UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

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

Respondents.

POST-HEARING BRIEF OF RESPONDENT OPTIONSXPRESS, INC.

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INTRODUCTION

This enforcement action never should have been brought. The Division of Enforcement ("Division") is trying to hold optionsXpress, Inc. strictly liable for executing a retail customer's trading strategies – trades that neither violated the actual language of Regulation SHO ("Reg. SHO") nor negatively impacted price or market integrity. Throughout this case, the Division has resorted to one new theory after another to characterize the trading as a "sham close-out." But it has eschewed the actual language and elements of Rules 204T and 204 (collectively "Rule 204") of Reg. SHO in favor of generalizations and standardless criteria.

The Division itself does not challenge the legitimacy of the trading strategies themselves – which involved box-spreads, three-way spreads, buy-writes, and deep-in-the-money calls. Instead, it posits a novel reading of the rule that these legitimate strategies become impermissible when they lead to frequent assignments that, in turn, cause "persistent" failures-to-deliver in the continuous net settlement ("CNS") system. But the Division has pointed to no language in the rule itself that the firm purportedly violated. Nor has it even attempted to articulate a standard under which assignments become too frequent, or CNS fails become too "persistent."

In fact, the Chicago Board Options Exchange ("CBOE"), optionsXpress's primary regulator, examined the trading in depth while it was ongoing and found that "***no violation has occurred.***" And the SEC lawyers who wrote the rule said the subject "***activity would not be considered a violation of 204.***" They noted that the SEC would have to "propose a [new] rule" if it wanted to cover the conduct.

The Division is left to argue that the trading violated the spirit of Rule 204. At trial, the Division even resorted to calling the conduct "fishy" and "smelly" – which, as this Court recognized, do not constitute enforceable legal standards reflected in the regulation. Those legal

standards are found in – and limited to – the language of Rule 204, a rule that must be construed narrowly because it imposes strict liability.

optionsXpress complied with a plain reading of that rule. Rule 204(a) required the firm to borrow or purchase shares sufficient to cover a CNS fail by no later than market open on the fourth day after the call was assigned (T+4). These assignments were timely covered "***in more than 99.3% of the cases***," as optionsXpress's expert, Dr. Atanu Saha testified. And each of those purchases "satisfied [the firm's] obligation under SHO," according to Dr. Erik Sirri – the former Director of Trading and Markets who was charged with promulgating the rule itself.

Unable to prove that optionsXpress violated Rule 204(a), the Division urges this Court to find "sham close-outs." The theory is that deep-in-the-money calls sold with the stock purchases and packaged as buy-writes sometimes (but not always) were exercised and assigned on the same day they were sold. But these buy-writes were not a sham – as a matter of law. Rule 204(f) provides the sole definition of "sham close-out," and expressly requires an "***arrangement with another person***" to circumvent Rule 204(a)'s close-out requirements.. At trial, the Division conceded that no such arrangement existed, thus leading the Division's theory to a dead end.

To the extent the Commission wishes to ban these trades (although it is unclear why such a ban would be necessary), there is a process for that – amend the rule. This enforcement action is nothing more than an improper attempt to promulgate a new regulation via prosecution, one that bypasses essential notice and comment requirements and seeks to punish optionsXpress without due process of law. The Division is empowered to enforce regulations, ***not*** to create them.

Market participants are entitled to clear notice of the rules governing their trading. In contrast to prior settlements, which all dwelt on sham arrangements as manipulative devices to

evade Reg. SHO, the standard of conduct the Division asserts in this case – that certain activity not contemplated in its rule can nevertheless operate as a sham – has left market participants up in arms about where the lines are drawn. To this day, the Division itself has drawn no such lines.

As the firm's primary regulator concluded when evaluating the trading, there was no violation at all, much less a fraud. The record showed no manipulation, no market impact, no market integrity issues, and no harm. Therefore, the Court should enforce the law as written and rule in favor of optionsXpress.

ARGUMENT

The trading background and facts of the case are set forth in optionsXpress's proposed Findings of Fact, the firm's Prehearing Brief, and Respondents' expert reports. Also, for the Court's convenience, testifying witnesses are listed and identified in Exhibit A.

I. The Division failed to prove that optionsXpress violated Reg. SHO.

The Division failed to carry its "ultimate burden of proof," which "remains on the Enforcement Division to prove each element of the alleged violation by a preponderance of the evidence." *See, e.g., Decker v. S.E.C.*, 631 F.2d 1380, 1385 n.7 (10th Cir. 1980). Indeed, the trial record demonstrated that optionsXpress satisfied the plain language of Rule. Thus, punishing optionsXpress under the Division's unpublished extension of the law would violate due process. Even if the Court were to accept the Division's reading of the rule, the record still established that Reg. SHO was satisfied.

A. optionsXpress satisfied the plain language of Rule 204.

The Division's entire theory in this case is based on an unprecedented extension of its "sham close-out" theory – namely, that Rule 204 bars the use of open market buy-writes with deep-in-the-money calls to close out a failure to deliver position. This theory conflicts with Rule 204's plain language and thus is legally flawed.

1. Rule 204 is a strict liability regulation that must be construed narrowly.

As a threshold matter, Rule 204 imposes strict liability and thus must be narrowly construed based on its plain language, and without resort to information outside the four corners of the regulation itself. This guiding principle is well established and has been recognized by various courts in the securities context. For example, the Supreme Court made this point clear when interpreting Rule 16(b) of the Exchange Act, which restricts insider trading by corporate officers, stating: "Because the statute imposes liability without fault within its narrowly drawn limits, . . . ***we have been reluctant to exceed a literal, 'mechanical' application of the statutory text.***" *Gollust v. Mendell*, 501 U.S. 115, 122 (1991) (internal and quotations omitted) (emphasis added). This remains true "even though in some cases a broader view of statutory liability could work to eliminate an evil that Congress sought to correct through § 16(b)." *Id.*[1]

The rationale is simple – imposing liability without regard to intent is a severe sanction. Thus, respondents should not be held liable under strict liability rules unless liability is clear and unambiguous. "As a matter of policy, . . . the draconian penalties of [a strict liability rule] should not be imposed when, as here, there is, to say the least, ***a confusing ambiguity*** as to whether its terms have been violated." *Jammies Int'l Inc. v. Nowinski*, 700 F. Supp. 189, 192 (S.D.N.Y. 1988) (emphasis added).

The Court's inquiry therefore begins and ends with the plain language of the rule itself. For purposes of this case, Rule 204(a) carries two requirements. First, the rule imposes a duty on

[1] *See also C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co.*, 705 F. Supp. 972, 976 (S.D.N.Y. 1989) ("[T]he [Supreme] Court emphasized that a narrow construction is appropriate because § 16(b) is a rule of strict liability . . . .") (citing *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972)); *Ho v. Duoyuan Global Water, Inc.*, __ F. Supp. 2d __, 2012 WL 3647043, at *21 (S.D.N.Y. Aug. 24, 2012) ("Because the statute [Section 11 of the Securities Act of 1933, which prohibits intentional misstatements and omissions in registration statements] provides for strict liability, Congress intended a narrowly constructed list of liable parties under the statute."); *In re Royal Ahold N.V.*, 351 F. Supp. 2d 334, 400 (D. Md. 2004) (same).

a participant of a registered clearing agency (e.g., optionsXpress) to deliver shares when it has a fail to deliver position according to CNS data resulting from a "long or short sale transaction" in an equity security. 17 C.F.R. § 242.204(a). The rule does not reference options, much less exercises or assignments of options, and it has not been established that this rule even applies in the options context. But assuming the rule applies to options trading, each assignment ultimately triggered a Rule 204(a) duty for optionsXpress. Thus, the second part of the rule, which addresses what is required after that duty is triggered, is most relevant here:

> . . . the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date [T+4], immediately close out its fail to deliver position ***by borrowing or purchasing securities of like kind and quantity.***

Id. (emphasis added).

As explained during the Division's cross-examination of Dr. Sirri, the Director of Trading and Markets at the time Rule 204T was enacted, this part of the rule requires only a borrow or purchase "transaction":

> [W]hat [Rule 204] says you must do is that you have to borrow or purchase securities of like kind and quantity, that's the very end of the statement. ***So what it requires is a transaction.*** That's what the requirement is . . . if you find yourself on the morning of T plus 4, what you must do is transact. You have to buy securities. That's what it says.

Tr. 3173:20-3174:2 (emphasis added).[2]

Thus, to satisfy its Rule 204(a) duty, optionsXpress merely needed to borrow ***or*** purchase securities "of like kind and quantity" to cover the "short sale transaction in that equity security" that gave rise to the CNS "fail to deliver position." 17 C.F.R. § 242.204(a). And that transaction must occur by the beginning of trading hours on T+4. OPX 915 at ¶ 78 (Sirri Rpt.). That is, the purchase transaction of securities satisfies the participant's obligations under Rule 204.

2 The transcripts are being corrected. Citations are to the original transcript.

Although the Division argues that optionsXpress violated Rule 204(a) by maintaining a prolonged fail-to-deliver position at CNS for certain securities (Div. Br. 14), CNS records have nothing to do with whether the second part of this rule has been satisfied.

As discussed in more depth below, the Division attempts to assert that a participant is in violation of Rule 204 if its fail-to-deliver position at CNS does not net to zero. That is simply not the case; a participant could absolutely meet the requirement by purchasing securities, even if the fail remained. Indeed, the only way a participant could ensure that its CNS position netted to zero would be to prevent any and all subsequent trading in the security that was the subject of the close-out, a result that clearly is not mandated by Reg. SHO, would not be practical, and could result in unintended harm to customers who needed to liquidate a position or establish a new hedge position.

Under a plain reading of the rule, therefore, a firm complies with its 204(a) obligation if and when it makes a timely purchase of stock "of like kind and quantity." The rule is satisfied once that transaction occurs; any additional transaction, such as a short sale, or any other delivery obligation (such as an option assignment), is of no consequence under this subsection. As Dr. Sirri aptly put it: "you buy securities of the like, kind and quantity, you execute the buy-write, you purchase the shares, ***therefore you've satisfied your obligation under SHO.***" Tr. 3211:20-24 (emphasis added). This plain reading of the rule controls, and any broader reading (like that urged by the Division) would violate the tenet that strict liability rules be narrowly construed.

2. optionsXpress satisfied the plain language of Rule 204(a).

The firm satisfied this plain reading of Rule 204(a). The Division cannot credibly dispute that optionsXpress purchased securities "of like kind and quantity" in response to each CNS failure-to-deliver. *See* Div. FOF ¶ 85.

Dr. Saha (optionsXpress's economic expert) gave unrefuted testimony that the "buys" in optionsXpress's buy-writes timely covered all short sales ***virtually 100% of the time.*** As explained in his report: "[A]nalysis of the account-level data for the optionsXpress customers in question . . . shows that ***in more than 99.3% of the cases,*** the short stock positions (resulting from assignments) were cured by the end of T+3 through legitimate purchases of the stocks by the customers." OPX 248 at 32 (Saha Rpt.) (emphasis added).[3] The data therefore show that the shares purchased in buy-writes were delivered within the window required under Rule 204(a).

3. The Division concedes that optionsXpress's trading was not a "sham close-out" under Rule 204(f).

Once Rule 204(a) is satisfied, the rule can be violated ***only*** if the transaction is a "sham close-out" under Rule 204(f), which was not adopted until July 31, 2009. And that provision, which supplies the sole definition of "sham close-out" in Rule 204, expressly requires an "arrangement with another person" to circumvent Rule 204(a)'s close-out requirements:

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

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[3] Dr. Saha's analysis showed that by the end of T+4, the number of short stock positions cured through legitimate purchases was at least *99.8%*. And as the Court observed during Dr. Saha's testimony, the data suggests that some of the purchases representing the difference between 99.3% and 99.8% occurred timely. Tr. 4383:-4385:4; FOF ¶¶ 274-278. In fact, the Division has failed to prove that ***any*** of the buy-writes violated Reg. SHO. *See* discussion, *infra*, Section I.D.

17 C.F.R. § 242.204(f) (emphasis added). As the Commission made clear, it had "determined to include rule text in subparagraph (f) of Rule 204" – and nowhere else – to address "sham close-outs." 74 Fed. Reg. 38266, 38278 (July 31, 2009).

The regulators have explained that the type of "sham" transaction Rule 204(f) was intended to cover is exemplified by the trading at issue in the non-precedential *Hazan* and *Arenstein* settlements. FOF ¶ 284. In both cases, the respondents entered into deals with friendly market makers and ***pre-arranged*** to ensure that delivery of shares did not occur. Under the terms of these illicit arrangements, the party that was obligated to buy shares simultaneously sold one-day FLEX (i.e., customized) call options for an equivalent number of shares using a buy-write. The counterparty – who was selling shares and purchasing the call – would then immediately exercise the call (or the call, which was written in the money and set to expire immediately, would automatically exercise).

The use of buy-writes in those cases did not make the transactions illegitimate; what made the transactions illegitimate was the parties' ***arrangement***. The transactions were illegitimate because, unlike here, delivery was guaranteed never to occur. Without an arrangement, a buy-write strategy would not necessarily prevent delivery of shares. The transaction is a "sham," and thus covered by Rule 204(f), if and only if the same parties are on opposite sides ***and*** those parties arrange to ensure that no shares are delivered. As Dr. Sirri explained, the sham turns on the existence "of a side deal or understanding" designed to avoid delivery. Tr. 3214:15-3215:2; FOF ¶¶ 105, 283.

Moreover, a sham under Rule 204(f) requires that the person with the close-out obligation "knows or has reasons to know that the other person [i.e. the counterparty] will not deliver securities in settlement of the purchase or borrow." 17 C.F.R. § 242.204(f). Here, the purchases

to close-out the fails were executed with unknown counterparties and the Division has introduced no evidence that the counterparties failed to deliver, much less that the firm knew or should have known that those unknown counterparties would not deliver on their sales.

Significantly, the Division (through counsel) essentially conceded there could not be a "sham close-out" here under the Rule 204(f) definition because there was no arrangement. As counsel told the Court: "***Neither of our experts ever said that there was an arrangement with the other parties.***" Tr. 4189:11-17 (emphasis added); *see also id.* at 4187:7-17. This concession was unavoidable; the witnesses uniformly testified that the trading did not involve any kind of arrangement. FOF ¶ 285. Unlike in the *Hazan* and *Arenstein* settlements, the trades at issue here were entered with anonymous counterparties; transacted on the open market; and involved standard, exchange-traded options. There was no arrangement, so there was no "sham."

This is an open-and-shut case. optionsXpress's buy-ins satisfied the plain language of Rule 204(a), and the Division has conceded that those purchase transactions were not sham close-outs under Rule 204(f). Thus, there can be no liability under Rule 204 as a matter of law.

B. The Division's expansive reading of Rule 204 fails as a matter of law.

1. The Division cannot impose liability under Rule 204(a) by relying on continuous CNS fails.

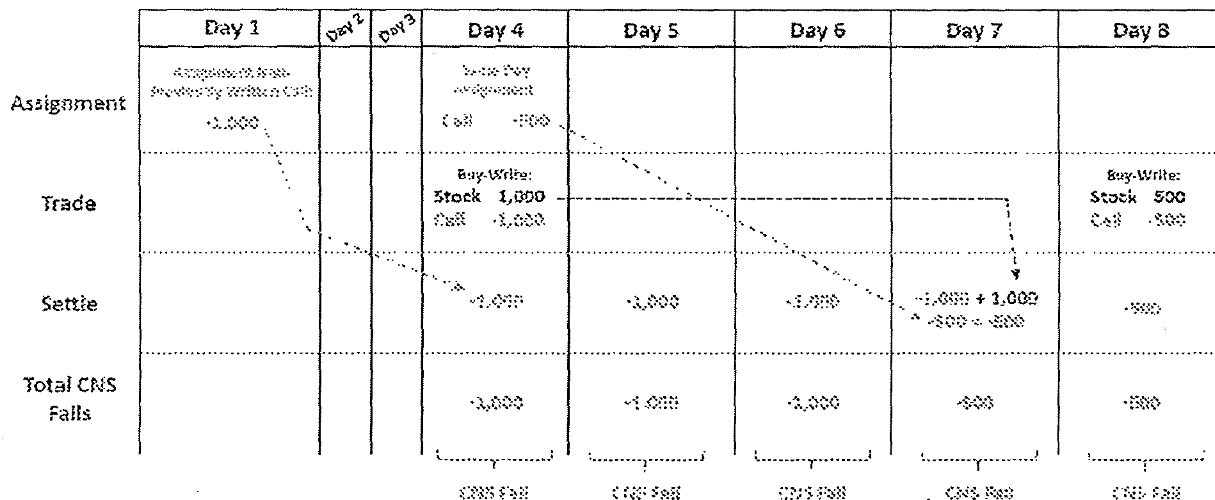
Ignoring the plain language of Rule 204(a), the Division argues that optionsXpress violated an interpretation of that Rule not tied to its actual language by maintaining a prolonged fail-to-deliver position at CNS in certain securities. But the Division's own fact witness on this topic (Louis Colacino) admitted that failures to deliver in CNS are not uncommon. And even an aged short position on CNS (i.e., a failure to deliver position continuing for multiple days without netting to zero or turning positive) does not indicate a Reg. SHO violation. FOF ¶ 290.

As discussed, Rule 204(a) requires a timely transaction, i.e., a borrow or purchase. When determining whether such a transaction occurred, Rule 204(a) looks to the broker's books and records, ***not*** its CNS position. As the adopting release to the rule makes clear: "to meet its close-out obligation a participant also must be able to demonstrate ***on its books and records*** that on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position and, therefore, that the participant has a ***net flat or net long position on its books and records*** on the applicable close-out date." 74 Fed. Reg. at 38272 (emphases added); *see also* 73 Fed. Reg. 61706, 61711 (Oct. 17, 2008). Dr. Saha thus relied on the firm's "books and records" to confirm compliance through stock purchases. FOF ¶¶ 274-275.

CNS data is irrelevant to this determination – not the least of which because, as Dr. Sirri reaffirmed, the rule "does not speak to the net position at CNS. The rule has explicitly not put the requirement on to flatten yourself at CNS at the end of the day." Tr. 3209:16-3210:4; *accord* Tr. 2774:21-2775:11 (Aylward). In fact, the Division's theory – i.e., looking for a change in CNS position to determine Reg. SHO compliance – ignores two fundamental aspects of how the CNS system works. ***First***, a stock purchase that complies with Reg. SHO will take three days (i.e., until settlement) to resolve a CNS fail. FOF ¶ 297. Dr. Saha showed how this delay in settlement can cause CNS fails to occur for an extended period even when Reg. SHO is satisfied:

Illustrative Example of Buy-Writes with Assignment

Panel B: Buy-Write with Same Day Assignment

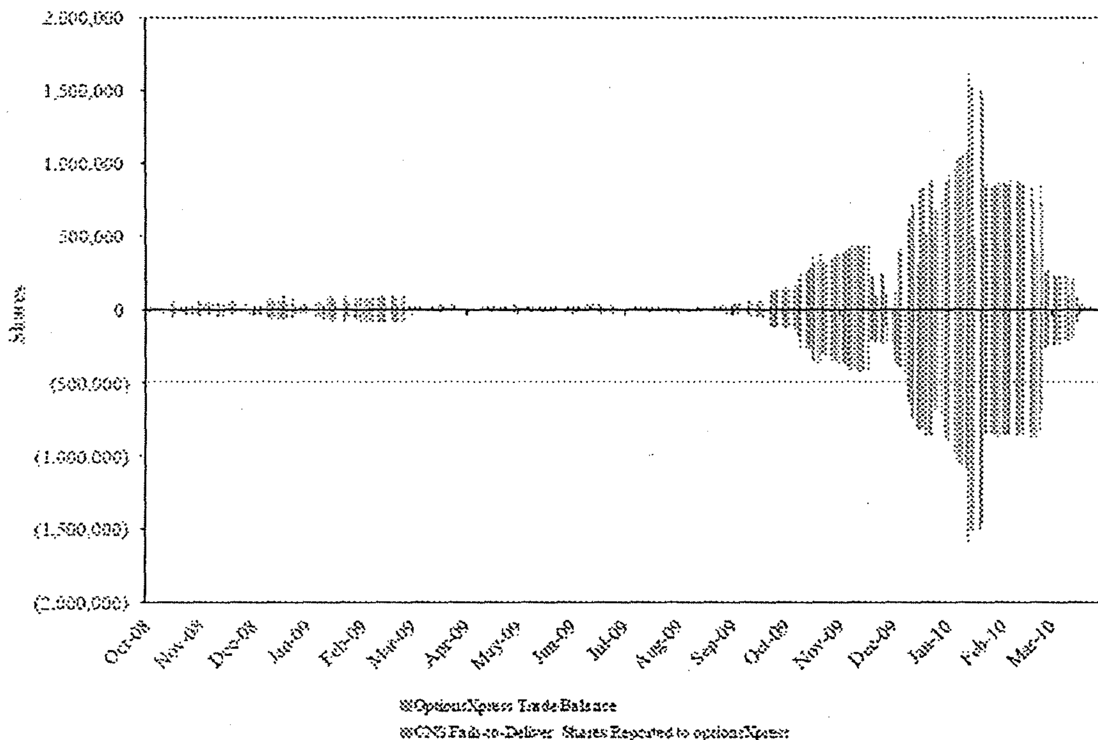


OPX 1006 at 9 (Saha Rebuttal Slides). Dr. Saha walked through this analysis at trial, stressing that "the buy-write happened in a Reg. SHO compliant manner and yet we can have 11 days in a row of CNS fails." He explained this hypothetical example involved only two assignments; if more than two assignments were considered, as often was the case in reality, then it is possible to observe CNS fails for many consecutive days in a row. Tr. 4393:7-8; 4393:20-4395:18; FOF ¶¶ 274-282.

Second, and further to this point, the firm's end-of day CNS position is an amalgamation of all trading that settled that day – including transactions completely unrelated to the trading that triggered a Reg. SHO close-out obligation. As Colacino testified, CNS shows only the net trading activity and, as a result, cannot show whether a party is "net short from trading activity on that day only or net short because of [a] prior day's trading activity." Tr. 85:23-86:5; *see also*

FOF ¶ 297. Dr. Saha illustrated this point by analyzing optionsXpress's stock purchases in SHLD:

Figure 1: OptionsXpress Trade Balance and CNS Fails-to-Deliver for Sears Holdings Corp.



OPX 248 at 31 (Saha Rpt.). This chart shows how the firm's books and records confirm purchases that satisfy Reg. SHO (the blue bars) – representing real economic activity – even when the firm maintained a continuous net fail position at CNS (the red bars). *Id.* at 32; *see also* OPX 680; FOF ¶ 296.

Because the CNS data reflects the combined sum of past ***and new*** fails, it is entirely possible for a fail to exist each day even though timely purchases occurred each day to cure existing fails. OPX 248 at 30-32 (Saha Rpt.); Tr. 108:18-22 (Colacino). Notably, the Division failed to challenge or undermine the analyses of Drs. Sirri and Saha during cross-examination,

and several other witnesses confirmed that CNS can show a fail even when a timely buy-in occurs. FOF ¶ 297.

This is precisely why, as Colacino testified, one needs to look to the "firm's own trading blotters," rather than to the CNS system, to determine whether a broker purchased sufficient shares to cover a short position on any given day. Tr. 88:22-90:3; FOF ¶ 297. Corroborating Colacino's testimony, John Ruth, a former Managing Director who co-headed Goldman Sachs Execution & Clearing L.P., testified that the CNS fails to deliver in this case were new fails – not the perpetuation of old fails – based on his analysis of the counterparties to such fails. OPX 250 at ¶¶ 3, 36, Exs. 3-4 (Ruth Rpt.) (testifying that "optionsXpress owed stock to different contra-parties on a daily basis, indicating that deliveries were being made").

In short, the Division's theory boils down to whether writing a deep-in-the-money call along with the buy-in designed to satisfy the Rule 204(a) obligation constitutes a sham. That question, of course, is addressed in Rule 204(f) – not Rule 204(a).

2. The Division cannot expand Rule 204(f)'s definition of "sham close-out" to cover buy-writes with deep-in-the-money calls.

As discussed, the Division concedes that optionsXpress did not violate the plain language of Rule 204(f), which requires an "arrangement" that does not exist here. Instead, the Division hopes to expand that Rule based on footnote 82 to the July 31, 2009 release, which states in relevant part:

> In addition, where 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. This argument fails for three independent reasons. ***First***, because Rule 204(f) must be construed narrowly, the definition of "sham close-out" cannot be expanded by reference to footnote 82. ***Second***, Reg. SHO's regulatory history confirms that a "sham" under Rule 204 was meant to require an "arrangement" (a term that nowhere appears in footnote 82), as expressly provided by Rule 204(f). ***Third***, the Division's reliance on non-precedential settlements and guidance pertaining to other regulations is misplaced.

(a) Footnote 82 has no legal effect.

Footnote 82 does not carry the force of law, because it was placed in a release and not the rule itself. As the D.C. Circuit emphasized: "language in the preamble of a regulation is not controlling over the language of the regulation itself." *Entergy Servs., Inc. v. F.E.R.C.*, 375 F.3d 1204, 1209-10 (D.C. Cir. 2004) (internal citations omitted); *Jurgensen v. Fairfax Cnty., Va.*, 745 F.2d 868, 885 (4th Cir. 1984) (same). Here, the language the Division is seeking to rely on does not even appear in a preamble to Reg. SHO, but rather, is buried amongst a total of 262 footnotes in the adopting release. Such language placed in explanatory footnotes certainly "does not enlarge or confer powers on administrative agencies or officers." *Wyo. Outdoor Council v. U.S. Forest Serv.*, 165 F.3d 43, 53 (D.C. Cir. 1999) (quoting *Ass'n of Am. R.R. v. Costle*, 562 F.2d 1310, 1316 (D.C. Cir. 1977)).

As the D.C. Circuit recognized, a regulator must not "bury what it believes to be the heart of its order in the last line of a footnote . . . Such obscurity and imprecision collide with the Commission's responsibility, shared by all federal agencies, of issuing intelligible orders." *McElroy Elecs. Corp. v. F.C.C.*, 990 F.2d 1351, 1366 (D.C. Cir. 1993) (internal citation omitted). Footnotes like the one at issue are "explanatory, ***not regulatory***." Office of the Fed. Reg., Nat'l Archives and Records Admin., Fed. Reg. Document Drafting Handbook, Ch. 7

(emphasis added); *see also Langbecker v. Elec. Data Sys. Corp.*, 476 F.3d 299, 311 n.22 (5th Cir. 2007) ("[a] footnote constitutes at best a comment on the regulations, and ***is not itself a regulation***") (emphasis added).

This is particularly true here, where the Commission expressly defined "sham close-out" in the rule itself. As the Supreme Court has explained, "[i]t is axiomatic that the statutory definition of the term excludes unstated meanings of that term." *Meese v. Keene*, 481 U.S. 465, 484 (1987); *Duncan v. Walker*, 533 U.S. 167, 174 (2001) ("It is [the court's] duty to give effect, if possible, to every clause and word of a statute.") (internal citations and quotations omitted); *see also King v. Jackson*, 468 F. Supp. 2d 33, 38 n.7 (D.D.C. 2006) (quoting *Meese*, 481 U.S. at 484, and refusing to extend plaintiff's preferred interpretation of the term "unlawful employment practice" because that term was defined by statute). It also is "well settled that regulations cannot be construed to mean what an agency intended but did not adequately express." *L.R. Wilson & Sons, Inc. v. Donovan*, 685 F.2d 664, 675 (D.C. Cir. 1982) (internal citations and quotations omitted).

Flouting all of these principles, the Division embraces footnote 82 in a transparent attempt to bypass the language of Rule 204(f) itself, which expressly requires an "arrangement." Thus, the Division's position should be rejected out-of-hand because it is inconsistent with the express requirements of the rule itself.

(b) Rule 204's regulatory history confirms that a "sham close-out" under Reg. SHO was intended to require an "arrangement."

Examining Rule 204's regulatory history is unnecessary because Rules 204(a) and 204(f) are both unambiguous. Regardless, this history confirms that at each stage in Reg. SHO's development, an "arrangement" was unequivocally deemed necessary for a sham close-out:

- **Aug. 6, 2004 (Rule 203 & Adopting Release):** "A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this paragraph (b)(3) ***where the participant enters into an arrangement . . . .***" 69 Fed. Reg. 48008, 48031 (Aug. 6, 2004) (outlining 17 C.F.R. § 242.203(b)(3)(v) as adopted on Aug. 6, 2004) (emphasis added); *see also id.* at 48018 n.96.

- **July 21, 2006 (Rule 203 Amending Release)**: "Regulation SHO prohibits a broker-dealer from engaging in ***'sham close outs' by entering into an arrangement*** with a counterparty to purchase securities . . . ." 71 Fed. Reg. 41710, 41711 n.13 (July 21, 2006) (emphasis added); *see also* 72 Fed. Reg. 45544, 45546 n.31 (Aug. 14, 2007); 73 Fed. Reg. 61690, 61692 n.26; DX 121 at 6 n.19 (Arenstein Settlement) (July 21, 2007).

- **Oct. 17, 2008 (Rule 204T Adopting Release)**: ***"[W]here a broker-dealer enters into an arrangement*** with another person to purchase securities, and the broker-dealer knows or has reason to know that the other person will not deliver securities in settlement of the transaction, ***the purchase will not be considered to be 'bona fide.'"*** 73 Fed. Reg. 61706 at 61714 (emphases added); *see also id.* at 61714-15 n.78 (referring to "'sham close outs' as entering into an arrangement with another person to create the appearance of a purchase that would not satisfy the close-out requirement of Regulation SHO.").

- **July 31, 2009 (Rule 204 Adopting Release & Final Rule)**: ". . . . we have determined to include rule text in subparagraph (f) of Rule 204 to provide that a participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of Rule 204 where the participant ***enters into an arrangement*** with another person to purchase or borrow securities . . . ." 74 Fed. Reg. 38266, 38278 (July 31, 2009) (emphasis added); *see also* 74 Fed. Reg. at 38292-93 (outlining 17 C.F.R. § 242.204(f) as adopted on July 31, 2009) (emphasis added).

Critically, Rule 204's adopting release explains that "[t]he Commission has designed [Rule 204] so that it is consistent with the close-out requirements of Rule 203(b)(3) of Regulation SHO." 74 Fed. Reg. at 38291. Yet, neither the precursor Rules 203 and 204T nor their respective releases includes any language equivalent to footnote 82. That language appears for the first time in the July 31, 2009, Rule 204 adopting release, after the notice and comment period. (*See infra* Section I.F addressing lack of notice). Thus, it is clear that footnote 82 was not meant to add any new or additional requirement to the express "arrangement" language the Commission decided to use in Rule 204 and throughout the Reg. SHO regulatory history.

In fact, the regulators who wrote Rule 204 have conceded as much. In August 2009, after Rule 204 was adopted, the SEC's Assistant Director for the Office of Trading Practices, Josephine Tao – who helped draft the rule – suggested possibly adding a new provision that would broaden Rule 204(f) by focusing on the economic purpose of the transaction: "***Should we propose a rule*** that would add a circumvention with no economic purpose rule?" OPX 559 (emphasis added); FOF ¶ 183. Of course, this very suggestion by an author of the rule demonstrates that such a requirement was not already in the existing rule. In fact, as CBOE Director Timothy MacDonald testified, Tao and her colleague Victoria Crane at Trading and Markets told him that the rule "couldn't cover everything," and thus the Commission would need to "go [] back and reevaluate the rule if they want to cover this type of trading." Tr. 3998:10-17; FOF ¶ 167.

This testimony from the regulators themselves is devastating to the Division's effort to construe the strict liability Rule 204(a) as already covering "this type of trading." Footnote 82 did not change the express definition of "sham close-out" carefully laid out in Rule 204(f) and the regulatory record – all of which requires an "arrangement."

(c) No prior settlement or regulatory guidance addresses the situation here.

The regulatory settlements upon which the Division relies so heavily – *Hazan*, *Arenstein*, and *TJM* – are of no import here and are distinguishable. In the first instance, these settlements have no precedential value. *See In re Del Mar Fin. Servs., Inc., et al.*, SEC Rel. No. 188, 2001 WL 919968, at *29 n.61 (Aug. 14, 2001).

Further, as explored in depth at trial and noted in the proposed Findings of Fact, the trading at issue in those cases (and in related guidance discussed by the Division) was materially different, both factually and legally, from the trading at issue in this case. Those cases involved

a scheme to evade the requirements of Reg. SHO and improper reliance on the market maker exception to the rule's locate requirement. They therefore involved situations where the transactions in their entirety were sham transactions with no other purpose, legitimate or otherwise. Further, those cases involved express arrangements between counterparties, including the use of customized FLEX options and one-day options, with the express and sole purpose being to get assigned to avoid delivery.

In stark contrast, the customers here did not sell short-term options (indeed, average maturity of Feldman's call options was about 36 days); did not use FLEX options; the trading had a legitimate economic purpose of maintaining a hedged position; and the customers were keen to avoid the costs and risks to their arbitrage strategy associated with assignments. FOF ¶¶ 67-72, 78-83. In fact, the customers sold standardized option contracts in the open market and had no control over whether or when they would be assigned or to whom. The economics behind call options and the assignment allocation process do not allow a seller of an options contract to know when or if their contracts will be assigned because the assignment allocation process for standard options is random. FOF ¶¶ 18, 71-74, 138, 309.

Finally, prior regulatory guidance on sham transactions in the context of other regulations are plainly irrelevant. *See* FOF ¶¶ 300-305.

C. Even if footnote 82 carried legal weight, the Division did not show that optionsXpress violated it.

Even if footnote 82 did somehow create a new rule, the Division failed to meet its burden of proving that optionsXpress actually violated that footnote. By its very terms, to prove optionsXpress violated footnote 82, the Division would need to establish both: (1) a "sale transaction" made on "th[e] same day" as the purchase of shares; and (2) that this transaction had "no legitimate economic purpose." The Division proved neither. Nor did optionsXpress

"know[] or ha[ve] reason to know that the other person [i.e., counterparty would] not deliver securities in settlement of the purchase or borrow," as required by Rule 204(f).

1. The Division failed to prove any "sale transaction" "on th[e] same date" of the buy-in.

Footnote 82 addresses "***sale transaction[s]***" purportedly "used to re-establish or otherwise extend the participant's fail position . . . ***on th[e] same date***" of "the applicable close-out date," i.e., the day on which stock was purchased. 74 Fed. Reg. at 38272 n.82 (emphases added). The Division, however, does not even argue that optionsXpress engaged in such same-day sale transactions, let alone prove it. Instead, the Division asserts that "[s]elling deep-in-the-money calls" is "***almost*** economically equivalent" to selling shares because they purportedly "were ***generally*** exercised the same day they were sold (and thus were assigned to the [c]ustomers later the same day)." OIP ¶¶ 28, 30; Div. FOF ¶ 55 (emphases added).

The Division is essentially claiming that the customers' trading was ***analogous*** to same-day sales transactions, not that the firm actually engaged in such transactions. A same-day call option sale cannot be "essentially the economic equivalent" of a same-day "sale transaction" unless that call were guaranteed to be exercised and assigned back that very same day.[4] But, here, the assignments were not guaranteed at all, much less guaranteed to be exercised on the same day as the close-out. In fact, of all of the deep-in-the-money calls written on the 25 stocks at issue in this case, fewer than one-third were fully assigned on the same day they were written. *See* OPX 248 at 25 (Saha Rpt.); FOF ¶¶ 76, 308. Unlike one-day FLEX options that are agreed to between two counterparties and guaranteed to be exercised virtually immediately, the written calls here were standard options traded on the open market with average time to expiration of

[4] Even then, it is questionable whether that would amount to an actual stock sale under the meaning of Rule 204(a), versus simply an obligation to deliver shares. Indeed, exercises and assignments of options are expressly not deemed to be "sales" for trade reporting and other purposes.

about 36 days. *See* OPX 248 at 12 (Saha Rpt.); FOF ¶ 69. Those standard options thus were not guaranteed, or even virtually guaranteed, to be exercised and assigned back the same day. *See* OPX 250 at 30-36 (Ruth Rpt.).

The Division's theory also flouts common sense, because the customers had no control over when their standard call options would be exercised or assigned. Again, unlike cases where parties entered an arrangement with a counterparty, or used one-day FLEX options with customized terms, the anonymous and unrelated counterparties had complete control over when (if ever) to exercise the calls at issue here. In fact, where options were ***randomly*** assigned to the customers, the Division failed to prove that the assignment related to options the customers even wrote, much less calls they wrote that same day. *See* OPX 248 at 25 (Saha Rpt.). The parties exercising the assigned calls may not have even been the parties who bought them from the customers in the first place. FOF ¶¶ 18-19, 73-74, 138.

In response, the Division has suggested that deep-in-the-money calls, by their very nature, are virtually certain to be executed and assigned on the same day they are written. *See, e.g.*, Div. FOF ¶¶ 80, 86. But even the Division's own expert never went that far. Instead, Dr. Harris said that "deep-in-the-money options are ***more likely to be exercised early*** than are options that are close to the money." DX 310 at ¶ 75 (Harris Rpt.) (emphasis added). According to the data, even that statement does not necessarily hold true. *See* OPX 248 at 26, Table 7 (Saha Rpt.) (40%-50% in-the-money calls assigned as frequently as 90%-100% in-the-money calls). Regardless, Dr. Harris concedes that the options were not guaranteed to be exercised on the same day they were written. In fact, Dr. Harris's own analysis shows that same-day full assignment of the written calls happened only 44% of the time (DX 382, Harris Rebuttal Exhibit A3, at Panel F), and he merely opines that counterparties to the deep-in-the-money calls "regularly exercised

their newly acquired call options on the day they traded ***or the next day*** . . . ." DX 310 at ¶ 28 (Harris Rpt.) (emphasis added). Trades on the "next day" do not even violate the Division's strained view of the law, because footnote 82 expressly states the stock "sale transaction" – which, under the Division's theory, is an exercised and assigned call option – must occur on "th[e] *same* date" as the stock purchase. OIP ¶ 15 (emphasis added). Stated another way, if a participant purchased shares by the opening of trading on T+4 to meet its Rule 204 close-out obligation, nothing would prevent the participant from selling the stock the very next day.

2. The trading had a legitimate economic purpose.

As the Division itself concedes, footnote 82 also does ***not*** apply if the trades at issue had a "legitimate economic purpose." 74 Fed. Reg. at 38272 n.82; *see also* Div. Br. 15. The customers did have a legitimate economic purpose: maintaining a hedged position.

As Feldman put it at the time: "[D]oing the buy-writes is crucial to maintain the neutral hedge." DX 58; FOF ¶ 62. The purpose of his trading was to conduct an arbitrage that existed as the result of publicly accessible mispricing in the two legs of the option positions. FOF ¶¶ 43, 55. The Division has strained to define the trading strategy as something other than an arbitrage, presumably because arbitrage strategies are perfectly legitimate. But that is beside the point – no matter how one characterizes the customers' trading strategy, it had both profit and loss potential and thus carried a legitimate economic purpose. FOF ¶¶ 56, 78-83, 310.

Such a hedged options strategy – regardless of whether it is technically arbitrage – is common and serves legitimate economic purposes. CBOE itself has made this precise point on several occasions. In 2007, in interpretive guidance concerning the pairing of stock purchases with options in the context of Reg. SHO close-outs, the CBOE noted: "we recognize that transactions matching options with stock may be used as part of a legitimate hedged strategy, and

we do not want to discourage their use for that purpose." DX 124; *see also* DX 129 (same); FOF ¶¶ 142-143.

Likewise, courts have acknowledged that hedged strategies, which have been used for decades, are perfectly legitimate and legal: "Hedging is lawful." *Lyons Milling Co. v. Goffe & Carkener*, 46 F.2d 241, 248 (10th Cir. 1931) (emphasis added). "Generally, short selling is a legitimate market strategy used to 'profit from an unexpected downward price movement to provide liquidity in response to unanticipated buyer demand, and to hedge a risk of a long position.'" *Rocker Mgmt., LLC v. Lernout & Hauspie Speech Prods. N.V.*, Civil Action No. 00-5965, 2007 WL 2814653, at *2 (D.N.J. Sept. 24, 2007) (quoting S.E.C. Div. of Market Regulation Key Points About Regulation SHO (Apr. 11, 2005)).

Indeed, the fact and expert witnesses uniformly confirmed that buy-writes were an integral part of a ***legitimate*** hedged, option-trading strategy: the buy cured the "fail to deliver" and the written call re-established the customer's hedge. FOF ¶¶ 310-311. For example, Zelezny came up with the same strategy independently of Feldman, and the SEC has ***never*** alleged that Zelezny's purpose was illegitimate. And CBOE thoroughly investigated that trading strategy and found "the Zelezny's were appropriately maintaining a hedged position." OPX 141; FOF ¶ 210.

The Division's expert, Brendan Sheehy, agreed that having an unhedged position after an assignment "is not something I would want to be in, that is for sure. I would not want to have that exposure." Tr. 1077:5-1079:1; 964:5-11; FOF ¶ 311. Dr. Saha confirmed, from an objective, economic standpoint, the "write" is, in fact, necessary to re-establish the hedged position. *See* OPX 248 at 17-21, 40 (Saha Rpt.). Both Drs. Saha and Sirri discussed why the

alternatives (a forced wind-down of the position, or remaining long) would make no economic sense. FOF ¶ 63.

In the OIP, the Division recited two possible illegitimate motives for a hypothetical trader to violate Reg. SHO: "Sellers sometimes [1] intentionally fail to deliver securities as part of a scheme to manipulate the price of a security, or [2] possibly to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high." OIP at ¶ 20. But neither motive applies here. First, the trading here did not cause any downward pressure on stock price. The Division's economic expert, Dr. Harris, conceded "that the buy-write trades had little effect on prices in the underlying stock markets[.]" DX 310 at ¶ 39 (Harris Rpt.); Tr. 1552:19-25 (Harris); *see also* FOF ¶¶ 40, 328-329. Second, the customers had no motive to avoid borrowing costs because optionsXpress never charged its customers borrowing fees; a point seemingly lost on the Division's trading expert until after the trial had commenced. FOF ¶¶ 48-49, 52.

3. The Division cannot prove any "sham close-out" theory based on strict liability.

The Division's reliance on footnote 82 to prove a "sham close-out" also ignores language in Rule 204(f) requiring proof that the respondent "knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow." That is, Rule 204(f), unlike Rule 204(a), does ***not*** impose strict liability for a "sham close-out." As discussed in more depth below, the Division cannot show that optionsXpress knew or had reason to know that delivery was not occurring as a result of the buy-write trades. *See* discussion, *infra*, at Section II.B. This too prevents any "sham close-out" theory under either Rule 204(f) or footnote 82.

D. The Division has failed to carry its burden of proving untimely buy-writes.

With its primary theory crumbling, the Division presses an alternate claim that optionsXpress repeatedly failed to execute the buy-writes at market open. That the Division is challenging when the purchases are made amounts to a concession that in fact the purchases *were made*. But in any case, the Division has failed to meet its burden of proving an actual violation, i.e., a late trade on T+4. In fact, throughout this case, the Division has continually misrepresented its purported evidence supporting that claim.

For support, the Division relies on the opinion of its expert (Dr. Harris) that "[f]or the 1,205 buy-writes executed before August 20, 2009, 97% of the buy-writes were executed after 10:00 a.m. Eastern Time." Div. Br. 20. But as Dr. Harris admitted on the stand, he made no effort to analyze whether these purportedly late buy-ins occurred on T+4, as opposed to an earlier date:

> Q: My question to you, sir . . . was whether or not you ever analyzed in connection with the opinion you have given here the frequency of optionsXpress in closing out by the beginning of T+4 the fail to deliver positions in Mr. Feldman's account caused by the assignments; did you ever do that study?
>
> A: ***I did not study whether the positions were closed by day one.***

Tr. 1561:22-1562 (emphasis added).

This presents a fatal flaw in the Division's theory. As the Division is well aware, the fact that a buy-in occurred after 10:00 a.m. on T+1, T+2 or T+3 is of no moment under Rule 204, which requires only that buy-in occur by the open on T+4. Thus, the purported fact that a large number of transactions occurred after 10:00 a.m. before August 20, 2009 is – in and of itself – meaningless.

In its brief, the Division tries to cure this flaw through obfuscation. According to the Division, all buy-writes occurring before August 20, 2009, necessarily occurred on T+4. *See*

Div. Br. 20. But that theory is counterfactual. To be sure, optionsXpress's policies did not specifically encourage buy-ins to occur on T+1 until August 20, 2009. But it does not necessarily follow that buy-ins took place only on T+4 until that date. In fact, this is not what happened. The record showed that, throughout the relevant period, the firm often bought the customer in the day after an assignment – i.e., on T+1 – as opposed to waiting until market open on T+4. FOF ¶ 274.

Critically, neither Dr. Harris nor the Division even attempted to refute Dr. Saha's finding that 99.3% of the time – including both before and after August 20, 2009 – short stock positions resulting from assignments were cured through stock purchases ***before T+4***. *See* OPX 248 at 32 (Saha Rpt.). These data do not lie – and they show the firm hardly ever waited until T+4 to buy its customers in, even before August 20, 2009. Dr. Harris conceded as much on cross-examination. Tr. 5010:4-13; FOF ¶ 315. In fact, after being presented with this fatal flaw during his first cross-examination, the Division called Dr. Harris back to the stand more than a month later as part of its rebuttal case. But even then, he still failed to offer any proof of any "late" buy-ins on T+4:

> Q: Now, when you testified, I think on September 11th, you said you hadn't determined how many of the transactions, either before or after August 20th, had occurred on T1, T2, T3 or the morning of T4; isn't that correct? And we can get your testimony out, but –
>
> A: No, I did not make that determination.
>
> Q: Right. And sitting here today in front [of] The Court, as of today, October 22nd, you still have not made that determination, have you?
>
> A: That's correct.

Tr. 5010:16-5011:1. Thus, he did nothing to rehabilitate his initial failure to show the date on which those later-in-the-day transactions occurred (i.e., T+1, T+2, T+3 or T+4). FOF ¶¶ 312-313.

To this day, the Division has yet to show a single late buy-in ***on T+4*** – what it must show to prove an untimely transaction under Rule 204(a). FOF ¶¶ 312-317. No matter how you cut it, late-in-the-day trades ***before T+4*** are not late under Rule 204(a). Thus, the Division has no basis to argue any stock purchases were untimely.

E. optionsXpress satisfied Rule 204(e) for the same reasons discussed above.

Rule 204(e) provides an exception to the close-out requirements of Rule 204(a) to the extent a participant qualifies for "pre-fail credit" under 204(e). Rule 204(e) merely clarifies that if a broker like optionsXpress were to buy the customer in after an assignment on T+1, T+2 or T+3 – i.e., before receiving an actual CNS fail notification the evening of T+3, when no settlement occurs – that early stock purchase would be deemed to satisfy Rule 204(a) through a "pre-fail credit." As common sense dictates, the broker would not also need to purchase (or borrow) stock before market open on T+4.

As Rule 204's adopting release states: "Rule 204(e) provides that even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with Rule 204(a) [i.e., by market opening on T+4] . . . a broker-dealer shall not be subject to the requirements of Rule 204(a)" if the broker-dealer complies with the conditions set forth in Rule 204(e)(1) though (4). 74 Fed. Reg. at 38274. optionsXpress satisfied Rule 204(a) through timely stock purchases, but in any case, for the reasons discussed above, the conditions of 204(e) were satisfied for each pre-fail purchase – i.e., the purchase (a) was "bona fide" (i.e., there was no "arrangement"); (b) occurred between T+1 and T+3, (c) was "of a quantity of securities sufficient to cover the entire amount of the . . . fail to deliver position;" and (d) caused the firm to have "a net flat or net long position on its books and records on the day of the purchase[.]" *See id.* at 38292-93.

The Division argues that optionsXpress provided no evidence that the firm was net flat according to "the entire books and records of optionsXpress" (Div. Br. 19), but this argument is incorrect and makes no sense. Dr. Saha did in fact provide data showing the firm as a whole was net flat on its books and records. OPX 248 at 30-31, Figure 1, Ex. 9A-9D (Saha Rpt.). The Division presented nothing in response.

More importantly, the rule simply requires the broker to show in its books and records where the firm bought stock of "like kind and quantity" to the assignment at issue. That is, the rule requires the firm to purchase (or borrow) "a quantity of securities sufficient to cover the entire amount of the [anticipated] fail to deliver position" and provide proof that ***those purchases*** actually occurred. 74 Fed. Reg. at 38292-93. That is precisely what Dr. Saha showed when he offered unrebutted expert testimony that "analysis of the account-level data [i.e., the firm's books and records] for the optionsXpress customers in question . . . shows that in more than 99.3% of the cases, the short stock positions (resulting from assignments) were cured within the T+3 window through legitimate purchases of the stocks by the customers." OPX 248 at 32 (Saha Rpt.).

optionsXpress thus plainly complied with the plain language of Rule 204(e) and its purpose: "The purpose of Rule 204(e) is to encourage broker-dealers to close out fail to deliver positions prior to the close-out date." 74 Fed. Reg. at 38276. According to SEC's guide to compliance with Rule 204, "Rule 204(e) allows broker-dealers to obtain pre-fail credit if they close out their fail to deliver position by purchasing or borrowing a quantity of securities sufficient to cover the entire amount of that broker-dealer's fail to deliver position." *Rule 204 Small Entity Compliance Guide* (Aug. 3, 2009) (*available at* www.sec.gov/divisions/marketreg/tmcompliance/34-60388-secg.htm).

Critically, the firm's satisfaction of Rule 204(e) provides a complete and affirmative defense to the alleged violation. The CNS data does not rebut this evidence – as explained above, it is possible and indeed common to have a persistent CNS fail position without a Reg. SHO violation. Thus, the Division has not met ***its burden*** of showing a Rule 204 violation regardless of whether the firm's activity is assessed through the lens of paragraph (a) or paragraph (e) of the Rule. Both subsections are satisfied through the firm's stock purchases before market open on T+4. Neither subsection addresses "sham close-outs," much less modifies Rule 204(f). And neither provision looks to CNS data to determine whether the close-out requirement was satisfied.

F. Holding optionsXpress liable under the Division's theory would violate optionsXpress's due process rights.

Punishing optionsXpress for the trading at issue under a footnote 82 theory would not only run afoul of the express language of the rule, it would violate optionsXpress's due process rights because it was not on adequate notice that this trading activity was unlawful. "Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule." *Affum v. United States,* 566 F.3d 1150, 1163 (D.C. Cir. 2009) (internal quotations omitted); *see also Gen. Elec. Co. v. E.P.A.*, 53 F.3d 1324, 1328 (D.C. Cir. 1995) ("Due process requires that parties receive fair notice before being deprived of property.").

Courts have consistently held that agency regulations must provide "adequate notice" to entities affected by a new regulation. Agencies must "reflect clear, rational decision making that gives regulated members of the public adequate notice of their obligations." *S.G. Loewendick & Sons, Inc. v. Reich,* 70 F.3d 1291, 1297 (D.C. Cir. 1995) (citing 5 U.S.C. § 706(2)(A)); *Gen. Elec. Co.*, 53 F.3d at 1328-29). Where notice is insufficient, "for example, ***where the regulation***

is not sufficiently clear to warn a party about what is expected of it – an agency may not deprive a party of property by imposing civil or criminal liability." *United States v. Approximately 64,695 Pounds of Shark Fins*, 520 F.3d 976, 980 (9th Cir. 2008) (emphasis added) (internal citation omitted) (quoting *Gen. Elec. Co.*, 53 F.3d at 1328-29).

Whether a party received adequate notice of regulatory requirements is determined by the "ascertainable certainty" standard. Under this standard, "[i]f, by reviewing the regulations and other public statements issued by the agency, a regulated party acting in good faith would be able to identify, with 'ascertainable certainty,' the standards with which the agency expects parties to conform, then the agency has fairly notified a petitioner of the agency's interpretation." *Hosp. of Univ. of Pa. v. Sebelius*, 847 F. Supp. 2d 125, 135 (D.D.C. 2012) (internal citations omitted); *see also Trinity Broad. of Fla., Inc. v. F.C.C.*, 211 F.3d 618, 629-30 (D.C. Cir. 2000) (finding lack of "ascertainable certainty" of new regulatory requirement where Commission failed to define key term in new regulation).

Any liability in this case would be far from "ascertainably certain." First and foremost, footnote 82 does not appear in the rule itself, thus no market participant could have been "ascertainably certain" that it applied by reading the strict-liability rule. *See Trinity Broad.*, 211 F.3d at 630 (respondent lacked "fair notice" from regulator, citing D.C. Circuit's rejection of placing key language in footnotes); *see also MCI Telecomm. Corp. v. F.C.C.*, 57 F.3d 1136, 1141-42 (D.C. Cir. 1995) (finding inadequate notice, noting that "[a]lthough this court has not unequivocally held that notice is inadequate solely because it is to be found only in a footnote, such placement has been a significant factor in our prior cases holding notice inadequate.").

Moreover, the prohibition supposedly contained in footnote 82 was never subjected to the notice and comment required by the Administrative Procedure Act. As noted previously (*supra*

page 16), the language of footnote 82 did not appear until Rule 204's adopting release, and it was never part of that Rule's predecessor or Rule 203. *See Paralyzed Veterans of Am. v. D.C. Arena L.P.*, 117 F.3d 579, 586 (D.C. Cir. 1997) ("Under the APA, agencies are obliged to engage in notice and comment before formulating regulations.").[5]

Cementing the fact that constitutionally required notice was not afforded here is clear evidence that optionsXpress's regulators themselves found the regulation unclear, acknowledged a need for further amendment, and never concluded that the firm or its customers violated the rule (as discussed further *infra* at Section II.B). For example, the CBOE investigator who supervised CBOE's investigation of optionsXpress testified that "we [CBOE] weren't sure what the rule was trying to express." Tr. 3983:2-9 (MacDonald); FOF ¶ 149. After obtaining guidance from the SEC, however, CBOE cleared the firm three separate times. Moreover, the authors of the rule determined that the trading was "something other than a sham closeout," and expressed their belief that this "activity would ***not be considered a violation of 204.***" Tr. 3998:3-9 (MacDonald); OPX 559, DX 237 (emphasis added), FOF ¶¶ 166, 245, 355. And the former Director of Trading and Markets himself testified that the trading "satisfied [the firm's] obligation under SHO." Tr. 3211:18-24 (Sirri).

If the regulators who wrote and enforced the rule were not on sufficient notice of the purported violation here, optionsXpress certainly had no such notice. In fact, despite

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[5] The Division's attempt to interpret and expand the scope of the Rule 204(f) textual language stands in marked contrast to other contexts in which the staff has, through proper rulemaking, issued interpretive guidance providing industry participants with needed clarity on new rules. For example, in 2003 the SEC issued a formal interpretive release to address concerns about certain types of married put transactions (purchases of puts in conjunction with purchases of the underlying security) structured to avoid the short sale rules. Recognizing that married puts can be part of a legitimate hedging strategy, a use it did not wish to discourage, the SEC clearly and carefully delineated those circumstances in which married puts could be used to create sham long positions in order to evade SEC rules. Appreciating the gray areas in its rules, the SEC published clear examples of activity it would deem legitimate and illegitimate. Securities Exchange Act Release No. 48795 (Nov. 18, 2003) (http://www.sec.gov/rules/interp/34-48795.htm). The APA and due process require no less.

optionsXpress's best efforts to attain "ascertainable certainty," the regulators at the SEC and FINRA only exacerbated confusion regarding the regulation's scope.[6] Only later – and without notice – did the Division decide that the activity was unlawful. But where an agency "effectively decid[es] to use a citation [or other punishment] as the initial means for announcing a particular interpretation – or for making its interpretation clear," the court "must ask whether the regulated party received, or should have received, notice of the agency's interpretation in the most obvious way of all: by reading the regulations." *Gen. Elec. Co.*, 53 F.3d at 1329 (internal citations and quotations omitted).

Here, the plain language of Rule 204, along with the conduct of the regulators, did not provide optionsXpress with notice that the activity at issue was unlawful. Indeed, as John Ruth (a market participant involved in Reg. SHO compliance) testified, market participants would not reasonably have anticipated that Reg. SHO applied under these circumstances. FOF ¶ 206. Courts have consistently found due process violations under analogous circumstances. *See, e.g., Gen. Elec. Co.*, 53 F.3d at 1332 (D.C. Cir. 1995) (notice inadequate where "different divisions of the enforcing agency disagree about their meaning"); *see also PMD Produce Brokerage Corp. v. U.S.D.A.*, 234 F.3d 48, 53 (D.C. Cir. 2000); *United States v. Chrysler Corp.*, 158 F.3d 1350, 1355-56 (D.C. Cir. 1998).

Such a finding would be particularly appropriate here, where the Division relies heavily on a footnote (82) that was not provided to the public until July 2009 – about half-way into the relevant period. At a minimum, it would violate the firm's due process rights to find it was

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[6] Such confusion was not limited to this case. According to the United States Government Accountability Office: "Trading and Markets' varied and at times untimely responsiveness to industry and SRO requests for interpretive guidance on Reg. SHO and the emergency orders conflict with the goals articulated in SEC's current Strategic Plan." OPX 646; FOF ¶ 336.

violating the terms of a regulatory footnote ***before*** it was even published. *See Affum*, 566 F.3d at 1163.

In sum, the Division would have this Court hold that, at some point, a pattern of assignment, buy-in and reestablishment violates Reg. SHO. If that were true, where should that line be drawn? For the benefit of firms that must structure their policies and procedures to ensure compliance, what is the standard to which firms are held?[7] The Division never answers these questions. Due process and the Administrative Procedure Act require clear notice of legal requirements. As Justice Kennedy put it:

> A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required. . . . This requirement of clarity in regulation is essential to the protections provided by the Due Process Clause of the Fifth Amendment. . . . It requires the invalidation of laws that are impermissibly vague. ***A*** conviction or ***punishment fails to comply with due process if the*** statute or ***regulation under which it is obtained "fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement.***"

F.C.C. v. Fox Television Stations, Inc., 132 S. Ct. 2307, 2317 (2012) (internal citations omitted) (emphasis added). The Division's entire case runs afoul of this fundamental principle.

II. The Division failed to prove that optionsXpress aided and abetted or caused Feldman's alleged securities fraud or Rule 10b-21 violation.

The Division's claims that optionsXpress aided and abetted, or otherwise caused, Feldman's alleged securities frauds are frivolous. This explains why the Division devotes such

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[7] The issues of persistent CNS fail to deliver positions from assignment and reestablishment are not unique to this case and these respondents. Dr. Saha and John Ruth testified to other strategies that employ deep-in-the-money calls, reverse conversions and box spreads, including risk arbitrage and dividend capture, and that whenever deep-in-the-money calls are written, there is risk of assignment. FOF ¶¶ 38, 78. They and others also testified that based on CNS data, persistent fails are commonplace and were not limited to optionsXpress. FOF ¶ 290. In the absence of other guidance, the only way a participant can ensure that its CNS position nets to zero would be to refuse any further orders in the security that was the subject of the close-out, a result that would pose harm to customers with open positions subject to market risk, and discourage a wider range of trading and arbitrage strategies that otherwise promote price efficiency.

little attention to these serious charges, just 1 ½ pages. To prevail on these fraud claims, the Division must first prove that Feldman committed a primary fraud violation, and then that optionsXpress acted with the requisite scienter to aid and abet or cause that primary violation. *See, e.g., Howard v. S.E.C.*, 376 F.3d 1136, 1142-43 (D.C. Cir. 2004). The Division has failed to satisfy either requirement.

A. The Division has failed to prove a primary fraud violation.

The fraud claims against optionsXpress fail because the Division did not prove that Feldman committed a primary violation. *See In re Haynes*, SEC Rel. No. 78, 1995 WL 696623, at *23 (Nov. 24, 1995). As the Supreme Court has held, there are two types of fraud actionable under the federal securities laws, manipulation and deception. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977). In this case, the Division has proven neither.

1. There was no underlying violation of Reg. SHO.

Here, the alleged fraud is based on a theory that the alleged violations of Reg. SHO amounted to a manipulative scheme that deceived investors. That is, the OIP alleges no other attempted fraud, and alleges no fraudulent misrepresentations. *See* OIP ¶ 2; Div. Br. 5, 26-27. Nor does the Division even attempt to argue that its theory of untimely buy-ins supports a claim a fraud. As set forth above (*see supra* at 3-32) and in Feldman's post-hearing brief (at 4-17), the Division has failed to prove that the buy-write trading violated Reg. SHO. A failure to prove a Reg. SHO violation necessarily means the fraud claim also must be dismissed. *See* Tr. 3055:25-3056:8 (Sirri); FOF ¶ 318.

2. There was no market manipulation.

The evidence also was insufficient to prove a fraudulent manipulation. "'Manipulation' is 'virtually a term of art when used in connection with securities markets.' The term refers

generally to ***practices***, such as wash sales, matched orders, or rigged prices, ***that are intended to mislead investors by artificially affecting market activity***." *Santa Fe Indus.*, 430 U.S. at 476 (emphasis added) (citation omitted).

The bottom line is that there is no fraud without a victim. Yet, the Division identified no such victim here. In fact, it presented no evidence that the trading at issue was manipulative or otherwise artificially affected market activity. Dr. Harris conceded he "did not study" whether "Feldman's trading had [a] meaningful impact on market price." Tr. 1552:19-25; *see also* FOF ¶¶ 312-313. And Dr. Saha filled that gap to find, without contradiction, that "stock prices did not fall as a result of the buy-write transactions." FOF ¶ 328.

The record also was completely devoid of any evidence that any market participant was harmed, i.e., there was no evidence anyone was deprived of voting rights, dividends, or stock loan fees. Dr. Harris admitted that he did no analysis to support such an argument. FOF ¶¶ 320-322, 326. And Dr. Saha gave unrebutted testimony that flatly contradicted the Division's claim of manipulation: "regardless of what happens at the CNS level, at the customer level they are credited" and, therefore, they can exercise their voting rights and receive dividends to which they are entitled. FOF ¶ 321. Indeed, it strains credulity that if the Division's theory (and it is nothing more than a theory) were correct, there would not be a single letter of complaint from a counterparty or some other document to prove it.

3. There was no misrepresentation or omission.

As discussed, the OIP alleges no misrepresentations or omissions by Feldman, and the testimony was consistent that he did not make misrepresentations to anyone, as discussed in Feldman's brief (pages 18-26). The Division presented no evidence to support such a

misrepresentation allegation.[8] The Division thus literally has no evidence of a primary fraud violation, and on this basis alone, the fraud charge must fail.

B. The Division failed to prove that optionsXpress acted with the requisite scienter or negligence.

Even if the Court were to find that Feldman did engage in fraud, to prove its aiding and abetting charge against optionsXpress the Division also would have to show the firm acted with at least "extreme recklessness." Div. Br. 27, 38-39 (citing *Howard*, 376 F.3d at 1143). The D.C. Circuit explained that this "extreme recklessness" standard requires an "obvious" violation of the law:

> Extreme recklessness . . . may be found if the alleged aider and abettor encountered "red flags," or "suspicious events creating reasons for doubt" that should have alerted him to the improper conduct of the primary violator, or if there was "a danger . . . so obvious that the actor must have been aware of" the danger. It is not enough that the accused aider and abettor's action or omission is "derived from inexcusable neglect." "Extreme recklessness" is neither ordinary negligence nor "merely a heightened form of ordinary negligence.

Id. at 1143 (internal citations or quotations omitted). Under this controlling precedent, there can be no extreme recklessness as a matter of law where: (1) "rather than red flags, [the respondent] encountered green ones"; (2) "the [applicable law] . . . has never been clear"; or (3) the theory of liability turns on whether the respondent "should have known . . . the legal requirements" under a securities "rule whose language was silent on the subject." *Id.* at 1145, 1147-49. As explained below, all three points are applicable to the facts of this case and negate the presence of scienter here.

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[8] The Division cites *Wharf (Holdings) Ltd. v. United Int'l Holdings Inc.*, 532 U.S. 588 (2001), for the proposition that it can constitute a fraudulent omission for someone to sell an option to a counterparty with the secret, undisclosed intent not to deliver stock to the counterparty if the option is exercised. However, here the customers always satisfied their contractual obligations to their counterparties. The Division's only argument is that the customers then entered into additional transactions to re-establish their positions. *Wharf (Holdings)* is an entirely different and inapposite fact pattern.

With regard to the Section 17(a)(3) claim, which summarily alleges that the firm caused a fraud committed with negligence, the Division still must prove that the firm "knew, or should have known, that [its] conduct would contribute to the violation." Div. Br. 33, 39 (citing *In re Robert M. Fuller*, SEC Rel. No. 8273 (Aug. 25, 2003)). To prove negligence, the Division must establish that optionsXpress "fail[ed] to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation" or acted with "culpable carelessness." *In re John P. Flannery & James D. Hopkins*, SEC Rel. No. 438, 2011 WL 5130058, at **33-34, 48 (Oct. 28, 2011) (Murray, Chief ALJ) (finding no negligence where respondent believed the truthfulness of certain reasonable language and relied on other knowledgeable persons).

As shown below, the record in this case makes a finding that optionsXpress acted with the requisite scienter, or even negligence, impossible.

1. The regulators gave optionsXpress multiple "green" flags.

The regulators themselves gave optionsXpress several "green" flags, evidence that bars a showing of extreme recklessness as a matter of law. *Howard*, 376 F.3d at 1147. For example:

- **<u>September 23, 2009</u>**: CBOE issues Letter of Caution to optionsXpress regarding Zelezny trades finding ***no violation*** of Reg. SHO. OPX 89; FOF ¶ 211.
- **<u>September 24, 2009</u>**: Recapping call with SEC, Stern sends e-mail stating: "***SEC said to keep doing what we are doing re: the Reg. Sho and short selling.***" OPX 246 at 746-47 (emphasis added). Internal FINRA report of this call confirms that Trading and Markets "told the firm that the activity would ***not be considered a violation of 204.***" DX 237 (emphasis added); FOF ¶¶ 245, 355.
- **<u>December 2 and 10, 2010</u>**: CBOE "determined that no violations of the Securities and Exchange Commission or Exchange rules were apparent with respect to the materials reviewed in conjunction with [two Reg. SHO] inquir[ies]." OPX 151; OPX 152; FOF ¶¶ 271-273.

optionsXpress acted reasonably – and certainly not recklessly or negligently – by relying on findings and advice by its primary regulator that the trading at issue did not violate Reg. SHO, much less constitute fraudulent misconduct. Indeed, representatives from all three regulators

testified that even after optionsXpress presented them with examples of the trading at issue, they never told the firm the trading violated Reg. SHO. FOF ¶¶ 214, 225, 253, 248-49, 265. Nor did any of optionsXpress's regulators tell the firm to stop the trading out of caution (or for any reason) until March 2010, when the firm shut down the trading. FOF ¶ 214-15, 225, 249, 253, 265, 267-69. These repeated green flags by regulators are sufficient, in and of themselves, to bar the Division's fraud claim. *Howard,* 376 F.3d at 1147.

2. Any violation here was far from "clear."

The Division also cannot prove fraud because the record independently confirms that it was far from "clear" whether the trading violated Reg. SHO, much less whether it was fraudulent. *Id.* at 1147-49.

First, Rule 204 does not expressly address the buy-write trading at issue here; indeed, it does not specifically address options trading at all. This undisputed fact, alone, provides an independent basis to reject the Division's Reg. SHO or fraud claims. *Id.* at 1145-49 (rejecting, as a matter of law, claim that extreme recklessness can be found where the respondent "should have known . . . the legal requirements" under a securities "rule ***whose language was silent on the subject***") (emphasis added).

Second, the Division cannot credibly argue that the law "clear[ly]" prohibited the trading at issue here in light of the following key evidence that comes directly from the government itself – including the internal regulatory files of CBOE and FINRA, as well as testimony from these regulators:

- <u>May 20, 2009</u>: SEC (Tao and Crane) tells CBOE in response to the trading at issue: "no fail no violation." OPX 647 at 1. CBOE recaps the call by stating: "SEC felt that the Zelezny's were conducting and maintaining a hedge to their position appropriately." OPX 129 at 3; FOF ¶¶ 160-61, 210, 335.

- **June 2009**: CBOE asks SEC "point blank" whether the trading is "a sham closeout," to which SEC responded: "it appears to be something else." Tr. 3997:10-3998:9 (MacDonald); FOF ¶ 166.

- **June 19, 2009**: CBOE issues report confirming that "the Zelezny's were appropriately maintain[ing] hedged position in multiple securities" and "[n]o fails ever occurred in any account maintained by Zelezny." The regulators thus "recommended that this matter be Filed without Action[.]" OPX 129 at 4-5; FOF ¶¶ 160-161, 177.

- **August 5, 2009**: Tao recognizes Rule 204 does not cover the trading at issue and asks: "***Should we propose a rule*** that would add a circumvention with no economic purpose rule?" OPX 559 at 1 (emphasis added); FOF ¶ 183.

- **October 2, 2009**: According to FINRA file, SEC told optionsXpress the trading "activity would ***not be considered a violation of 204***." DX 237 (emphasis added); *see also* Tr. 2837:12-20 (Huber); FOF ¶¶ 245, 355.

- **February 3, 2010**: CBOE letter to the SEC recaps May 20, 2009 call and confirms, yet again, that CBOE "had been informed [by Trading and Markets] that there was not a Regulation SHO violation." OPX 605 at 2; FOF ¶¶ 334-335.

Third, the record is replete with evidence that compliance officers at optionsXpress carefully analyzed whether the trading at issue violated Reg. SHO or otherwise was unlawful. These efforts to ensure compliance are evidence of good faith, a relevant consideration in evaluating scienter. *Howard*, 376 F.3d at 1147-48; *see also Flannery*, 2011 WL 5130058, at *48 (finding no negligence where "Flannery reasonably relied on . . . other knowledgeable persons").

Fourth, expert testimony further belies any finding of recklessness or negligence here. Dr. Sirri, the former Director of Trading and Markets, testified that the buy-writes "satisfied [the firm's] obligation under SHO," a regulation over which he had responsibility while at the SEC. Tr. 3211:18-24. And John Ruth – the only individual to testify in this case outside of optionsXpress personnel who had responsibility for Reg. SHO compliance – testified without rebuttal that Reg. SHO "was not clear, particularly as it applied to options trading. . . ." OPX 250 at ¶ 41.

3. **optionsXpress proactively contacted its regulators to determine whether the trading violated Reg. SHO.**

As discussed above, CBOE found no Reg. SHO or fraud liability, the SEC lawyers who wrote the rule also found that the "activity would not be considered a violation of 204," and their former boss (Dr. Sirri) testified to his opinion that there was no such violation. FOF ¶¶ 245, 208-215, 338. It is hard to conceive of more compelling evidence to defeat the Reg. SHO and fraud claims. Yet, the record also is replete with further evidence that optionsXpress carefully considered the law and contacted its regulators to determine whether the trading at issue was proper. This evidence belying any finding of extreme recklessness or culpable carelessness includes:

- **September 2008**: In an e-mail exchange after Rule 204T became effective, CBOE "confirm[ed]" that optionsXpress traders "do not need to close out a position if [they] are concerned about assignment risk" as long as the company "meet[s] [its] delivery obligation." DX 326; FOF ¶ 114. In response, optionsXpress quickly adopted new procedures to ensure compliance. *See* OX 242; FOF ¶¶ 112-114.
- **Fall 2008:** The firm's Legal, Compliance, Operations, Clearing, and Execution Departments discussed the *Arenstein* settlements and found the trading to be materially different. FOF ¶¶ 133-141.
- **Spring and summer of 2009:** The firm fully complied with CBOE's routine investigation of the trading at issue. *See, e.g.*, OPX 339; FOF ¶¶ 129-130.
- **August 6, 2009**: The firm analyzed the *Hazan* and *TJM* settlements, and Strine authored a detailed e-mail distinguishing the trading. OPX 678; FOF ¶¶ 184-195.
- **September 24, 2009:** The firm asked FINRA for guidance on whether it could bundle buys and writes for best execution. FINRA suggested the firm contact SEC. FOF ¶ 229. The firm told FINRA it would continue to allow its customers to keep trading because of the lack of a clear rule. Tr. 2724:11-25 (Aylward); FOF ¶ 229.
- **September 24, 2009:** The firm called Trading and Markets seeking guidance. In response, SEC told the firm to "keep doing what you're doing." FOF ¶ 242. While SEC later told the firm it could give "no comfort" on that issue due to pending FINRA inquiries, no regulator ever told optionsXpress the trading was unlawful, or otherwise asked the firm to stop the trading – until March 2010. FOF ¶¶ 247-249, 253, 265, 269.

- **<u>March 2010</u>**: The firm shut the trading down after, for the first time, the Division expressed its discomfort with the trading. FOF ¶¶ 267-270.

This timeline, supported by documentary evidence from optionsXpress and testimony by the regulators themselves, shows that optionsXpress continuously and proactively sought guidance from regulators to ensure compliance under a changing and oftentimes contradictory regulatory regime. The Division offered no expert to rebut the testimony by Ruth demonstrating the reasonableness of optionsXpress's conclusion that its customers' trading was qualitatively different than the trading that was the subject of enforcement actions like *Hazan* and *TJM*.

4. The evidence cited by the Division fails to show aiding and abetting or causing fraud.

The Division's purported evidence of scienter comes nowhere close to proving up its fraud claims based on a theory of aiding and abetting or causation. First, the Division relies primarily on musings by regulators that the trading "could" or "may" violate the law. According to the Division: (1) "optionsXpress was informed by Ms. Tao of Trading & Markets that the trading at issue ***could be a fraud***"; and (2) "optionsXpress's in-house counsel's notes reflect that they were informed that the customers' transactions ***may be a 'sham.'***" Div. Br. 39 (emphasis added). But this alleged evidence is both factually and legally insufficient to demonstrate the scienter needed to establish fraud.

Even if Tao asked the firm to consider whether the conduct could be unlawful, such a question is hardly enough to support a theory of culpable carelessness, much less extreme recklessness. There is no evidence that Tao ever articulated a theory of manipulation or deception or identified a possible victim. At the very most, she simply asked a question – one that carries no weight here. As Tao herself readily conceded, "I tend to be known as the person

who says the word fraud a lot." Tr. 3775:1-4; *see also* Tr. 3714:1-8; 3733:13-22 (Tao); FOF ¶ 352.

In fact, there was no basis to find a fraud at the time, as confirmed by the testimony of Timothy MacDonald, a CBOE Director. As he explained on the stand, Tao suggested that he look into potential fraud charges based on the trading at issue. When he did, he found that ***such a fraud "charge just wasn't lining up with the facts"***:

> Q: Did you find fraud?
>
> A: No.
>
> Q: Did you find any intent to manipulate the market?
>
> A: No.
>
> Q: Any intent to manipulate . . . the market as to optionsXpress or the customer?
>
> A: No.
>
> Q: No as in you didn't find any such intent?
>
> A: Did not find anything.
>
> ***Q: Did you find that a possible 10b-5 charge just wasn't lining up with the facts?***
>
> ***A: Correct.***

Tr. 3994:18-3995:15 (emphasis added); FOF ¶ 158.

Second, the Division argues that optionsXpress should have known Feldman's trading was fraudulent because three other brokers prohibited it. This assertion is also insufficient to establish scienter on optionsXpress's part. First, there is no evidence that any of the brokerage firms shut down Feldman's trading because they believed there was a Reg. SHO violation, much less a fraud. FOF ¶¶ 363-367. Second, and most importantly, it would be impossible to establish optionsXpress's scienter based on the actions of third parties that optionsXpress was not even aware of during the relevant period.

Moreover, two of the three firms (TD Ameritrade and E*Trade) stopped Feldman's trading ***after*** the relevant period in this case – that is, ***after*** optionsXpress itself stopped Feldman's trading. FOF ¶ 364. This action by these two firms obviously could have no possible relevance to optionsXpress's state of mind during the relevant period. And there is no evidence that either of these firms ever notified optionsXpress or that optionsXpress was otherwise aware that they stopped Feldman's trading. Thus, the Division's proof is several steps removed from even being relevant to the fraud charge against optionsXpress. *See La. Sch. Employees' Ret. Sys. v. Ernst & Young LLP*, 622 F.3d 471, 480-85 (6th Cir. 2010) ("Conclusory allegations about what [defendant] must or should have known . . . do not amount to specific allegations that show material misstatements or omissions committed with recklessness").

Only Penson/Terra Nova terminated Feldman's trading during the relevant period, but that action also has no relevance to establishing any scienter on the part of optionsXpress. Robert Crain, the only Penson employee to testify, conceded that he never once told optionsXpress that his firm believed Feldman's trading violated Rule 204, much less constituted a fraudulent manipulation. On the contrary, he admitted that Penson's decision to ask Feldman to leave was based on the large capital requirements of Feldman's account and Penson's own capital challenges, rather than regulatory concerns. FOF ¶¶ 365-367.

C. In addition, the Division failed to prove that optionsXpress aided and abetted and caused Feldman's alleged violation of Rule 10b-21.

The Division's claim under Rule 10b-21 fails as a matter of law. Rule 10b-21 "targets short sellers who deceive their broker-dealers about their source of borrowable shares for purposes of complying with Regulation SHO's 'locate' requirement." Rule 10b-21 Adopting Release, 73 Fed. Reg. 61666, 61674 (Oct. 17, 2008). Rule 10b-21 has four elements: (1) an order to sell a security; (2) deceiving a broker-dealer, participant of a registered clearing agency,

or purchaser regarding his intention, or ability, to deliver the security by settlement date; (3) failure to deliver the security by settlement date; and (4) requisite scienter. 17 C.F.R. § 240.10b-21 (2012).

Tellingly, the Division made no effort at the hearing to develop its Rule 10b-21 allegations, because that claim is unfounded and illogical: i.e., the Division is essentially accusing a broker-dealer of aiding and abetting a customer to deceive *itself*. (*See* Feldman Br. at 37-39). Not a single witness testified that Feldman either elected to provide his own locate source, or that he represented to optionsXpress (or anyone else) that he had an ability or intent to deliver securities. Nor did any witness testify that Feldman ever deceived anyone regarding his intention, or ability, to deliver the security by settlement date. Rule 10b-21 is only triggered when a seller ***misrepresents*** to a broker-dealer, clearing participant, or purchaser that the seller has the shares or has a locate source for the shares. *See* 73 Fed. Reg. at 61674. Absent some deception or misrepresentation, Rule 10b-21 simply does not apply.

Rule 10b-21 also addresses only orders to sell. *See* 17 C.F.R. § 240.10b-21. But this case does not involve orders to sell; rather, it deals with assignments of option contracts. The rule does not mention an obligation to locate or deliver stock when a customer sells call options.

To violate Rule 10b-21, there also must be an actual failure-to-deliver. *See* 73 Fed. Reg. at 61671 ("Further, because one of the principal goals of Rule 10b-21 is to reduce fails to deliver, violation of the rule will occur ***only if*** a fail to deliver results from the relevant transaction.") (emphasis added). As discussed above, optionsXpress properly delivered all securities, so no one was deprived of stock ownership in this case.

Finally, the Division has failed to demonstrate that optionsXpress had the requisite scienter needed to substantially assist Feldman to deceive a broker-dealer. In fact, there is no

such allegation. As the Commission recognized when Rule 10b-21 was proposed, the possibility of an aiding and abetting claim under this rule "is modest":

> So a key element to establish the primary violation is that the broker/dealer was deceived. In order to establish an aiding and abetting charge, not only must there be a primary violation and substantial assistance, but the broker/dealer has to know of the violation. So it is close, maybe not exactly, but close to a ***contradiction*** in terms that the broker/dealer would have both been deceived and know about the potential violation. ***So I think the realm of aiding and abetting liability here is modest.*** Broker/dealers, of course, could be primary violators if they in turn deceive other participants in the transaction under the proposed rule.

DX 401 at 9 (emphases added); FOF ¶ 369. And the hearing showed it does not apply here.

III. The remedies sought by the Division are unsupported and excessive.

Even if this Court were to rule against optionsXpress on the merits, it should not order the arbitrary and unsupported remedies requested by the Division.

A. If ordered, disgorgement should be limited to net profits from commissions related to the buy-write trading.

Disgorgement is unwarranted because optionsXpress acted lawfully. But, if ordered, disgorgement must be limited to net ***profits*** from the commissions earned as a result of the buy-write trading – not the hard-to-borrow fees optionsXpress allegedly avoided. Disgorgement must be a "reasonable approximation of profits causally connected to the violations." *In re Ronald S. Bloomfield*, SEC Rel. No. 416A, 2011 WL 1591553, at *35 (Apr. 26, 2011) (Murray, Chief ALJ).

The Division failed to meet its burden of showing a reasonable approximation of profits. Even under the Division's theory that every buy-write constituted a Reg. SHO violation, the appropriate amount to disgorge cannot exceed $1,574,999, the amount of commissions Dr. Harris calculated were paid to optionsXpress as a result of the buy-write trades that are at the

heart of this case. *See* FOF ¶ 370.[9] But even this amount is far too high, because it reflects commission revenues – ***not*** profits (i.e., revenues less expenses). By ignoring expenses, Dr. Harris provided a grossly inflated estimate of profits. *See* FOF ¶ 372 (explaining that firm's profit margin was approximately 44%). This figure also includes commissions earned before the adoption of Rule 204(f) and the publication of footnote 82, on which the Division relies to support its theory of liability. Any profits on commissions before July 31, 2009, should thus be excluded.

The Court should summarily reject the Division's argument that $1,908,744 should be disgorged because – as Dr. Harris concedes – this figure includes commissions that were paid as a result of trades ***other*** than the buy-writes. *See* DX 310 at ¶ 42 (Harris Rpt.); FOF ¶ 370. Commissions paid based on other transactions are not causally connected to the alleged violation, and thus should not be disgorged.

The Division also departs from all reason by seeking disgorgement of the hard-to-borrow fees supposedly avoided by optionsXpress. *See* Div. Br. 42. This requested remedy is patently absurd because optionsXpress did not avoid paying any hard-to-borrow fees. Rule 204 states plainly that a market participant may either borrow ***or*** purchase securities of like kind and quantity. 17 C.F.R. § 242.204. Thus, by the very terms of the rule, optionsXpress was not obligated to pay hard-to-borrow fees, and the Division cannot point to any rule or regulation that says otherwise. Its theory makes no sense whatsoever.

Even if the Court were to accept this nonsensical argument, it should reject the $7 million figure proposed by the Division. As discussed, optionsXpress consistently and repeatedly sought guidance from regulators to ensure it was complying with Reg. SHO. In light of the firm's track

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[9] Dr. Harris's report shows that the commissions related to Feldman's buy-write trading for the specific periods of time alleged in the OIP are just $807,213. FOF ¶ 371.

record of good faith, and the muddled directives it received from regulators, the Court should exercise its discretion and reject the inflated and excessive figure urged by the Division. *See S.E.C. v. Huffman*, 996 F.2d 800, 803 (5th Cir. 1993) (court has "broad discretion" in fashioning equitable remedy of disgorgement); *see also In re Gregory M. Dearlove, CPA*, SEC Rel. No. 315, 2006 WL 2080012, at *63 (July 27, 2006) (rejecting Division's requested disgorgement).

B. The Division failed to establish the basis for a civil penalty.

The gross deficiencies in the Division's proof is matched only by the gross hyperbole in the penalty it demands – close to ***$1 billion*** for a purported and unproven technical and victimless violation of a strict-liability rule. The truth is, the Division has failed to establish that any civil penalty is warranted.

In this case, a penalty would not serve the public interest. Relevant factors to this determination include (1) whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the harm to other persons resulting either directly or indirectly from the act or omission; (3) the extent to which any person was unjustly enriched; (4) whether the respondent previously had been found by the Commission or another regulatory agency to have violated the securities laws, or the rules of a self-regulatory organization; and (5) the need to deter the respondent and other persons from committing the acts or omissions. *See* 15 U.S.C. § 78u-2(c).

For the reasons discussed above, the Division has failed to prove fraud, manipulation, or reckless disregard of a regulatory requirement. For these reasons, second- and third-tier penalties are legally unavailable here, and the first factor for any kind of penalty also is absent.

The Division argues that optionsXpress harmed market participants, undermined market integrity, and greatly profited from the alleged scheme. *See* Div. Br. 44. But the evidence at

trial belies such claims. As already demonstrated, the Division failed to introduce a shred of evidence that other market participants were harmed, or that market integrity was undermined. Dr. Harris admitted "[t]here is no data that supports that" – i.e., evidence that "Feldman and optionsXpress . . . undermined market integrity." Tr. 1546:8-1547:5; FOF ¶ 330. Dr. Harris further testified that he did no analysis to support his conclusory assertions that market participants could not vote their stock or that market participants failed to receive dividends as a result of optionsXpress's conduct. Tr. 1426:23-1427:15; 1429:2-11; FOF ¶ 322.

And the Division's contention that optionsXpress greatly profited from the alleged scheme is divorced from reality. Even according to the Division's calculation, optionsXpress, over the course of 18 months, earned only $1.9 million in commission revenues from ***all*** accounts referenced in the OIP, not just Feldman's account, and from all trades, not just buy-writes. *See* Div. Br. 42 n.16; *see also* FOF ¶ 370. Such a figure hardly qualifies as substantial enough to warrant a finding that the firm "greatly profited" from the alleged scheme.

Finally, even if a penalty were warranted, it should be far less than what the Division proposes. According to the Division, a third-tier penalty of $725,000 is appropriate for each "act or omission" in violation of Reg. SHO. *See* Div. Br. 44. It then veers toward absurdity by noting that "optionsXpress violated Reg. SHO in 25 securities on at least 1,200 occasions," which would require an astronomical $870,000,000 penalty. *Id.* at 45 n.17. To say the least, it would be a gross misreading of Exchange Act section 21B(a) to impose a fine of nearly ***one billion dollars*** for such a technical, strict liability violation.

The Division has focused on the ***pattern*** of conduct that allegedly "harmed market participants and undermined market integrity," not individual and separate buy-ins. Thus, if the Court were to find a Reg. SHO or Rule 10b-21 violation, the public interest would be best served

by assessing a first-tier penalty of no more than $75,000 based on a single violation. *See, e.g., In re J.P. Turner & Co., LLC*, SEC Rel. 395, 2010 WL 2000509, at *17-18 (May 19, 2010) (rejecting Division's theory of multiple violations for respondent's repeated republication of deficient written supervisory procedures). Any higher penalty would not be appropriate, because the record does not support a finding of second or third tier violations (warranted only for acts of fraud, deceit, manipulation, or deliberate or reckless disregard of the law). *See* 15 U.S.C. § 78u-2(b); *see also* Marc I. Steinberg & Ralph C. Ferrara, Securities Practice: Federal and State Enforcement §§ 6:10, 6:11 (2012).

C. The Court should not enter a cease-and-desist order.

Finally, there is no basis for a cease-and-desist order. It is undisputed that optionsXpress immediately ceased the buy-write trading at issue when asked to stop; thus, the conduct at issue ceased over three years ago. Moreover, the Division's own expert was unable to identify a single victim, and he conceded that share prices were not impacted – thus further undermining the need for a cease-and-desist order. *See In re KPMG Peat Marwick LLP*, SEC Rel. No. 1360, 2001 WL 47245, at *26 (Jan. 19, 2001).

The Division argues that "optionsXpress is still a registered broker dealer and thus has the opportunity to commit future violations." Div. Br. 46. But such a vacant assertion is insufficient as a matter of law to justify a cease-and-desist order, as recognized by the D.C. Circuit:

> Under this view, apparently, the "risk of future violation" element is satisfied if (1) a party has committed a violation of a rule, and (2) that party has not exited the market or in some other way disabled itself from re-commission of the offense. Given that the first condition is satisfied in every case where the Commission seeks a cease-and-desist order on the basis of past conduct, and the second condition is satisfied in almost every such case, this can hardly be a significant factor in determining when a cease-and-desist order is warranted. ***The Commission itself has disclaimed any notion that a cease-and-desist order is***

> ***"automatic" on the basis of such an almost inevitably inferred risk of future violation.***

WHX Corp. v. S.E.C., 362 F.3d 854, 859 (D.C. Cir. 2004) (emphasis added).

CONCLUSION

For the reasons stated above, the Division failed to show that optionsXpress violated Reg. SHO or that it aided and abetted or caused any fraud.[10]

Dated: January 11, 2013

Respectfully submitted,

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ATTORNEYS FOR OPTIONSXPRESS, INC.

[10] optionsXpress incorporates by reference the post-hearing briefs of Respondents Jonathan Feldman and Thomas Stern.

EXHIBIT A

optionsXpress, Inc.: Synopsis of Witnesses' Hearing Testimony (File No. 3-14848)

Witness	Title / Role	Education / Licenses	Key Areas of Testimony
Aylward, Christina	Senior Regulatory Analyst, Market Regulation Department Short Sales Team (FINRA)	Boston College	• Conducted investigation of optionsXpress based on FINRA's automated Reg. SHO surveillance (Tr. 2677:6-2680:4) • Participated in September 2009 telephone conferences with optionsXpress re Reg. SHO compliance (Tr. 2680:12-2689:18; 2697:20-2724:25) • Discussed optionsXpress's Reg. SHO compliance with CBOE in January 2010 (Tr. 2725:1-2744:6)
Colacino, Louis	Director, CNS Operations Department (DTCC)	High School (no college)	• Analyzed CNS accounting summaries that listed optionsXpress's and other participants' net positions in each security (Tr. 39:13-68:8; 85:2-104:4; 124:17-129:21) • Explained CNS notices of intention to buy-in issued to optionsXpress (Tr. 68:9-82:22; 104:5-113:24)
Coronado, Jeremy	Trading Specialist (optionsXpress)	Purdue University, North Central; Series 3, 4, 7, and 63 licenses	• Dealt directly with Feldman and other customers, placing sell call orders in conjunction with buy-ins, per their instructions (Tr. 519:15-520:7; 536:3-537:12; 632:24-635:1) • Communicated with compliance, supervisors, and customers regarding Reg. SHO compliance and buy-in procedures (Tr. 541:25-546:20; 614:18-621:11)
Crain, Robert	Risk Management Director (First Global Capital Corporation) / Former Vice President of Risk (Penson)	Bailey University, B.B.A.; Dallas Baptist University, M.B.A.; Series 7, 24, and 66 licenses	• Set margin and capital requirements for Feldman's trades cleared by Penson and analyzed concerns regarding Feldman's trading activity (Tr. 763:9-765:15; 772:19-774:22)

optionsXpress, Inc.: Synopsis of Witnesses' Hearing Testimony (File No. 3-14848)

DeMaio, Gene	Senior Vice President, Options Regulation (FINRA)	Fordham University; Fordham University, J.D.; New York University, L.L.M.	• Participated in early 2010 telephone conference with optionsXpress re Reg. SHO compliance (Tr. 2905:2-2913:10; 2914:8-2915:17)
Feldman, Jonathan	Trader (self-employed) / Former Senior Vice President (Eastern Savings Bank)	Ner Israel Rabbinical College & Johns Hopkins University, Joint B.S.; Johns Hopkins University, M.Sc.; Ner Israel Rabbinical College, Rabbinical Ordination Masters	• Traded reverse conversions, among other positions, with optionsXpress starting in December 2008; paired sell call orders with Reg. SHO buy-ins to re-establish positions (Tr. 2110:25-2113:16; 2133:14-2152:2)
Harris, Larry	Professor of Finance and Business Economics (University of Southern California Marshall School of Business)	University of California, San Diego, B.A.; University of Chicago, M.A.; University of Chicago, Ph.D.; C.F.A. Institute, Chartered Financial Analyst	• Analyzed and opined re Saha Report, Sirri Report, and Ruth Report (Tr. 1360:18-1366:24; 1395:21-1398:5; 1401:14-1404:13; 4855:7-20)

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Huber, Yvonne	Director (FINRA)	University of Richmond, B.B.A.; Johns Hopkins University, M.Sc.	• Supervised Aylward's investigation of optionsXpress based on automated Reg. SHO surveillance (Tr. 2797:4-13) • Participated in late 2009 and early 2010 telephone conferences with optionsXpress, SEC Trading and Markets, and CBOE re optionsXpress's Reg. SHO compliance (Tr. 2847:22-2856:15; 2824:19-2838:15; 2857:4-2861:15)
Lamm, Scott	Investigator (CME Group) / Former Senior Investigator, Department of Market Regulation (CBOE)	University of Illinois	• Led CBOE's 2010 Reg. SHO inquiries to optionsXpress, triggered by automated Reg. SHO surveillance (Tr. 4661:4-4668:8; 4692:3-4702:14) • Discussed buy-write trading at optionsXpress with FINRA in early 2010 (Tr. 4726:2-4733:3)
Lapertosa, John	Managing Partner (OnPoint Executions)		• Sought liquidity for and sourced execution of Feldman's and other optionsXpress customers' buy-writes through market makers on exchange floor (Tr. 1248:23-1255:15)
MacDonald, Timothy	Director, Department of Market Regulation (CBOE)	Elmhurst College; Northern Illinois University, M.B.A.	• Supervised Overmyer's 2009 Reg. SHO investigation of optionsXpress (Tr. 3981:18-3983:6) • Sought guidance from SEC Trading and Markets staff in May and June 2009 telephone conferences regarding Reg. SHO's application to the buy-write trading activity (Tr. 3983:7-3999:15) • Supervised Lamm's 2010 Reg. SHO inquiries to optionsXpress, triggered by automated Reg. SHO surveillance (Tr. 4005:11-4008:5)

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Mikus, Roderick	Vice President of Securities Lending Operations (E*TRADE Financial)	University of Colorado; Series 7, 8, 63, 53, 24, and 27 licenses	• Analyzed E*TRADE's concerns regarding its ability to deliver shares owed by Feldman in connection with his assignment on deep-in-the-money call options (Tr. 4797:5-4803:2; 4825:15-4826:18)
Molnar, Ronald	Director of Clearing Operations (optionsXpress)	University of Illinois, Chicago, B.S.; Series 12, 24, 27, and 62 licenses	• Supervised clearing department's handling of assignments of exercised options from OCC (Tr. 279:3-281:10; 307:24-315:12) • Provided input on optionsXpress's compliance with Reg. SHO from clearing department's perspective, including the firm's buy-in procedures (Tr. 289:18-290:20)
Overmyer, Daniel	Compliance Officer (IMC Financial Markets) / Former Chief Investigator, Department of Market Regulation (CBOE)	Quincy University, B.S.; Saint Xavier University, M.B.A.; University of Pennsylvania, Certified Regulatory & Compliance Professional; Series 3, 4, 7, and 24 licenses	• Led CBOE's 2009 Reg. SHO investigation of Zelezny's buy-write trading at optionsXpress (Tr. 3810:6-11; 3815:1-19) • Sought guidance from SEC Trading and Markets staff in May and June 2009 telephone conferences and e-mails regarding Reg. SHO's application to the buy-write trading activity (Tr. 3838:7-3865:14)
Payne, August	Relationship Manager (Beacon Financial) / Former Trading Specialist (optionsXpress)	University of Colorado; Texas State, M.A.	• Served as middleman between clearing, customers, and execution to coordinate Reg. SHO buy-ins (Tr. 1874:13-19) • Communicated with compliance, supervisors, and customers regarding Reg. SHO compliance and buy-in procedures (Tr. 1917:7-1920:19; 2041:23-2043:20)

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optionsXpress, Inc.: Synopsis of Witnesses' Hearing Testimony (File No. 3-14848)

Risley, Jay	Executive Vice President of Clearing (optionsXpress)	Indiana University, B.S.; Series 7, 63, and 24 licenses	• Provided input on optionsXpress's compliance with Reg. SHO from clearing department's perspective, including the firm's buy-in procedures (Tr. 161:3-22; 182:16-186:17) • Supervised clearing department's handling of assignments of exercised options (Tr. 253:4-264:12)
Ruth, John	Financial Services Consultant (self-employed)	Indiana University, B.A.; DePaul University, M.B.A.; Series 4, 7, 10, 24, 55, and 62 FINRA licenses; NFA Principal, Associate Member, Branch Manager, and Series 3 Associated Person	• Analyzed and opined re Harris Report and Sheehy Report (Tr. 4166:5-4169:7)
Saha, Atanu	Senior Vice President and Head of New York Office (Compass Lexecon)	University of Alberta, Canada, M.A.; University of California, Davis, Ph.D.	• Analyzed and opined re Harris Report and Sheehy Report (Tr. 4173:17-4375:7)
Sheehy, Brendan	Trader (PEAK6 Investments)	Indiana University (Kelley School of Business); Series 56 license	• Analyzed and opined re Saha Report, Sirri Report, and Ruth Report (Tr. 653:24-659:18; 691:23-695:18; 696:1-701:18)

Sirri, Erik	Professor of Finance (Babson College)	California Institute of Technology, B.S.; University of California, Irvine, M.B.A.; University of California, Los Angeles, Ph.D.	• Analyzed and opined re Harris Report and Sheehy Report (Tr. 2966:22-2969:8; 3004:4-17)
Stella, Giovanni	Broker (Exchange Financial Access) / Former Execution Trader (optionsXpress)	Loras College; Series 3, 4, 6, 7, 24, and 63 licenses	• Dealt directly with Feldman and other customers, placing sell call orders in conjunction with Reg. SHO buy-ins, per their instructions, with floor brokers (Tr. 1109:20-1114:11) • Communicated with compliance, supervisors, and customers regarding Reg. SHO compliance and buy-in procedures (Tr. 1139:6-1150:18; 1206:16-1218:9)
Stern, Thomas	Former Chief Financial Officer and Registered Financial Principal (optionsXpress)	DePauw University, B.A.; Series 4, 7, 24, 27, and 63 licenses; IIROC Registered OSC and PD & O, CCO, and Options Principal	• Served as "utility infielder" among optionsXpress staff and primary liaison between optionsXpress and regulators (Tr. 1621:22-1622:17; 1626:1-1628:2) • Participated in September 2009 telephone conferences between optionsXpress and regulatory entities, including FINRA and the SEC, in which the buy-write trading was explained and guidance was sought (Tr. 1650:4-1652:7)

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optionsXpress, Inc.: Synopsis of Witnesses' Hearing Testimony (File No. 3-14848)

Strine, Kevin	Vice President of Compliance (optionsXpress)	U.S. Air Force; University of Nebraska, Lincoln, B.A.; University of Wisconsin, Madison, J.D.; Series 4, 6, 24, 63 licenses	• Assisted with optionsXpress's Reg. SHO compliance efforts, which included revisions to the firm's buy-in procedures and discussions regarding the buy-write trading (Tr. 3283:23-3284:18; 3293:7-3294:6; 3342:4-3349:3) • Responsible for responding to Reg. SHO related regulatory inquiries and sought guidance about Reg. SHO's application to the buy-writes from regulatory entities including FINRA, CBOE, and SEC (Tr. 3373:15-3374:13; 3325:22-3329:2; 3411:4-3412:2)
Tao, Josephine	Assistant Director, Office of Trading Practices, Division of Trading and Markets (SEC)	George Washington University; George Mason University, J.D.	• Participated in late 2009 and early 2010 telephone conferences and other correspondence with optionsXpress, FINRA, and CBOE regarding the buy-write trading activity at optionsXpress (Tr. 3577:8-3589:14; 3600:24-3604:15; 3607:19-3629:16)
Tortorella, Scott	Manager of Clearing Operations (optionsXpress)	Western Illinois University	• Reviewed daily CNS data and instructed execution desk regarding Reg. SHO buy-ins (Tr. 364:22-367:2)
Zelezny, Mark	Trader (self-employed)	University of Southern California, B.S.; Series 6 and 7 licenses	• Traded reverse conversions and other positions with optionsXpress; paired sell call orders with Reg. SHO buy-ins to re-establish positions (Tr. 4101:15-4104:24) • Subject of CBOE's 2009 Reg. SHO investigation along with optionsXpress and market makers (Tr. 4134:7-4137:22)

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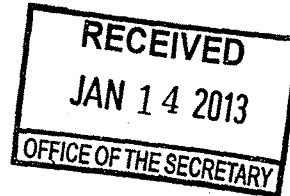


January 11, 2013

VIA FACSIMILE

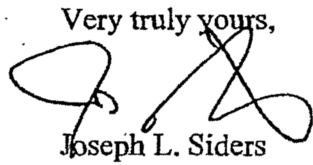
Elizabeth M. Murphy
Office of the Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: *In the Matter of optionsXpress, Inc., Thomas E. Stern, and Jonathan I. Feldman,* Administrative Proceeding No. 3-14848

Dear Ms. Murphy:

Enclosed please find the Post-Hearing Brief and Proposed Findings of Fact of Respondent optionsXpress, Inc., in connection with Administrative Proceeding No. 3-14848.

Very truly yours,



Joseph L. Siders

Enclosures

Cc: Counsel of Record (w/enclosure)

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