of the purchase or borrow. The only trading records produced at the hearing were those of the six accounts, not the entire books and records of optionsXpress and thus do not show whether or not optionsXpress had a net flat or net long position on its books and records. DFOF ¶ 47; Div. Ex. 1 (trade detail) (only relates to 6 customer accounts); Tr. at 4431, 4436-4437 (Saha) (testified that he looked at only the six accounts, not optionsXpress' entire books). It is unlikely that optionsXpress would have been able to do so, because the evidence that was introduced – the CNS reports – shows that optionsXpress did not end the day net flat or net long but instead ended each day with a failure to deliver, as evidenced by its daily closing position ("CLOSING POS" column) on the CNS Account Summary. DFOF ¶ 38; Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries). Even if optionsXpress was buying-in the Customers at T+1, which it was not, it would not have qualified for the pre-fail credit and has not met its burden of proof.

F. optionsXpress Violated Reg. SHO When The Buy-Writes Were Not Executed At Market Open

Even if this Court concluded that the buy-write transactions had a legitimate economic purpose and satisfied optionsXpress' delivery obligation, optionsXpress still violated Reg. SHO by not closing out its failures to deliver at market open. To the extent optionsXpress relied on the "buy" portion of the buy-writes to close out its failures to deliver, the transactions needed to be closed out at market open on T+4. *See* 73 Fed. Reg. at 61710-11 (Reg. SHO requires a participant like optionsXpress, when it has failure to deliver positions, to close out each failure to deliver position "by no later than the beginning of regular trading hours on the settlement day following the settlement date" ("T+4")). The evidentiary record proves, however, optionsXpress did not execute the buy-writes at market open.

It should be undisputed that prior to August 20, 2009, optionsXpress only required its customers to be bought in when it calculated a failure to deliver on T+4. *See* Tr. at 1642 (Stern) ("[W]e started out on T+4 which was the – what the rules said that we had to have coming down from T+11, and then at some point later on, I believe it was in August of 2009 . . . we went to buying in on T+1."). For the 1,205 buy-writes executed before August 20, 2009, 97% of the buy-writes were executed after 10:00 a.m. Eastern Time. DFOF ¶ 159; Div. Ex. 497 (Harris Rebuttal) at Ex. 26. And for the entire time period relevant to this case, sixty-seven percent (67%) of the buy-writes were executed after 10:00 a.m. Eastern Time, with the first trade in the buy-write being executed on average approximately 1 hour and 35 minutes after market open. *Id.* Thus, even if the Court were to decide that optionsXpress is correct that the buy-writes were legitimate, optionsXpress still violated Reg. SHO on hundreds of occasions.

While Reg. SHO is a strict liability violation, there is ample evidence that optionsXpress knew the buy-writes that purported to cure the failures to deliver were not being executed at market open. In late October 2008, the Clearing Department and traders raised concerns to the Compliance Department that the stock was not being bought in at market open. The Compliance Department replied: "According to the rules, they need to be closed out at the opening. The

industry is pushing back on this, and requesting the [whole] day, but as it is now, we need to cover at the open." DFOF ¶ 129; Div. Ex. 202. Nonetheless, *for another ten months*, optionsXpress continued to allow the Customers until the end of the day on T+4 to "buy" in with a buy-write. DFOF ¶ 47; Div. Ex. 1 (trade detail); Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries). Even when the firm changed its procedures in an attempt to execute the buy-ins by the market open, it was all in vain – the buy-writes continued to be executed later in the day, contrary to Reg. SHO. DFOF ¶ 159; Harris Report (Div. Ex. 310) at ¶ 186.

At the hearing, optionsXpress witnesses tried to blame the late buy-writes on a computer glitch that they claimed happened infrequently. But Dr. Larry Harris' ("Harris") unrebutted calculations regarding the times the buy-writes were executed proves that this is not the case. DFOF ¶ 159; Div. Ex. 497 (Harris Rebuttal) at Ex. 26. In any event, optionsXpress' computer glitch argument is no defense to the strict liability requirements of Reg. SHO.

G. optionsXpress Cannot Avoid Liability By Claiming It Relied On Regulators

optionsXpress believes it can exculpate itself from strict liability by arguing that it relied on guidance from regulators – including CBOE, FINRA, and the SEC – that the buy-writes it executed for Feldman and the other Customers were permissible trades that satisfied optionsXpress' close-out obligations under Reg. SHO. Putting aside that the facts do not reflect that any regulator said the trading was permissible, this argument is of no moment, because "the case law is consistent . . . that persons in the securities industry cannot blame [regulators] for their failure to carry out their responsibilities." *In the Matter of Stephen J. Horning*, AP File No. 3-12156, 2006 WL 2682464, *22 (Sept. 19, 2006) (Murray, A.L.J.) (holding that "persons in the securities industry cannot blame the Commission for their failure to carry out their responsibilities"), *aff'd*, *Horning v. SEC*, 570 F.3d 337 (D.C. Cir. 2009); *see also In the Matter of Gualario & Co., LLC*, AP File No. 3-14340, 2012 WL 627198, *14 (Feb. 14, 2012) (reliance on regulators is "not a defense to the registration violation"); *In the Matter of Certain Broker-*

Dealers Who Failed to File All or Part of Form BD-Y2K, AP File No. 3-9759, 1999 WL 557616, *12 (Aug. 2, 1999) (Murray, A.L.J.) ("It is established that a broker-dealer cannot shift its responsibilities for compliance with applicable requirements to the . . . Commission.").[6]

Putting the legal unavailability of this defense to the side, the evidence presented at the hearing demonstrates the fallacy of Respondents' argument. Not only did optionsXpress recognize, but choose to ignore, numerous red flags that the trading was problematic, it also misled regulators about the nature and extent of the Customers' trading. DFOF ¶ 201. And more importantly, the regulators never gave the "comfort" that optionsXpress purportedly sought. On the contrary, the testimony by Ms. Josephine Tao ("Tao") of the Commission's Division of Trading and Markets ("Trading & Markets") established that on October 2, 2009 she informed optionsXpress that the staff of the Commission would not give optionsXpress any comfort. DFOF ¶ 204. This was after Ms. Tao had warned optionsXpress that its customers may be engaging in fraudulent activity. DFOF ¶ 199.

Moreover, it was clear from the evidence at the hearing that officers at optionsXpress were well aware of the regulatory issues they faced in allowing the buy-write activity to continue. For example, in mid-November 2008, the head trader at optionsXpress sent an email to the Clearing Department about a *Wall Street Journal* article describing the trading in the *Arenstein* case and noting that FINRA had several ongoing cases involving this activity: "There is an article in the WSJ about how short sellers in [Sears] are using options to circumvent the SEC cover rule. I think we need to review this." The head of the Clearing Department emailed

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[6] *See also, e.g.*, *In the Matter of the Application of Ronald Pellegrino*, AP File No. 3-12941, 2008 WL 5328765, at *14 (Dec. 19, 2008) (holding that a "regulatory authority's failure to take early action [does not cure] a violation"); *In the Matter of Newbridge Sec. Corp.*, AP File No. 3-13099, 2009 WL 1684744, at *55 (June 9, 2009) (Kelly, A.L.J.) (holding that "it is well settled that respondents cannot shift responsibility for compliance to the NASD or the Commission"); *In the Matter of Quest Capital Strategies, Inc.*, AP File No. 3-8966, 2001 WL 1230619, at *8 (Oct. 15, 2001) ("We have repeatedly pointed out that a broker-dealer cannot shift its responsibility for compliance with applicable requirements to...us."); *In re W.N. Whelan & Co.*, 50 S.E.C. 282, 284, 1990 WL 312067, at *2 (Aug. 28, 1990) ("A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation.").

back: "[The Customers are] definitely doing this." DFOF ¶ 32; Div. Ex. 255 (email exchange); Div. Ex. 256 (*WSJ* article). Nonetheless, and as the series of events described below show, the firm remained undeterred in its execution of the Customers' buy-writes – even in the face of heavy regulatory scrutiny.

On February 26, 2009, CBOE notified optionsXpress that it was investigating the trading to determine whether SEC Rule 204T had been violated. DFOF ¶ 135. Stern, who functioned as optionsXpress' primary regulatory liaison, was involved in the response to CBOE's investigation and reviewed the Customers' trading. DFOF ¶ 136; Div. Ex. 162 (Stern) at 426-427. In May 2009, FINRA initiated its first investigation into the Customers' trading. DFOF ¶ 140.

On September 23, 2009, optionsXpress received a letter of caution from CBOE concerning the way the firm processed buy-ins for the Customers. DFOF ¶ 183. On September 24, 2009, prompted by concerns raised by the traders who executed the Customers' buy-writes right after those traders had read *Hazan*,[7] (DFOF ¶ 188-192), optionsXpress' in-house counsel, Stern (who was aware of *Hazan*), and two compliance officers called FINRA, purportedly for guidance about the Customers' trading. DFOF ¶ 195. FINRA said it would not discuss the issue because of its ongoing investigation. Div. Ex. 230 (FINRA Notes).

The same day, the same optionsXpress individuals called Trading & Markets. DFOF ¶ 198. optionsXpress claims that, based on facts provided by the firm on the call, representatives of Trading & Markets told optionsXpress to "keep doing what you're doing—keep closing out," and that Trading & Markets would get back to them on whether it had a best execution obligation to combine, as buy-writes, the Customers' buy-in orders with sales of calls. DFOF ¶ 198. However, optionsXpress failed to convey complete and accurate information on the call

[7] After reading the *Hazan* case, the primary trader who executed the Customers' buy-writes told his supervisor on September 23, 2009 that he "would not be placing any [buy-write] orders today." DFOF ¶ 189. When the trader's supervisor emailed him that the trades should continue, the trader forwarded a copy of his supervisor's email to his personal email account. The clear inference being that the trader understood that the Customers' trading was almost identical to the trading in the *Hazan* case and he wanted a record that he had notified his supervisor of the case.

with Trading & Markets. For instance, Stern provided a misleading fact pattern on the call to show the fact that the buy-in was not linked specifically to the amount of the assignment, despite his knowledge of the Customers' trading.[8] DFOF ¶ 200. Moreover, upon further investigation, Trading & Markets learned that FINRA had three open investigations and that the Customers appeared to be using deep-in the-money calls to circumvent Reg. SHO and "re-establish their failing short position." DFOF ¶ 201.

Upon learning the true story about optionsXpress and the Customers from FINRA, Trading & Markets called optionsXpress on October 2, 2009, and spoke to its in-house counsel and Stern, telling them that the SEC could provide optionsXpress with "no comfort" about the firm's or the Customer's conduct. DFOF ¶ 204. Shortly after the October 2, 2009 call with Trading & Markets, optionsXpress' in-house counsel, Stern, and two compliance officers again called FINRA and reported that optionsXpress had received a call from the SEC, was at a loss about what to do, and was seeking guidance on the activity. DFOF ¶¶ 205-06; Div. Exs. 234, 235 (FINRA Notes). FINRA told optionsXpress that if it wanted guidance, it should send a request in writing to FINRA's general counsel or the SEC – optionsXpress chose to do neither. DFOF ¶¶ 206-07. Instead, optionsXpress continued executing the Customers' buy-writes and the Customers (and the firm) continued avoiding their hard-to-borrow fees. This allowed optionsXpress to continue to earn significant commissions. DFOF ¶ 207.

Put simply, optionsXpress never received any blessing from its regulators that the buy-write trading complied with Reg. SHO. On the contrary, optionsXpress made a deliberate business decision to allow the trading to continue.[9]

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[8] Specifically, to give the impression that the firm's failures were decreasing, Stern told Trading & Markets that the Customers sold *less* calls than the amount of their buy-ins, which is impossible given that the Customers' were trading buy-writes – which are by definition trades involving an *equivalent* number of shares purchased and calls sold – for their buy-ins.

[9] In January 2010, after the Division made a request for information, optionsXpress told Feldman that it was going to keep in place a commission increase that it imposed following Feldman's return from another broker-dealer. DFOF ¶¶ 223, 234, 235. Given that optionsXpress made its own

II. FELDMAN VIOLATED THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS

Feldman's scheme to profit by not delivering shares he sold is fraud. Indeed, the kind of deceptive conduct that Feldman engaged in has long been illegal under the federal securities laws. Feldman was neither a completely naïve trader nor the world's smartest trader – he was a sophisticated trader who understood the system and profited solely because he fraudulently manipulated it to his advantage by failing to follow the rules like everybody else. The fact that Feldman found the one broker-dealer who would allow his scheme to continue is not a legitimate defense to this action.

A. The General Anti-Fraud Provisions Of The Federal Securities Laws Prohibit Feldman's Conduct

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit (a) "employing any device, scheme or artifice to defraud" or (c) engaging "in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person." Section 10b-5 does not require that there be a specific oral or written statement; "conduct itself can be deceptive." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008). In *Ernst & Ernst v. Hochfelder,* the Supreme Court stated that Section 10(b) reflected "overall congressional intent to prevent 'manipulative and deceptive practices which . . . fulfill no useful function." 425 U.S. 185, 206 (1976). The Supreme Court recognized that Section 10(b) is "a catch-all clause to prevent manipulative devices" designed "to enable the Commission 'to deal with new manipulative (or cunning) devices.'" *Hochfelder*, 425 U.S. at 202-03 (quoting Thomas G. Corcoran, a spokesman for the drafters, during hearings prior to the enactment of the Exchange Act). It is for this reason that the securities laws and rules must be read broadly and flexibly and not "technically and restrictively." *SEC v. Zandford*, 535 U.S. 813, 819 (2002).

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aggressive interpretation of Reg. SHO in order to allow the trading to continue, it cannot now credibly claim that there is somehow a due process violation because of the Division's alleged "new" interpretation of Reg. SHO. *See* optionsXpress Pre-Hearing Brief at pp. 21-23 (claiming that the Division's case violates due process because optionsXpress allegedly had no notice that the trading might violate Rule 204).

These laws are enacted for the purpose of protecting against fraud and are designed to prevent "all the ingenious variations of security fraud that arise." *United States v. Jensen*, 608 F.2d 1349, 1354 (10th Cir. 1979). Feldman's scheme is just another variation of securities fraud.

1. Feldman's Trading Strategy Was A Manipulative Scheme That Deceived Market Participants

Trading is a classic form of conduct that can be deceptive. Feldman's trading scheme – the sale of option contracts with no intention of fulfilling the terms of those contracts – is a type of conduct that courts have already found to be fraudulent. In *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, the Supreme Court held that selling an option while secretly intending not to fulfill one's obligations under the options contract is securities fraud. 532 U.S. 588, 596-97 (2001). "To sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith." *Id.; see also Walling v. Beverly Enter.*, 476 F.2d 393 (9th Cir. 1973) (entering "into a contract of sale with the secret reservation not to fully perform it is fraud cognizable under § 10(b)").

The record is unequivocal that market participants were deceived by Feldman's manipulative conduct in two distinct ways. First, certain investors were deceived about the nature of the trading as it related to the reported volumes. For example, financial message boards discussed irregularities with Sears trading. In late December 2009, a friend of Feldman, who was engaged in the same trading at optionsXpress, told Feldman that the participants in the message boards "think Sears is buying back shares. . . . ***they have no idea***." Div. Ex. 370. Feldman himself admitted that he was aware that people on the message boards were confused about the trading he was engaging in. DFOF ¶ 274.

Second, other market participants were deceived because they did not receive their shares in a timely fashion. From his scheme, Feldman was able to extract a small profit from thousands of different unsuspecting market participants – a fraud called "salami slicing." *See* Harris Report (Div. Ex. 310) at ¶ 200 (describing "salami slicing" frauds). While the use of a buy-write in some circumstances is an entirely appropriate investment tool, Feldman's use of the buy-write

here simply allowed him to avoid delivering stock to other market participants. Put another way, Feldman's use of a buy-write was a matched order that was set up to avoid his delivery obligations. Manipulative and deceptive devices such as the trading employed by Feldman have long been prohibited by the anti-fraud provisions of the securities laws. *Hochfelder*, 425 U.S. at 206 & 205 n.25 (1976) (holding that matched orders as "orders for the purchase [and] 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/purchase of such security."); *cf. Superintendent of Ins. of State of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971) ("practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the regulatory agency have been found practically essential.").[10]

2. Feldman Acted With The Requisite *Scienter* To Violate Section 10(b), Rule 10b-5, And Section 17(a)(1)

The scienter required for a Section 10(b), Rule 10b-5, or Section 17(a)(1) violation is "a mental state embracing the intent to deceive, manipulate or defraud." *Hochfielder,* 425 U.S. at

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[10] Feldman has cited *United States. v. Finnerty*, 533 F.3d 143 (2d Cir. 2008), for the proposition that "[b]road as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression." Feldman Motion for Summary Disposition at 20. Feldman's reliance on *Finnerty* is misplaced. First, the facts of *Finnerty* are inapposite. In *Finnerty*, the Second Circuit overturned a criminal conviction where Finnerty had surreptitiously interposed his trades between the buyers and sellers of publicly-traded stock to conduct otherwise arms-length stock transactions and profit from both transactions. The court found that the purchasers and sellers of the stock received the benefit of their bargain. *Finnerty,* 533 F.3d at 145. As the court in *SEC v. Simpson Capital Mgmt., Inc.*, 586 F. Supp. 2d 196, 204 (S.D.N.Y 2008) noted in distinguishing *Finnerty:* "[A]ll that Finnerty did was to execute trades at disclosed terms...[he] did not deceive either the buyer or the seller with respect to the terms of their trades. Each side of the trade knew what it got—the shares purchased or sold and at what price." *Id.* at 204. Here, unlike in *Finnerty*, the purchasers of Feldman's sales did not receive the benefit of their bargain – they were deceived as to the terms of their trades. Harris Report (Div. Ex. 310) at ¶¶15, 49, 85. Simply put, purchasers did not get their shares in a timely fashion as a result of Feldman's trading. Further, there is clear and unequivocal evidence that other market participants were deceived about the nature and purpose of Feldman's trading (see supra). Second, the Second Circuit has given *Chevron* deference to the Commission's post-*Finnerty* adjudicatory decision finding Finnerty's conduct to be deceptive, which the Second Circuit has held "'trumps' [the Second Circuit's] prior interpretation in *Finnerty*." *See Van Cook v. SEC,* 653 F.3d 130, 141 (2d Cir. 2011) (citing *David A. Finnerty,* Exchange Act Release No. 59998, 95 SEC Docket No. 2534, 2009 WL 1490212, at *3 (May 28, 2009)).

193 n.12. Scienter may be established by showing either (1) knowing conduct or (2) "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." *Dolphin & Bradbury v. SEC,* 512 F.3d 634, 639 (D.C. Cir. 2008). With respect to direct violations, a willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). "[K]nowledge of one's actions and their consequences is all the law requires; a demonstration of a subjective belief that those actions are illegal is unnecessary" for purposes of scienter. *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 79 n.32 (D.C. Cir. 1980).

Feldman does not (and cannot) dispute that his options trading strategy was executed deliberately and intentionally and that optionsXpress executed the trading he requested. As part of his strategy, Feldman sold deep-in-the-money call options knowing that they were likely to be exercised and assigned (or was recklessly indifferent to that probability). As a result of the assignments, Feldman was required to deliver these shares by the standard settlement date. Instead of delivering shares, Feldman entered into buy-write transactions to give the appearance of delivery but for which no delivery actually occurred. Feldman knew that his sales were not settling and knew that his trading was deceiving market participants. He encountered numerous red flags that this trading was problematic and deceptive.

a. Feldman Knew His Call Options Would Be Assigned And Stock Would Not Be Delivered

Despite his argument to the contrary, the record is clear that Feldman was well aware that the call options he sold would be almost immediately assigned and result in an obligation to deliver stock, which Feldman sought to avoid. Indeed, on numerous occasions, Feldman was expressly told that his options were being assigned on a regular (if not daily) basis. For example, one broker told Feldman "***market-makers are always going to assign what you're short.***" Div.

Ex. 218 (emphasis added). That same broker told him in the same conversation that the counterparties to the buy-writes were exercising (or "dropping") "on almost every one" of Feldman's deep-in-the-money calls. Feldman had a similar discussion with a trader at optionsXpress who explained: "***the market maker is usually always going to assign*** whatever call [it purchases] . . . ***normally you'll always going to get assigned.***" Div. Ex. 221 (emphasis added).

Feldman himself expressed in writing his understanding that he was going to get assigned on a daily basis, and that his trading activity would not result in stock being delivered in settlement of his trades. For example, Feldman exclaimed to one broker: "***I don't settle the stock@all,***" Div. Ex. 25 (emphasis added), and conveyed to the same broker: "So I could do a buy-write ***and then I wouldn't settle.***" Div. Ex. 94 (emphasis added). Feldman also asked the broker: "So how many SHLD do I have to buy-in today (***to avoid settlement***)?" Div. Ex. 27 (emphasis added). Feldman also sent an instant message to a friend, who was engaged in the same trading at optionsXpress: "it [a]lmost doesn't matter, JUL or SEP, ***as u get assigned that night anyway, so what's the diff?,***" Div. Ex. 246, and even told one floor broker in an instant message, "Do u realize that w my daily buy writes this year . . . that's $51mm/day of 1099! Proceeds. My annual 1099! Will be over $2bb!. . . ***See how it happens? Same trade every day. Get assigned stock + sell options***". Div. Ex. 89 (emphasis added). Feldman's hearing testimony best expresses his understanding of the implications of his trading, when he readily admitted it would be "stupid to say" that none of his deep-in-the-money calls (that were part of the buy-writes) were going to get assigned. Tr. at 2156 (Feldman).

Moreover, Dr. Harris's analysis of Feldman's trading confirms that his deep-in-the-money calls were exercised and assigned on a daily basis. DFOF ¶ 80. Indeed, for large portions of his trades the ***entire*** amount of his calls were assigned on the day they were written (even though there is a random assignment process). Thus, there should be no doubt that at the time he was trading Feldman knew (or should have known) that there was a very high likelihood that his calls would be exercised and assigned.

b. Feldman Knew His Trading Created A False Market Impression

Feldman's sham reset transactions created the false appearance of a higher volume of trading in the market. Harris Report (Div. Ex. 310) at ¶¶ 39, 179-185; Sheehy Report (Div. Ex. 375) at ¶ 63. As discussed above, financial message boards commented on the odd trading in Sears. Feldman's friend informed him that the participants in the message boards "think Sears is buying back shares . . . they have no idea." Div. Ex. 370. Feldman himself admitted that he knew the message board posters were confused by the volume of trading they were seeing in Sears (which was attributable to Feldman's buy-writes). DFOF ¶ 274.

c. Feldman Knew His Trading Created Regulatory Concerns

Feldman was well aware that his trading was raising regulatory concern. For instance, Feldman told a friend, who was engaged in the same trading at optionsXpress: "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. ***(Until someone notifies the SEC and they shut down the strategy!!)***." Div. Ex. 29 (emphasis added). Feldman was also informed by optionsXpress that the SEC was investigating his trading. DFOF ¶ 141. Even though he was told the SEC was investigating his trading, it was business as usual for Feldman as he continued to place the buy-write trades.

Feldman was also told about delivery requirements by optionsXpress. optionsXpress sent Feldman copies of Reg. SHO on several occasions and a compliance officer explained to Feldman that "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." Div. Ex. 28. Feldman responded by asking if there were other ways he could "***restart the clock.***" *Id.* (emphasis added). Feldman asked about "restarting the clock" even though he had previously been sent a copy of the *Hazan* case that expressly detailed the illegal nature of "restarting the clock."

Another broker-dealer, Terra Nova, also told Feldman that there were regulatory issues with his trading. In fact, within two weeks of Feldman transferring part of his positions to Terra Nova, Feldman was told that Terra Nova's clearing broker, Penson Financial Services ("Penson"),

was requiring that he pay hard-to-borrow fees if he wanted to continue the trading.[11] Instead of paying the hard to borrow fees, Feldman fled back to optionsXpress, the only broker that would take him. As Feldman told his friend: "Millions of $$ inc [sic] comissions[sic],,,,yet treat me/us like criminals...But, in the big picture...***it's still quite the gig...where can you get such mkt-bating [sic] retu[r]ns consistently***? So, as disgusting as [optionsXpress] are [sic], have to bend over and get raped, and take the punishment[.]" Div. Ex. 249.

d. Other Broker Dealers Prohibited Feldman's Trading

Feldman knew from the outset of his trading that his strategy would only work if he did not pay hard-to-borrow fees. Thus, Feldman started his trading at optionsXpress. optionsXpress was the only broker who allowed Feldman to conduct his strategy for any significant period of time. When Feldman tried his strategy elsewhere, he was shut down.

In November 2009, while optionsXpress was dealing with regulatory scrutiny from FINRA relating to Feldman's and the Customers' trading activity, Feldman decided to try his strategy at a firm called Terra Nova, which cleared his trades through Penson. DFOF ¶ 280. Penson had never seen a strategy like Feldman's before, and thought it was strange to have a strike price so low on his deep-in-the-money calls. DFOF ¶ 281. According to Penson, Feldman's deep-in-the-money calls had a high probability of assignment. *Id.* Feldman's trading in fact resulted in recurring assignments, (DFOF ¶ 282) – the high frequency of which was "out of the ordinary" for Penson, (DFOF ¶ 281) – which led to fails to deliver at CNS for Penson, necessitating daily Reg. SHO Rule 204 buy-ins for Feldman in an effort to meet Penson's delivery obligations. DFOF ¶ 282.

According to Penson, Feldman's buy-writes never satisfied Penson's original delivery obligation relating to Feldman's trading, leaving Penson with a failure to deliver position at CNS

[11] While at Terra Nova, Feldman was told: "[The clearing broker] finally had a CNS fail, not net flat outside of Reg. SHO where they said their compliance told them that they had to go out and buy this stock no matter what." Div. Ex. 97. The broker further advised that regulators were concerned about this type of activity: "I don't think [optionsXpress is] going to take you because the CBOE regulators are starting to get heavy on this activity, that's why [the clearing broker] is getting more than likely skittish." *Id.*; *see also* Tr. at 2300-01 (Feldman).

that would never (and did not) change unless Penson borrowed stock to make delivery (which it began doing immediately, and accordingly charged Feldman the borrowing fees). DFOF ¶¶ 282-283. Penson believed that the buy-writes did not satisfy its delivery obligations to CNS and had a policy against using buy-writes to cure fails to deliver. *Id.* After less than a month, Penson made it clear that they no longer wanted Feldman's business because the failures to deliver caused by Feldman's trading were affecting the clearing broker's ongoing operations, and the firm recognized it was creating Reg. SHO Rule 204 regulatory problems. DFOF ¶¶ 284-285 (Robert Crain of Penson did research into fails to deliver and found a memorandum from the law firm Willkie Farr & Gallagher discussing the violative activity in the *Hazan* and *TJM* cases and believed that Feldman's trading was the same).

Even after Feldman had been told to leave Penson and informed he could no longer do buy-writes at optionsXpress in March 2010, Feldman tried his strategy in hard-to-borrow securities at TD Ameritrade in late 2011 and early 2012. DFOF ¶ 286. Feldman was only able to do his trading there for a period of about two to three months. *Id.* According to Feldman, TD Ameritrade told him that he could not do the trading anymore because "it was costing them too much money." *Id.* On January 20, 2012, however, TD Ameritrade told Feldman that his "strategy that continues to be executed creates operational risk, market risk, ***and potential regulatory risk*** for the clearing firm. The nature of 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." *Id.*

Feldman also tried his trading strategy at yet another firm, E-Trade, in 2011. DFOF ¶ 287. Like Terra Nova and TD Ameritrade, he was able to conduct his strategy there only for a very short period of time. *Id.* As at optionsXpress and TD Ameritrade, at E-Trade, Feldman continued to use either buy-writes or same-day "buy" of stock and "write" of deep-in-the-money calls, and was

assigned on those calls day-over-day, which created delivery issues for E-Trade. *Id.* Unlike optionsXpress, E-Trade had Rule 204 concerns about allowing Feldman's trading to continue. DFOF ¶¶ 288-289. E-Trade understood that failures to receive – which other clearing brokerages would acquire if E-Trade did not deliver – could create regulatory concerns regarding possession and control that could affect customer trading activity. DFOF ¶ 289.

Like Penson, E-Trade did not believe Feldman's use of buy-writes or same-day "buy" and "write" would satisfy E-Trade's delivery obligations to CNS. DFOF ¶ 288. Rather than relying on Feldman's buy-write trading to make delivery, E-Trade took other steps to ensure that shares were delivered to CNS. *Id.* As a result, E-Trade's representative testified that E-Trade did not have any immediate fails to deliver at CNS, but was nonetheless concerned that it would not be able to satisfy its delivery obligation if it allowed Feldman's trading to continue. *Id.* E-Trade proceeded to shut down Feldman's trading. DFOF ¶ 290.

Simply put, Feldman is not the kind of person who takes no for an answer. Feldman went searching for a broker-dealer who would allow him to do buy-writes. He found just one, optionsXpress. Feldman's buy-write trades caused failures to deliver for that firm which meant that market participants were not receiving shares on a timely basis. As a result, Feldman should be found liable for violating the anti-fraud provisions of the securities laws.

3. At A Minimum, Feldman Negligently Relied On His Broker

Section 17(a)(3) of the Securities Act prohibits any person from engaging in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a)(3). The Division need only prove that a defendant acted with negligence with respect to 17(a)(3) violations. *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999).

Throughout the hearing, Feldman tried to portray himself as someone who completely relied on his broker to determine whether his trading violated any of the securities laws. Feldman disclaimed any knowledge of the settlement system and what his responsibilities were

as it related to that system – an argument belied by his contemporaneous communications with brokers and traders – and, in essence, argues that "my broker let me do it so I should not be found liable." Yet, during the hearing, Feldman made clear that he is someone who pushes to get what he wants and is not the type of person who trusts what others – including his brokers – are telling him regarding regulatory compliance. The skepticism reflected in ***the Court's*** direct questioning of Mr. Feldman underscores this point:

> Q [Mr. Block] Well, you never called anybody at the SEC in September or October 2009 to determine whether they were giving you the straight scoop, did you; they being optionsXpress?
>
> A I think that would be one of the most bizarre things in the world to do to pick up the phone and call the SEC after their broker-dealer is the one who told them that they were talking to them, and told them that everything was fine.
>
> Q All right. So, you have didn't do it then, right?
>
> A No, I did not.
>
> Q Okay.
>
> **JUDGE MURRAY: Wait a minute. Why do you say that was bizarre? I thought you told me earlier that you didn't trust people, that you checked things out. Why would you characterize that as bizarre?**
>
> THE WITNESS: I never said I don't trust people.[12] I said when it comes to business relationships, I'm always weary of maybe being overcharged or someone trying to take advantage of or justify fees that wouldn't be there. I just suppose when people tell me we had a concern, and I say what was the concern, they say, oh, it was because the SEC was looking at your trades -- they are the ones who told me the SEC was looking at the trades, and the same person told me that the SEC said the trades were fine. So, it's not a matter of not trusting the people. It's a matter of just watching out for myself when it comes to commissions and things like that.

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[12] In fact, not only had Feldman testified that he does not trust people but he proceeded to admit further on in this same line of questioning from the Court that he testified that he doesn't trust people. *See* Tr. at 2244-2245 ("Question: Now, is it fair to say when they would tell you various changes and procedures, you -- you didn't take it easily, you didn't just sit down and be like, oh, okay, ***you questioned things; right?*** Answer: ***Absolutely***. Question: And you pushed back; that's part of doing business is pushing back and saying is this really the only way we can go about doing it? Answer: Well, that's a term that's used, but, yes, I would push back and press them to see, you know, are they doing this for a business reason or are they doing this because it's a rule. And, you know, ***I'm not a trusting type*** when it comes to negotiating…."); Tr. at 2633 ("***When I say I don't trust people***, it's not that I don't trust people. When it comes to negotiating, I know that parties -- when it comes to negotiating prices, I know that parties sometimes say things just to make their case better and sometimes they don't even understand what they're saying ….").

JUDGE MURRAY: That's what I don't understand. I mean, didn't you sense that you were vulnerable? You didn't bother checking it out whether, in fact, what you were doing was lawful, at least in the estimation of the SEC?

THE WITNESS: He told me that they had a conference call with the SEC with several of their senior –

* * * * * * * * *

JUDGE MURRAY: But you've indicated in your e-mails, I think, that they were making considerable commissions from your trades.

THE WITNESS: They certainly were, is was why I was originally confused, why would you limit my trading, don't you want me to do more business. Then they explained that there were other concerns and that they were -- they had other concerns other than just making a lot of commission, and then it became clear to me that they were very concerned about being in compliance, and that became obvious to me.

JUDGE MURRAY: That's what I don't understand.

THE WITNESS: Okay. They had limited my trading in order –

JUDGE MURRAY: It was in their interest to keep this trading going, and you didn't call the SEC and check where your testimony, I think, is that you are sort of like a doubting Thomas. You like to check things out, because you think or you want to assure yourself that people aren't taking advantage of you. So, for you to say it would be bizarre for you to call a government agency and find out for yourself whether these -- what the agency's difficulties or concerns with, but you trusted the broker-dealer, it just seems -- I can't square that with the rest of your testimony. I mean, I can square it, because it's your testimony. I just don't understand it, I guess.

THE WITNESS: Okay. Well, allow me to explain. When I say I don't trust people, it's not that I don't trust people. When it comes to negotiating, I know that parties -- when it comes to negotiating prices, I know that parties sometimes say things just to make their case better and sometimes they don't even understand what they're saying, or that they just say it because they want to have a higher commission -- oh, you have to pay a higher commission because you take up a lot of our time.

JUDGE MURRAY: So, you double check them?

THE WITNESS: I don't double check. I question them.

Tr. at 2626-2634.

As the above questions and answers make clear, Feldman acted with, at a minimum, negligence in placing his buy-write trades that resulted in numerous failures to deliver. Feldman did not do any reasonable due diligence to find out about the legality of his trading. On the contrary, he encountered numerous red flags which should have caused him to stop the trading.

During his time at optionsXpress, Feldman was informed that the SEC was investigating his trading. DFOF ¶ 141. Feldman was told after less than a month of trading at Terra Nova that Penson did not want to clear his business and asked him to leave Terra Nova ***immediately***. DFOF ¶¶ 213-214. Penson also charged Feldman hard-to-borrow fees even though he claims he thought his buy-writes were satisfying his delivery obligations. DFOF ¶ 214. Feldman was given Rule 204 to read and also sent the *Hazan* case. DFOF ¶¶ 165, 193. Feldman was told that the CBOE was getting "skittish" about this type of trading activity and Feldman was told that no one else on the street would allow it. DFOF ¶¶ 76, 222. After optionsXpress stopped him from pursuing his trading strategy in March 2010, Feldman tried to do the exact same type of trading at two other broker-dealers – both of which quickly put a stop to it, at least in part due to regulatory concerns. Given the numerous red flags that he encountered throughout his trading at optionsXpress, as set forth above, Feldman was at a minimum negligent in continuing the buy-write activity. Feldman's reliance on his broker argument should not be countenanced and the Court should find him liable for, at a minimum, violating Section 17(a)(3) of the Securities Act. *See SEC v. Simpson Capital Mgmt., Inc.*, 586 F. Supp. 2d 196, 208 (S.D.N.Y. 2008) (defendant may be liable for deceptive conduct even though his broker is the one who did the late trading when defendant "identified individuals at five-broker dealers who agreed to participate in the late trading scheme").

B. Feldman Violated Rule 10b-21

Under Rule 10b-21, it is a manipulative or deceptive device or contrivance 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 to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date." 17 C.F.R. § 240.10b-21. To prove a violation of Rule 10b-21, the Division must show (1) scienter; (2) that an order was submitted to sell an equity security; (3) the

seller deceived a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security; and (4) the seller failed to deliver the security. The scienter required for a violation of 10b-21 is the same as for a violation of 10b-5: "a mental state embracing the intent to deceive, manipulate or defraud." *See Hochfielder*, 425 U.S. at 193 n.12. When determining whether a failure to deliver has occurred under Rule 10b-21, the question is not whether there is a failure to deliver in the CNS system as it is for violations of Reg. SHO, but rather whether there is a failure to deliver ***by the seller***. 73 Fed. Reg. at 61672. "[S]ellers should promptly deliver the securities they have sold and purchasers have the right to the timely receipt of securities that they have purchased." *Id.* Rule 10b-21 targets the misconduct of sellers, specifically, individual sellers who fail to deliver securities that they sold. *Id.* at 61674.

Here, the record is clear that Feldman submitted orders to sell call options on hard-to-borrow securities knowing that they would be promptly exercised and assigned.[13] *See* Div. Ex. 246 (Feldman instant message to his friend: "it slmost [sic] doesn't matter, JUL or SEP, ***as u get assigned that night anyway, so what's the diff***?") (emphasis added); Div. Ex. 89 (Feldman telling a floor broker in an instant message, "Do u realize that w my daily buy writes this year . . . that's $51mm/day of 1099! Proceeds. My annual 1099! Will be over $2bb!. . . ***See how it happens? Same trade every day. Get assigned stock + sell options***") (emphasis added); Div. Ex. 218 (Feldman being advised by a broker at Terra Nova that "***market-makers are always going to assign what you're short***" and that the counterparties to the buy-writes were exercising (or "dropping") "on almost every one" of Feldman's deep-in-the-money calls) (emphasis added); Div. Ex. 221 (Feldman being advised by an optionsXpress trader that "***the market maker is usually always going to assign*** whatever call [it purchases] . . . ***normally you'll always going to get assigned***") (emphasis added). Moreover, Feldman did not intend to make delivery when those

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[13] Options are equity securities. 15 U.S.C. § 78c(a)(11); 17 C.F.R. § 240.3a11-1.

deep-in-the-money call options would get exercised and assigned. Instead, he intentionally executed buy-write trades that did nothing more than give the appearance of purchasing stock for the purposes of delivery but that would not (and, in fact, did not) result in any delivery, which Feldman admittedly understood.[14] *See* Div. Ex. 25 (Feldman exclaimed to a broker at Terra Nova: "***I don't settle the stock@all***") (emphasis added); Div. Ex. 38 (Feldman conveyed to same broker: "So I could do a buy-write ***and then I wouldn't settle***") (emphasis added).

The foregoing makes clear that Feldman undertook a trading strategy – i.e., the use of buy-writes in response to exercised and assigned call options – that resulted in him failing to deliver the securities that he was obligated to deliver when the call options he sold were exercised and assigned. In other words, Feldman failed to "promptly deliver the securities [he had] sold and [denied] purchasers [] the right to the timely receipt of securities that they [had] purchased." 73 Fed. Reg. at 61672. Feldman undertook this trading strategy with the knowledge and intent of avoiding delivery requirements at settlement, which is to say he did so with "a mental state embracing the intent to deceive, manipulate or defraud." *Hochfielder*, 425 U.S. at 193 n.12. Feldman's manipulative and deceptive trading is precisely what Rule 10b-21 was designed to prevent. Accordingly, the Court should hold Feldman liable for violating Rule 10b-21.

III. OPTIONSXPRESS CAUSED AND WILLFULLY AIDED AND ABETTED FELDMAN'S VIOLATIONS OF THE SECURITIES LAWS

To establish aiding and abetting liability, it is necessary to show (1) a securities law violation by a primary wrongdoer; (2) "substantial assistance" to the primary violator; and (3) that the accused provided the requisite assistance with knowledge of the securities law violation. *See Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (holding that extreme recklessness is sufficient); *see also SEC v. Apuzzo*, --- F.3d ----, No. 11–696–cv, 2012 WL 3194303, at *7 (2d Cir. Aug. 8, 2012) (holding that to prove aiding and abetting liability the SEC must prove "that [the defendant] in some sort associate[d] himself with the venture, that [the defendant]

[14] Options are settled by delivering the securities when the options are exercised and assigned. DFOF ¶ 45.

participate[d] in it as in something that he wishe[d] to bring about, [and] that he [sought] by his action to make it succeed") (quoting *United States v. Peoni,* 100 F.2d 401, 402 (2d Cir.1938)). To establish causing liability, the Division must show that: (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. *See In the Matter of Robert M. Fuller*, Securities Act Rel. No. 8273 (Aug. 25, 2003).

As explained in detail above, Feldman's trading activity violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rules 10b-5 and 10b-21, thereunder. Feldman's fraudulent trading activity would not have been possible without the knowing and substantial assistance of optionsXpress; indeed, Feldman was precluded from perpetuating his scheme when he briefly moved his account to Terra Nova.

As outlined above, optionsXpress was fully aware of Rules 204 and 204T of Reg. SHO, and rather than follow the rules to prevent Feldman's fraudulent conduct, optionsXpress took every opportunity to find ways to avoid its regulatory obligations so that Feldman's trading (and the firm's resulting commissions) could continue. optionsXpress was informed by Ms. Tao of Trading & Markets that the trading at issue could be a fraud. DFOF ¶ 199. optionsXpress' in-house counsel's notes reflect that they were informed that the Customers transactions may be a "sham." *Id.* Despite these warnings from its regulators, optionsXpress allowed Feldman's and the Customers' trading to continue. In short, optionsXpress' conduct is the epitome of aiding and abetting fraudulent behavior and the Court should find it liable. *See Graham*, 222 F.3d at 1004-06 (broker liable for aiding and abetting customer's fraud when broker encountered numerous red flags regarding the customer's peculiar trading); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595 (10th Cir. 1979) (holding that broker willfully aided and abetted manipulative wash and match trades scheme when he "knew or had reason to know that such trading was economically irrational").

IV. STERN CAUSED AND WILLFULLY AIDED AND ABETTED BOTH OPTIONSXPRESS' AND FELDMAN'S SECURITIES LAW VIOLATIONS

A. Stern Caused optionsXpress' Violations Of Rules 204T And 204 Of Reg. SHO

Section 21C of the Exchange Act provides in pertinent part that the Commission may order any person who "is, was, or would be a cause" of a violation of the Exchange Act "to cease and desist from committing or causing such violation." To establish causing liability, the Division must show that: (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. *See In the Matter of Robert M. Fuller*, Sec. Rel. 8273 (Aug. 25, 2003). Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *KPMG, LLP v. SEC,* 289 F.3d 109, 120 (D.C. Cir. 2002). Because Rules 204 and 204T do not contain a scienter element, a causing violation of those rules can be based on negligence.

As set forth above, optionsXpress violated Reg. SHO. Stern's conduct, as optionsXpress' CFO and primary regulatory liaison, contributed to and caused optionsXpress' violations. Stern was closely involved in the approval and implementation of optionsXpress' "perpetual fail" policy, (DFOF ¶ 166), a buy-in policy which institutionalized optionsXpress' Reg. SHO-circumventing conduct. Through that involvement, Stern became intimately familiar with the Customers' trading. DFOF ¶¶ 136, 166-167. Yet Stern, who knew about *Hazan*, and was aware of Reg. SHO's close-out requirements "on a pretty much daily basis," Div. Ex. 162 (Stern) at 56, provided misleading and inaccurate information about that trading to Trading & Markets in an attempt to justify the conduct. DFOF ¶ 200. As the one optionsXpress individual, along with the firm's in-house counsel, who was on every call with the regulators, Stern also knew that these regulators – far from providing any comfort – had in fact raised concerns about the trading. DFOF ¶¶ 199, 204-206, 227-229. Nevertheless, Stern allowed the Customers' trading to continue, contributing to optionsXpress' violations. And even when optionsXpress' Compliance

Department determined that the buy-writes had to stop, Stern was part of the firm's decision to keep doing what it was doing – that is, violating Reg. SHO with the daily buy-writes.

The Division has never claimed that Stern was the ringleader and sole cause of optionsXpress' regulatory failures, nor does the Division have to prove these facts for any of its claims. Instead, the Division must show that an act or omission by Stern contributed to the violation and Stern knew, or should have known, that his or her conduct would contribute to the violation. The Division has shown this. Accordingly, the Court should find that Stern's conduct makes him liable for causing optionsXpress' Reg. SHO violations.

B. Stern Willfully Aided And Abetted optionsXpress' Violations Of Reg. SHO

To establish aiding and abetting liability, it is necessary to show (1) a securities law violation by a primary wrongdoer; (2) "substantial assistance" to the primary violator; and (3) that the accused provided the requisite assistance with knowledge of the securities law violation. *See Howard*, 376 F.3d at 1143 (holding that extreme recklessness is sufficient). As set forth above, optionsXpress violated Reg. SHO and Stern provided knowing and substantial assistance to the firm's violations for which the Court should hold him liable. This is evidenced by his: (1) knowledge of the close-out requirements of Reg. SHO, the Customers' trading activities, and the *Hazan* case; (2) involvement in the approval and implementation of optionsXpress' "perpetual fail" buy-in policy; (3) intentional misleading of Trading & Markets; and (4) the fact that he did not recommend to any of his co-officers that the trading cease despite the heavy regulatory scrutiny optionsXpress faced and the concerns expressed by optionsXpress' own Compliance Department.

C. Stern Caused And Willfully Aided And Abetted Feldman's Fraud

Stern's misconduct in causing and aiding and abetting optionsXpress' violation of Reg. SHO also caused and aided and abetted Feldman's violations of the fraud provisions of the

Securities Act and Exchange Act.[15] Stern's role in institutionalizing the firm's "perpetual fail" policy, overruling his Compliance Department, providing misinformation to regulators, and ignoring those same regulators' concerns enabled Feldman – with whose trading activities Stern was intimately familiar – to perpetrate his fraud. This is a classic example of causing and aiding and abetting behavior, for which the Court should find Stern liable. *See Graham*, 222 F.3d at 1005-06.

V. THE COURT SHOULD ORDER DISGORGEMENT, PENALTIES, AND OTHER EQUITABLE RELIEF

A. optionsXpress Should Disgorge $7,214,977 Plus Pre-Judgment Interest

By willfully and repeatedly failing to comply with its obligations under Reg. SHO, optionsXpress avoided paying $7,214,977 of hard-to-borrow fees. Harris Report (Div. Ex. 310) at ¶¶ 41, 188, 199. Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to require an accounting and disgorgement, including reasonable interest. 15 U.S.C. § 77h-1(e); 15 U.S.C. § 78u-3(e). It is well-established that disgorgement of losses avoided is an appropriate means of disgorgement. *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995); *SEC v. Pentagon Capital Mgmt. PLC,* 844 F. Supp. 2d 377, 425 (S.D.N.Y. 2012). Based on its willful misconduct, disregard of its responsibilities as a broker-dealer, and aiding and abetting of Feldman's fraud, optionsXpress should be ordered to pay $7,214,977 plus pre-judgment interest.[16]

B. Feldman Should Disgorge $4,000,000 Plus Pre-Judgment Interest

Through perpetrating his fraud, Feldman earned illicit gross "profits" of more than $4 million. Harris Report (Div. Ex. 310) at ¶ 151. As Courts have long recognized, wrongdoers should not be allowed to profit from their misconduct. *SEC v. First Jersey Sec., Inc.,* 101 F.3d

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[15] Because Section 10(b) and Rules 10b-5 and 10b-21 have a scienter element, the standard for causing these violations is essentially the same as an aiding and abetting charge.

[16] optionsXpress also directly earned $1,908,744 in commissions related to its violations of Reg. SHO. Harris Report (Div. Ex. 310) at ¶ 42. At a minimum, the Court should order optionsXpress to disgorge this amount plus pre-judgment interest.

1450, 1474 (2d Cir. 1996) ("The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws."). This principal is incorporated into the federal securities laws which provide that those who violate the federal securities laws, including the anti-fraud provisions, should disgorge their ill-gotten gain. 15 U.S.C. § 77h-1(e); 15 U.S.C. § 78u-3(e).

Disgorgement is an equitable remedy, and it is well-established that a court has "broad discretion not only in determining whether or not to order disgorgement but also in calculating the amount to be disgorged." *SEC v. Svoboda*, 409 F. Supp. 2d 331, 344 (S.D.N.Y. 2006) (citing *First Jersey Sec., Inc.*, 101 F.3d at 1474-75). The Division may quantify the amount of the defendants' disgorgement liability by "producing a reasonable approximation of [the defendants'] ill-gotten gains." *SEC v. Calvo*, 368 F.3d 1211, 1217 (11th Cir. 2004); *SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995). The burden then shifts to the defendants to clearly demonstrate, if appropriate, that the disgorgement figure is not a reasonable approximation. *SEC v. First City Financial Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989); *SEC v. Benson*, 657 F. Supp. 1122, 1133 (S.D.N.Y. 1987). In determining the amount of disgorgement, all doubts should be resolved against the defrauding party. *First City*, 890 F.2d at 1232 (citations omitted); *SEC v. Solow*, 554 F. Supp. 2d 1356, 1365 (S.D. Fla. 2008) ("The SEC has established a reasonable disgorgement total, and all doubts as to the size of the disgorgement must be resolved against the defendant.").

The Division's request for disgorgement in the amount of $4,000,000 plus prejudgment interest is a reasonable approximation of Feldman's ill-gotten gains. Dr. Harris calculated the amount that Feldman profited from by engaging in the buy-write trading. In order to calculate this number, Dr. Harris tabulated every single buy-write Feldman traded during the periods in question in the OIP. DFOF ¶ 309; Harris Report (Div. Ex. 310) at ¶¶ 33, 151. Thus, Feldman should disgorge the profits from his illicit scheme – $4 million – plus any prejudgment interest.

At the hearing, Feldman's expert criticized Dr. Harris's calculations because they included the entire time period that Feldman traded at optionsXpress. To the extent the Court views this as a valid criticism, Dr. Harris also calculated Feldman's profits after December 1, 2009 (when Feldman returned to optionsXpress from Terra Nova). In this short period of time, Feldman still made $1,389,422 from his trading. DFOF ¶ 309. At a minimum, Feldman should be ordered to disgorge this amount plus prejudgment interest.

C. The Respondents Should Be Ordered To Pay Civil Money Penalties

Exchange Act Section 21B(a) authorizes the Commission to assess a civil money penalty where a respondent has willfully violated the Exchange Act or rules and regulations thereunder. A willful violation of the securities laws means the intentional commission of an act that constitutes the violation. Put another way, there is no requirement that the actor "must also be aware that he is violating one of the Rules or Acts." *Wonsover*, 205 F.3d at 414 (internal quotations marks and citation omitted).

The Exchange Act has a three-tier system identifying the maximum amount of penalty. For each "act or omission" by a natural person, the maximum amount of a penalty is $7,500 in the first tier, $75,000 in the second tier, and $150,000 in the third tier. *See* 17 C.F.R. § 201.1003, Subpt. E, Table IV. For an entity like optionsXpress, the tiers are $75,000, $375,000 and $725,000. *Id.* To determine whether to issue a penalty, courts consider the following six statutory factors: (1) fraud; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) need for deterrence; and (6) such other matters as justice requires. *See* Exchange Act Section 21B(c) ("Determination of Public Interest").

The conduct of optionsXpress and Feldman harmed market participants and undermined market integrity. optionsXpress and Feldman greatly profited from the scheme. *See* Harris Report (Div. Ex. 310) at ¶¶ 83-88. A third-tier penalty is warranted against both optionsXpress and Feldman for each of their multiple violations, in order to deter other market participants from

engaging in similar conduct.[17] Because Stern did not directly profit from his actions, the Division requests a second-tier civil money penalty of $75,000 against him.

D. The Respondents Should Be Ordered To Cease-And-Desist

Exchange Act Section 21C authorizes the Commission to enter a cease-and-desist order against any person who is "is violating, has violated, or is about to violate" any provision of the Exchange Act or rule or regulation thereunder. 15 U.S.C. § 78u-3. In considering whether a cease-and-desist order is appropriate, the Court looks to see whether there is some risk of future violations. *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1185 (2001). The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction. *Id.* at 1191. In fact, a single violation can be sufficient to indicate some risk of future violation. *In the Matter of Ofirfan Mohammed Amanat*, Exchange Act Rel. No. 54708, 2006 WL 3199181, at *12 n.64 (Nov. 3, 2006). The Commission has indicated that other factors may demonstrate the need for a cease-and-desist order such as the seriousness of the violation, the degree of harm to investors or the marketplace resulting from the violation, the sincerity of assurances against future violations, the opportunity to commit future violations and the remedial function to be served by the cease-and-desist order in the context of other sanctions sought in the proceeding. *Id.* at *12. In this case, each of the Respondents should be ordered to cease-and-desist from violating the securities laws.

1. optionsXpress Violated Multiple Provisions Of The Securities Laws

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 10(b), Rule 10b-5 and Rule 10b-21 of the Exchange Act as well as Section 17(a) of the Securities Act. optionsXpress engaged in multiple acts that caused it to fail to deliver thousands of securities in a timely fashion. By doing

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[17] The penalties in Section 21B are based on "each act or omission." 15 U.S.C. § 78u-2. optionsXpress violated Reg. SHO in 25 securities on at least 1,200 occasions. Feldman committed fraud in connection with 13 securities over 20 different periods.

this, optionsXpress avoided paying over $7 million of hard-to-borrow fees that should have been paid to other market participants. If optionsXpress had followed the mandates of Rules 204T and 204, Feldman would not have been able to carry out his fraud. optionsXpress is still a registered broker dealer and thus has the opportunity to commit future violations. As a result, optionsXpress poses a substantial, continuing risk of harm to investors and the marketplace. In sum, a cease-and-desist order is in the public interest.

2. Feldman Poses A Future Risk To Investors And The Marketplace

Feldman traded billions of dollars of options contracts. He placed numerous trades with no intention of delivering shares. This conduct greatly undermines market integrity. Harris Report (Div. Ex. 310) at ¶¶ 83-88. Feldman's conduct was at least negligent. He encountered numerous red flags that put him on notice that his trading was problematic yet he continued to trade in the marketplace. Feldman's activities demonstrate that he will continue trading and that he even tried to find other broker-dealers who would allow his use of buy-writes to continue. In short, he poses a substantial, continuing risk of harm to investors and the marketplace and a cease-and-desist order should issue.

3. Stern Poses a Future Risk to Investors and the Marketplace

While Stern no longer works at optionsXpress, he has given no assurances against future violations and testified that he hoped to work in the securities industry again. Tr. at 1795 (Stern). Stern has refused to acknowledge that his conduct violated the securities laws. He misled regulators and had a cavalier attitude regarding regulatory requirements. Stern poses a substantial, continuing risk of harm to investors and the marketplace. Accordingly, a cease-and-desist order should issue because it is in the public interest.

E. Stern Should Be Barred

Exchange Act Section 15(b)(6) authorizes the Commission to bar a person associated with a broker-dealer if he has willfully violated the federal securities laws and such sanction is in the public interest. In determining whether an industry bar is in the public interest, courts

consider the factors identified in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979). Those factors include: (1) the degree of scienter involved; (2) the isolated or recurrent nature of the violations; (3) the sincerity of assurances against future violations; (4) and the likelihood that a respondent's occupation will present opportunities for future violations. *Id.*

Stern aided and abetted violations of the antifraud provisions of the securities laws as well as the close-out requirements of Reg. SHO. Stern's actions helped optionsXpress avoid paying over $7 million in hard-to-borrow fees. This caused harm to other market participants. Stern misled regulators and continued to allow the Customers to engage in the trading in question despite numerous red flags. Stern has offered no assurances against future violations, indeed he has not even acknowledged that what he did was a violation. He has been involved in the financial industry for decades and testified that he would like to resume work within the industry. Without an industry bar, Stern will have the opportunity to commit more violations of the securities laws.[18]

CONCLUSION

As the foregoing demonstrates, Feldman's trading was a manipulative and deceptive scheme that violated Section 10(b) of the Exchange Act, and Rules 10b-5 and 10b-21 thereunder, as well as Section 17(a) of the Securities Act. optionsXpress caused and willfully aided and abetted Feldman's and other Customers' abusive naked short selling, and in the process violated its delivery obligations under Reg. SHO. Finally, Stern's active role as optionsXpress' primary regulatory liaison and in setting optionsXpress' policies and procedures for handling the

[18] The Division asks that Stern be permanently barred from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized rating organization. Stern should also be barred from 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. Finally, Stern should be barred from 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.

improper trading aided and abetted both optionsXpress' violations of Reg. SHO and Feldman's violations of the securities laws. The Court should order disgorgement from optionsXpress and Feldman, enter cease and desist orders regarding their conduct, permanently bar Stern from activity in the securities markets, and impose substantial civil penalties.

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Respectfully submitted,

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