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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of

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

Respondents.

ADMINISTRATIVE PROCEEDING
File No. 3-14848

JONATHAN I. FELDMAN'S POST-HEARING BRIEF

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I. INTRODUCTION

The Division has failed in every material respect to establish every element of every claim against Jonathan I. Feldman, save the fact that he entered into securities transactions in interstate commerce. In sum, the following was conclusively shown at the hearing:

- Mr. Feldman received numerous assurances from optionsXpress that it was complying with its delivery obligations, including confirmation that the SEC approved of its compliance efforts.
- Mr. Feldman's strategy did not depend on anyone failing to deliver securities in the CNS system or otherwise.
- Mr. Feldman was transparent and honest with everyone he communicated and transacted business with, including brokers and members of the media.
- Mr. Feldman had no control or responsibility concerning delivery of securities, and he took every step asked of him by optionsXpress.
- Mr. Feldman received daily confirmations from optionsXpress that delivery of securities had occurred.
- No investors were deceived, because shares were delivered by optionsXpress as required under Reg SHO.

The Division offered no testimony by an actual investor who even claimed that they themselves were deceived. Not one. Instead, the Division presented entirely theoretical evidence concerning technical aspects of Reg SHO. The Division rests its theoretical case on the proposition that Mr. Feldman and optionsXpress committed fraud by intentionally not delivering on T+3. The Division's charges fail because (1) Mr. Feldman had no control over the delivery process or ability to monitor it; (2) even if he did, Reg SHO does not require delivery on T+3, and thus purchasers are not entitled to delivery on T+3; and (3) there is no explicit or implicit promise by anyone submitting a trade order—and least of all a retail customer—that there will be delivery on T+3. To bring absolute clarity to this dispositive issue: Neither Mr. Feldman nor optionsXpress—nor any other seller of securities—represented or guaranteed to any other

counterparty that delivery would occur by T+3. Instead, the exceptionally complex CNS system—of which Mr. Feldman had absolutely no control—allowed for an indeterminate delivery date of at least until T+7. The evidence shows that delivery occurred within this period for all of optionsXpress' trading at issue at least 99.3% of the time. Because the Division failed to prove a Reg SHO violation, the Division also failed to prove that Mr. Feldman deceived anyone.

Even if the Division proved that optionsXpress violated Reg SHO, the Division still failed to prove that anyone was deceived. Every aspect of Mr. Feldman's trading—sometimes daily buy-writes, high-volume trading, and frequent same-day exercise of the written calls—were all visible to the marketplace. The CNS fails-to-deliver were reported on the SEC's own website. Also, any counterparty who had a fail-to-receive knew about it. Yet counterparties and other purchasers continued to buy shares day after day with no evidence of impact on price or volume.

Mr. Feldman relied on his well known, reputable brokers to deliver shares, as the regulatory framework and the marketplace expected him to do. This good faith and reasonable reliance wholly refutes the allegation that Mr. Feldman had the necessary scienter for the Division's fraud-based and negligence charges. To be sure, the Division has presented no evidence of a conspiracy between optionsXpress and Mr. Feldman to deceive the public about when shares would be delivered. To the contrary, all the evidence presented in this case shows that optionsXpress assured Mr. Feldman that it was complying with its Reg SHO delivery requirements. Most importantly, optionsXpress confirmed compliance when it sent Mr. Feldman daily confirmations that he was not short for any stock he had purchased to cover a buy-in.

The Division's asserted motive for Mr. Feldman and measure of ill-gotten gains—that Mr. Feldman tried to avoid delivery so that he could avoid hard-to-borrow fees—was proven meritless because Mr. Feldman would not have paid hard-to-borrow fees in any event, regardless of whether optionsXpress borrowed and regardless of whether delivery occurred. Thus, the centerpiece to the Division's theory of liability and measure of illicit gain for Mr. Feldman, has been conclusively debunked, not only by Respondents' experts but by the Division's own expert, Dr. Larry Harris.

II. LEGAL STANDARD

To prove violations of Section 17(a)(1), Section 10(b), and Rule 10b-5, the Division must establish that, in connection with the purchase or sale of securities, Mr. Feldman made an untrue statement of material fact, omitted a fact that rendered a prior statement misleading, or committed a deceptive act as part of a scheme to defraud, and that he acted with scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195-96, 214 (1976). Scienter is an intention to deceive, manipulate, or defraud. *Id.* The degree of recklessness the Division must prove is "a highly unreasonable omission, involving not merely simple, <u>or even inexcusable</u> [] negligence, but an extreme departure from the standards of ordinary care . . . which present[ed] a danger of misleading buyers or sellers that [was] either known to [Mr. Feldman] or [was] so obvious [that he] must have been aware of it." *S.E.C. v. Ficken*, 546 F.3d 45, 47-48 (internal quotations omitted); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978) (even carelessness approaching indifference may not be sufficient to establish *scienter*).

To prove a violation of Section 17(a)(2) or (3), the Division must prove that Mr. Feldman obtained money or property by means of an untrue statement or omission of a material fact or engaged in a transaction, practice, or course of business which operated as a fraud or deceit upon

the purchaser. The Division must show that Mr. Feldman acted at least negligently—that is, without reasonable care. *S.E.C. v. Shanahan*, 646 F.3d 536, 546 (8th Cir. 2011). "Reasonable care is the degree of care which a reasonably prudent [person] would use under like circumstances." *Densberger v. United Technologies Corp.,* 297 F.3d 66, 69 (2d Cir.2002).

Though courts generally acknowledge that the anti-fraud provisions under the federal securities laws "'do[] not require a specific oral or written statement,'" courts hold that as "broad as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression." *United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008) (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148 (2008)).

To prove their Rule 10b-21 claim, the Division must demonstrate that Mr. Feldman: (1) submitted an order to sell an equity security; (2) while deceiving a broker or dealer, a participant of a registered clearing agency, or a purchaser; (3) about his intention or ability to deliver the security on or before the settlement date; and (4) failed to deliver the security on or before the settlement date. Rule 10b-21(a). The scienter requirement of Rule 10b-21 is the same as that required under Rule 10b-5. *See* Rule 10b-21 Adopting Release, 73 FR at 61671 & n.55.

III. ANALYSIS

A. <u>Division Did Not Prove Anyone Was Deceived</u>

Dr. Erik Sirri was the only expert who testified at the hearing as an expert on Reg SHO, and the Division did not object to his report or expert testimony. *See* Jonathan Feldman's Counterstatement of Proposed Findings of Fact ("FOF") at ¶ 20. Dr. Sirri is the former Chief Economist for the Commission and the former Director of the Commission's Division of Trading & Markets, the Division that drafted and implemented Rule 204 and Rule 10b-21 under his leadership. *See* Tr. at 3001:13-3002:2 (Sirri). As such, Dr. Sirri is one of the preeminent experts

on compliance with Reg SHO and the application of Rule 10b-21. By contrast, the Division offered the expert testimony of Dr. Harris, who readily acknowledged that he was not an expert on Reg SHO. *See* Tr. at 1615:6-21 (Harris) (Dr. Harris has "no specific knowledge" of whether conduct is permissible under Rule 204 and does not know everything there is to know about Rule 204 and its implications), 1481:18-21 (Harris) (Dr. Harris is not "closely familiar" with Rule 204).

Dr. Sirri provided credible and clear testimony that debunked critical misunderstandings and misinterpretations of Reg SHO on which the Division bases its charges. The core of Dr. Sirri's analysis and expert opinions concerning Reg SHO as applied to Mr. Feldman's trading went unrebutted:

- Reg SHO compliance is the measure of whether delivery of shares occurs in a timely manner. Sirri Report, OPX-EX-915 at ¶ 75.
- Mr. Feldman's trading did not cause a Reg SHO violation. Tr. at 3211:8-3212:20 (Sirri).
- Mr. Feldman had no ability or obligation to deliver shares. Sirri Report, OPX-EX-915 at ¶¶ 11-13.
- Mr. Feldman had no ability to determine whether optionsXpress complied with Reg SHO. *Id.* at ¶¶ 143-147.
- Reg SHO permits delivery after T+3, until at least T+7 or later, under common circumstances. OPX-EX-915 at ¶ 78.
- A CNS fail-to-deliver, even if for multiple consecutive days, does not mean that the clearing member violated Reg SHO. *Id.*

1. **<u>No Evidence of Non-Compliance with Rule 204</u>**

For all of the trading at issue, delivery could only be affected by a broker-dealer through the CNS system that is governed by Reg SHO. *See* Tr. at 116:22-117:9 (Colacino); *see also* Sirri Report, OPX-EX-915 at ¶¶ 58, 75. The only alleged fraud in this case resulted from fails-to-

deliver that allegedly violated Reg SHO. If there was no violation of Reg SHO, then there was also no fraud. *See* Tr. at 3055:14-3056:4 (Sirri); *see also* Tr. at 3766:22-3767:7 (Tao) (when she looked at the reverse conversions and three-way strategies, the question that arose was did the broker-dealer comply with the Reg SHO compliance issues arising out of that trading). Therefore, the first predicate for a finding that Mr. Feldman committed fraud is a finding that optionsXpress violated Reg SHO as a result of Mr. Feldman's trading. *See* FOF at ¶ 119 (quoting Dr. Sirri's statement that if there was no Reg SHO violation, then there was no fraud or deception).

In its post-hearing brief, the Division asserts two bases for its contention that optionsXpress did not comply with its delivery obligations, both of which misconstrue Reg SHO and are unsupportable. The Division's first theory—that optionsXpress committed fraud by not borrowing and delivering on T+3 as required by Rule 204—fails because Rule 204 categorically does not require a broker to borrow shares or to deliver on T+3[1]:

> A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement . . . by settlement date, <u>or</u> if a participant of a registered clearing agency has a fail to deliver position . . . in any equity security . . . the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, <u>immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity</u>.

17 C.F.R. §242.204(a) (emphasis added). Thus, a broker-dealer complies with Reg SHO by <u>either</u> delivering on T+3 <u>or</u> purchasing or borrowing shares to close out its position by the beginning of trading on T+4. FOF at ¶ 24; Sirri Report, OPX-EX-915 at ¶¶ 76-78.

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[1] The Division unequivocally and falsely states that Rule 204 and Rule 204T require delivery at CNS by T+3. *See*, e.g., DPB at 2, 7 ("Rules 204 and 204T of Reg SHO require broker-dealers like optionsXpress . . . to deliver shares into CNS no later than three days after the shares are sold"); DFOF at ¶ 301 (stating that purchasers "presumed they would receive shares" within three days).

Dr. Sirri explained that there are commonly occurring reasons why a broker sometimes does not have to take any action to deliver pursuant to Rule 204. For example, if the firm has a fail-to-receive in CNS, or if the firm already has shares in inventory, or if a customer has an offsetting purchase on the same trade date, or because of netting with other customer trades that day. FOF at ¶ 30; Tr. at 2970:13-25 (Sirri). Tr. at 2970:22-2971:6 (Sirri). Dr. Sirri also explained that a firm does not have to borrow shares if it purchases shares on or before T+4 of like kind and quantity. FOF at ¶ 30; Tr. at 2971: 7-10 (Sirri).

The Division's equally unsound second theory—that Mr. Feldman's buy-writes were "shams" because they did not clear up optionsXpress' fail-to-deliver position at CNS—fails because there is no rule or requirement that a broker clear up its CNS position. *See* Tr. at 3170:11-25-3171:1-8; 3180:19-23 (Sirri) ("Rule 204(a) doesn't require the broker to make progress on its CNS position."). Instead, Reg SHO requires a broker to purchase or borrow shares when it has a CNS fail. If the broker purchases, the CNS fails may persist for at least three more days—i.e., T+7. In this case, optionsXpress would require Mr. Feldman to purchase shares to help satisfy optionsXpress' delivery obligation. Tr. at 235:10-236:7 (Risley). Mr. Feldman bought in as required by optionsXpress. FOF at ¶ 79; Tr. at 2060:15-21 (Payne).

The only evidence the Division presented to support its theory of a Reg SHO violation was the CNS data showing that optionsXpress had multiple consecutive days of fails-to-deliver at CNS. *See* Division Post-Hearing Brief ("DPB") at 14-15. Again, however, fails-to-deliver at CNS are not evidence of a Reg SHO violation and in fact occur frequently and naturally in the system. *See* FOF at section C.III. Because CNS is a net, continuous system and delivery does not occur for three days after the trade date, it is possible to have what look like "continuous" fails-to-deliver at CNS without violating Reg SHO. *Id.* Thus, the number of days of fails

displayed on CNS reports is largely irrelevant. Thus, it is frequently impossible to tell if a fail-to-deliver originated on the date of the report or is a fail-to-deliver that has existed for days. *Id.*; Tr. at 90:7-25 (Colacino).

The Division has presented no evidence to contradict Dr. Sirri's opinion that the buy-writes complied with Reg SHO because Reg SHO does not require the broker-dealer to clear up its CNS position:

> But the thing that's notable here it [Rule 204(a)] doesn't require the broker to make progress on its CNS position. That's not what it says. You could have said that. It could have been written in terms of CNS. It talks about delivering shares.
> . . . .
> The requirement of SHO isn't that it change your CNS delivery position. The requirement is that you buy shares of like kind and quantity. And those shares of like kind and quantity and were bought when a buy-write is executed.

Tr. at 3170:11-25-3171:1-8; 3180:19-23 (Sirri) (emphasis added). Specifically, Dr. Sirri's expert opinion that the "buy" portion of the buy-write satisfied Reg SHO remains unrebutted. *See* Tr. at 3211:21-25 (Sirri) ("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."). The simultaneous writing of a call does not negate that the shares were bought as required by Reg SHO. Tr. at 3212:12-20 (Sirri). Thus, the buy-in satisfied Rule 204, and there was no delivery failure under Reg SHO. *Id.* Because Reg SHO permitted the buy-writes, no one could have been deceived by them because they were not violative of any rule. *See* Tr. at 3055:14-3056:4 (Sirri).

Once the requirements of Rule 204(a) are satisfied, Rule 204 can be violated only if the transaction is a sham closeout under Rule 204(f). *See* Rule 204. The Division cannot prove a violation of Rule 204(f) (and it does not appear that it even attempts to) because Rule 204(f) concerns collusion:

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

17 C.F.R. §242.204(f) (emphasis added). To constitute a sham under rule 204(f), there must be an arrangement, i.e., something more than just a market order between two counterparties that do not know each other. *See* Tr. at 3218:18-3219:1(Sirri). The Division did not present any evidence of such an arrangement, and none existed. *See* FOF at ¶ 32; Tr. at 3771:24-25 (Tao). Because the Division has not proven a violation of Rule 204(f), it cannot show a violation under Rule 204(a), and thus the Division has failed to show that any provision of Rule 204 was violated.

The Division also argues that shams are prohibited by footnote 82 to the Adopting Release for Rule 204. Footnote 82 provides, in relevant part:

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

OPX-EX-865 (emphasis added). As a threshold and dispositive matter, Mr. Feldman is not a participant, and thus footnote 82 has no application to him. The participant, optionsXpress, had the ability to take a host of options when Mr. Feldman bought in, including accepting the buy-writes, borrowing, or using stock in inventory. *See* FOF at ¶ 25. Mr. Feldman had no control over which avenue optionsXpress chose to take. *See* FOF at ¶¶ 44, 46. Even if this were not the case, footnote 82 cannot be the basis of liability for either optionsXpress or Mr. Feldman because a footnote in an Adopting Release or preamble to a regulation is not law. *See, e.g.*, *Energy Servs., Inc. v. F.E.R.C.*, 375 F.3d 1204, 1209-10 (D.C. Cir. 2004). 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).

As important, footnote 82 also cannot form the basis for optionsXpress' alleged Reg SHO violation because the fact and expert witnesses uniformly confirmed that buy-writes were an integral part of a legitimate option trading strategy: The buy satisfied Mr. Feldman's buy-in requirement and the written call reestablished Mr. Feldman's hedge. FOF at ¶ 114. Dr. Sirri confirmed this, testifying that the buy-writes offered a legitimate means to reduce risk in Mr. Feldman's options strategy. Sirri Report, OPX-EX-915 at ¶ 54. Indeed, Mr. Zelezny and other optionsXpress customers came up with the same strategy independently of Mr. Feldman, and the SEC has never alleged that Mr. Zelezny's or the other customers' purpose was illegitimate. And CBOE thoroughly investigated that trading strategy and found "the Zelezny's [sic] were conducting and maintaining a hedge to their position appropriately." OPX-EX-129.

Mr. Feldman's strategy had a legitimate economic purpose because the strategy exposed Mr. Feldman to risk of loss, the "hallmark of any legitimate economic strategy." Tr. at 4408:8-15 (Saha); *see also* FOF at ¶ 118 (describing the significant risks associated with the reverse conversion and three-ways). As Dr. Atanu Saha, optionsXpress' expert, explained:

> You have reward but you also have risk. The buy-writes had legitimate economic purpose because the buys covered the short position and the writes reinitiated the hedge.

Tr. at 4408-11-15 (Saha); *see also* Sirri Report, OPX-EX-915 at ¶ 110 ("I have been asked to assume that a trade or a trading strategy would have a 'legitimate economic purpose' if the purpose of the strategy is to make trading profits, and the trading strategy is not designed to

make these profits through deceptive means, including misrepresentations, collusion, market manipulation, or misappropriating information."). These definitions are in accord with caselaw, which has long recognized the legitimacy of hedging strategies. *See, e.g., Lyons Milling Co. v. Goffe & Carkener*, 46 F.2d 241, 248 (10th Cir. 1931) ("Hedging is lawful. It is recognized as a <u>legitimate</u> and useful method of insuring against loss on a contract for future delivery.") (emphasis added).

The Division did not rebut Dr. Saha's definition of "legitimate economic purpose" with a counter-definition. *See* DPB at 15-16. Further, the Division asserts that Dr. Sirri's definition assumes facts that were not true, because Mr. Feldman's trading was "deceptive"—circular reasoning that is impossible to even engage.

The Division's inability to produce a definition for "legitimate economic purpose" underscores the unconstitutionally vague nature of this language. Indeed, it is tantamount to requiring optionsXpress and Mr. Feldman to establish an "appropriate economic purpose," whatever that would mean. Even if the Division could overcome the fact that a footnote to an Adopting Release of a rule is not law, it cannot seek to find optionsXpress or Mr. Feldman liable for violating something that the Division itself cannot define. *See, e.g., Broadrick v. Oklahoma*, 413 U.S. 601, 607 (1973) (a rule is unconstitutionally vague when "men of common intelligence must necessarily guess at its meaning."); *Gen. Elec. Co. v. U.S. E.P.A.*, 53 F.3d 1324, 1329 (D.C. Cir. 1995) ("'elementary fairness compels clarity' in the statements and regulations setting forth the actions with which the agency expects the public to comply.") (quoting *Radio Athens, Inc. v. FCC*, 401 F.2d 398, 404 (D.C.Cir.1968)). It 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).

Significantly, the SEC's Division of Trading & Markets recognized that the trading did not violate any existing rule, including Rule 204, and relayed that conclusion to the Chicago Board Options Exchange ("CBOE"), optionsXpress' primary regulator, and the Financial Industry Regulatory Authority ("FINRA"). FOF at ¶ 64 Moreover, none of these regulators raised footnote 82 in their numerous communications with each other or optionsXpress during this time. This alone demonstrates that footnote 82 is not part of Reg SHO and is being misused by the Division because it cannot prove a Reg SHO violation.

If regulators want to proscribe buy-writes, in-the-money calls, or CNS fails, then they must create a rule that prohibits them. As Dr. Sirri testified, the SEC could have drafted Rule 204 to require brokers to clear up their fail-to-deliver positions at CNS, but no such rule was written. Tr. at 3170:11-25-3171:1-8; 3180:19-23 (Sirri).

2. Feldman's Trading Did Not Result in a Reg SHO Violation

The Division presented no evidence or testimony to rebut Dr. Sirri's opinion that if Mr. Feldman was the only customer trading securities at optionsXpress, optionsXpress could have relied on his buy-writes to satisfy its Reg SHO obligations. Reg SHO. FOF at ¶ 23. Moreover, the Division also failed to prove it was Mr. Feldman's trading that contributed to any alleged Reg SHO violation. The Division has not been able to prove that any fails-to-deliver were a result of Mr. Feldman's trading or the other six customers, because it is impossible to map a fail-to-deliver at CNS to a particular customer or trade. FOF at ¶ 87; Tr. at 3257: 11-3258:8 (Sirri) ("You can't map two, you certainly can't map 300,000."). This is particularly true because optionsXpress is one of the largest brokerage firms, with thousands of customers. FOF at ¶ 7. The Division ignores the inability to map CNS fails to a particular customer, but this distinction is significant because it means that the Division cannot show that it was Mr. Feldman's trading

that was causing the CNS fails. The Division asserts that Mr. Feldman was not buying in on T+1 or T+4, but really on "T+6, T+10, or T+227." DPB at 17. This statement by the Division as it relates to Mr. Feldman is indisputably false, because Mr. Feldman never had a position that was open for 227 days; so it was impossible that there was a fail-to-deliver at CNS for 227 days as a result of his trading. FOF at ¶ 89. This lack of understanding by the Division underscores the Division's complete failure to show a nexus between Mr. Feldman's trading and the CNS fails-to-deliver.

3. Even if There Was a Reg SHO Violation, Feldman Had No Delivery Obligation or Control Over Delivery

Even assuming *arguendo* that optionsXpress had violated Reg SHO, this would not demonstrate that Mr. Feldman violated any securities laws. This is primarily true because customers have no obligations under Reg SHO, which applies only to broker-dealers. Tao Tr. at 3762:20-3763:4. Because Reg SHO compliance is exclusively the broker-dealer's obligation, optionsXpress assumed all delivery responsibility, and Mr. Feldman relied on optionsXpress to deliver. FOF at section D.1. Mr. Feldman had absolutely no control over how optionsXpress chose to deliver and was not privy to optionsXpress' internal communications concerning how to fulfill its delivery obligations. FOF at sections D.1 and ¶ 58. Thus, even if the Division had been able to show that optionsXpress violated Reg SHO because it failed to deliver, even if as a direct result of Mr. Feldman's buy-writes (and indeed no such evidence was presented), Mr. Feldman would still not be liable.

The Division's focus on Mr. Feldman's obligations under the optionsXpress customer agreement to deliver securities to optionsXpress in fact exonerates Mr. Feldman. *See, e.g.*, Division's Proposed Findings of Fact ("DFOF") at ¶ 31 (citing to witness testimony that a customer can have a fail-to-deliver to optionsXpress and the optionsXpress Customer

Agreement); Tr. at 3016:25-3018:21 (Sirri); Feldman Tr. at 2127:5-12; 2128:10-16, 2131:25-2132:11. None of Mr. Feldman's brokers ever contended, either contemporaneously or at the hearing, that Mr. Feldman failed in any respect or breached his customer agreement with them. FOF at ¶ 50. This point requires emphasis: Not one single live witness testified, and not one single exhibit stated or implied, that Mr. Feldman breached or otherwise failed to honor any obligation in any customer agreement. *Id.* The Division cannot successfully claim that Mr. Feldman breached an agreement with optionsXpress when optionsXpress—the party to whom the obligation is owed—never claimed that Mr. Feldman failed to deliver shares to optionsXpress. *Id.* Mr. Feldman's delivery obligation to his brokers under the terms of the customer agreements is the only delivery obligation of Mr. Feldman's that the Division presented evidence of, and it is inapposite to the Division's allegations in this proceeding.

4. The Division Has Failed to Show Harm to Any Victim

The Division has failed to show harm to any victim because it has failed to show that any person or entity failed to receive their shares within the time permitted by Reg SHO. Under Reg SHO, a variety of circumstances could lead to optionsXpress delivering as late as T+7 and still being Reg SHO compliant. FOF at ¶ 27. Dr. Harris, the Division's expert, did not determine how many shares were delivered by T+7, but he did determine that the purchasers received their shares within T+10 99.3% of the time and within T+5 98.4% of the time. Harris Report, Div. Ex. 311 at ¶ 196; *see also* Saha Report, OPX-EX-248 at 32 ("[I]n 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."). For Sears stock alone, CNS fails-to-receive were resolved in T+10 98.7% of the time and within T+5 96.2% of the time. *Id.*; *see*

also Harris Tr. at 1422:1-16. Dr. Harris did not look at the percentage of purchasers that received their stock within T+3 or T+7. Harris Tr. at 1422:17-14:23:19.

Moreover, the Division did not identify a single victim of the alleged fraud. The Division attempted to make its case based on hypothetical victims who may not have received their shares on time. These attempts fell flat because no witness, including the Division's expert witness, could identify what harm occurred to an actual victim. FOF at section G3. No market participants testified that they failed to receive shares they thought they would receive. Not one single witness. This is because no counterparties or market participants understood that they were guaranteed shares on T+3, because CNS fails-to-deliver are permitted and naturally and frequently occur in the system. *See* FOF at section C.3; Tr. at 118:10-23 (Colacino). Specifically, the market makers who were the counterparties had a view of the market because it was their own clearing firms that were exercising the calls optionsXpress sold on Mr. Feldman's behalf and, under the Division's theory, failing to receive in the CNS system. FOF at ¶ 111.

The Division contends that if the "agreements" between traders to have their trades reliably settle are not honored, "traders would not be willing to allow brokers and exchanges to arrange trades with strangers." DFOF at ¶ 304. This theory is wholly unsupported and erroneous, because the Division offered no evidence that the settlement problems have or can induce investors to avoid the market or that anyone did so in this case. In particular, there was not even an attempt to establish that volume or price of securities transactions were affected whatsoever. FOF at ¶ 121. This theory is discredited because the counterparties to the trades continued to transact if they experienced fails-to-receive. FOF at ¶ 111. It is illogical to contend that these traders and their clearing firms were deceived by Mr. Feldman (indeed, no one even knew Mr. Feldman's name, because optionsXpress did trading in its own name) when these same

clearing firms were knowingly and voluntarily participating as counterparties to the sometimes daily buy-writes.

Similarly, the Division failed to prove that purchasers were harmed because they lost voting or dividend rights. It was definitively established that no purchasers lost their dividend rights. *See* Tr. at 113:20-24 (Colacino). The Division's expert confirmed that he had done no analysis as to whether any purchaser lost voting rights as a result of not receiving shares. Tr. at 1428:9-18 (Harris). Dr. Harris hypothesized that it was possible large firms lost money because they were not able to loan out the shares they should have received. Tr. at 1431:7-17 (Harris). But the Division presented no evidence that this actually occurred, and its expert acknowledged that he had not done any analysis to determine which brokers were harmed or what the damage to these brokers was between T+3 and T+7 or T+8, when over 98.4% of them received their shares. FOF at ¶ 28.

The Division's allegation that market participants were deceived because they were confused about the "nature" of the trading was shown to be based on entirely lacking evidence. DPB at 26. The Division did not bring in a single witness who claimed to have been deceived regarding the "nature" of the trading. Instead, the Division points to e-mails from Mr. Feldman making light of the fact that anonymous posters on a Yahoo! Message Board were making incorrect guesses about the source of the volume spikes in Sears stock. Div. Ex. 29. It is not even possible to determine whether these anonymous posters were even investors in SHLD or any other stock. In any event, anonymous Internet chatter is the least credible evidence. Moreover, the Yahoo! Message Board comments demonstrate the marketplace was well aware of the volume in the trading. That this engendered some speculative comments by anonymous

Internet posters, as likely many trades do, does not make the trading deceptive. Tr. at 2266:18-25 (Feldman).

To the contrary, the entire marketplace, including the counterparties to Mr. Feldman's trades, could view every material aspect of the trading. Mr. Feldman used standard, non-customized options, and all of the options traded by Mr. Feldman were listed on the exchange. FOF at ¶ 13. The buy-writes were traded on the open market and executed on the CBOE, AMEX, or ISE. FOF at ¶ 100. The marketplace could look at the open interest and determine that people were selling high volume calls, and the counterparties were sometimes exercising on the same day. *See* FOF at ¶¶ 102-104 It was openly known that high volume trading was occurring and that the counterparties were exercising daily. *See id.*; Tr. at 1322:1-4 (Lapertosa). The marketplace could similarly view the number of fails-to-deliver at CNS in every security on the SEC's own website. *See* FOF at ¶ 103; Tr. at 3473:19-3474:17 (Strine). Thus, every aspect of Mr. Feldman's trading strategy and optionsXpress' CNS activity occurred in broad daylight and with the knowledge of the entire marketplace.

The Division also could not identify any actual harm to the marketplace that resulted from the buy-writes. Evidence in the record shows that Mr. Feldman's trading had no impact on market integrity because any effect on the marketplace would be demonstrated in share prices, and the share prices of the stock did not change as a result of the buy-writes. Tr. at 4423:2-14 (Saha) ("any effect that takes place in the marketplace would be crystallized in share prices. Price affects all available information."); Tr. at 4425:1-25 (Saha) ("there was no impact of the buy-write transactions on the risk-reward contributions of the securities."); Tr. at 1552:19-25 (Harris) (conceding that he "did not study" whether "Feldman's trading had [a] meaningful impact on market price.").

B. The Division Did Not Prove Feldman Engaged in Deception

1. Trading Included Only Open-Market Transactions in Listed Securities

Mr. Feldman's trading strategy involved absolutely no deception. The strategy combined a mixture of the following components, each of which was executed in an arms-length, open-market transaction in listed securities:

- Sale of at-the-money put options on a stock;
- Purchase of at-the-money call options on the same stock;
- Short sales of the same stock;
- Purchases of shares in the same stock; and
- Sales of in-the-money calls on the same stock.

Each component was unremarkable standing alone or combined.

To maintain his hedge against the long position, Mr. Feldman submitted "buy-writes" consisting of: (1) purchasing stock to cover the closed short position, and (2) selling in-the-money call options. The in-the-money call options had characteristics of a short position, thereby providing the hedge against Mr. Feldman's long position. Contrary to the Division's assertion that Mr. Feldman found "just one" brokerage that allowed buy-writes, buy-writes are very common and offered at every major brokerage. *See, e.g.*, Tr. at 632:13-633:25 (Coronado); *see also* DPB at 33. Mr. Feldman thus did not seek out a brokerage firm that allowed buy-writes; he sought out firms that did not charge hard-to-borrow fees and had low commissions. FOF at ¶ 6.

From inception through today, anyone could implement Mr. Feldman's strategy, and Mr. Feldman did so based on publicly available information using publicly listed, standard American options with unknown counterparties. Tr. at 619:11-24 (Coronado); Tr. at 4122:1-4123:2

(Zelezny). Indeed, Scott Lamm, the Division's rebuttal witness from the CBOE, testified that other broker-dealers were allowing their customers to engage in the same trading strategies as Mr. Feldman. *See* FOF at ¶ 15; Tr. at 4763:14-4764:20 (Lamm). Mr. Feldman demonstrated his trading strategy at the hearing using screen prints of actual trading platforms. *See* OPX-EX-916(a)-916(e); Feldman Tr. at 2412:1-2424:22, 2429:23-2439:24 (Feldman). Every witness with knowledge confirmed that neither Mr. Feldman nor anyone at optionsXpress knew who the counterparties to Mr. Feldman's trades were. *See* Tr. at 634:5-19 (Coronado); Tr. at 1215: 5-8 (Stella); Tr. at 1313:14-25 (Lapertosa). Also of note, none of the counterparties knew who Mr. Feldman was. This is because optionsXpress did all trades in its own name, not by customer.

2. <u>Feldman's Conduct Did Not Deceive Marketplace or Counterparties</u>

Deception is a prerequisite for fraud, and "broad as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression." *United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008) (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148 (2008)). There is no allegation that Mr. Feldman made any affirmative misrepresentation or omitted any material fact. FOF at ¶ 49. Indeed, the evidence shows that Mr. Feldman was completely open about his trading strategy to anyone who asked, including members of the media. FOF at ¶¶ 104-105. The only challenged conduct by Mr. Feldman was his submission of the buy-write orders. Thus, for the Division to be successful in any claim against Mr. Feldman, they must prove that the submission of the buy-write orders alone deceived someone.

Courts have roundly rejected the notion that submission of a trade order, with nothing more, is deceptive. In *Finnerty*, the defendant was charged with interpositioning resulting in alleged illegal profits. During trial, the prosecution presented evidence that the defendant

directed NYSE clerks to execute interpositioning trades ahead of existing public orders. *Id.* at 147. While acknowledging that "conduct itself can be deceptive," the Court of Appeals for the Second Circuit found that the government had not shown the defendant committed fraud because it "identified no way in which Finnerty communicated anything to his customers, let alone anything false." *Id.* at 148-49. The *Finnerty* Court also rejected the government's argument that the defendant's deception was self-evident because he had the advantage of being able to see pending orders to buy and sell a particular stock, and he determined the price ultimately paid:

> It may be that Finnerty unfairly profited from superior information. But "not every instance of financial unfairness constitutes fraudulent activity under §10b." . . . And characterizing Finnerty's conduct as "self-evidently deceptive" is conclusory; there must be some proof of manipulation or a false statement, breach of a duty to disclose, or deceptive communicative conduct. "Section 10(b) is aptly described as a catchall provision, <u>but what it catches must be fraud</u>."

Id. at 150 (quoting *Chiarella v. United States,* 445 U.S. 222, 232 (1980)) (emphasis added).

Finnerty reaffirmed that the mere execution of a trade (even if it has an improper purpose, which is not the case here) cannot establish a Section 10b violation. It must be accompanied by some misleading impression or statement. *Id.* at 149. This is true even when the submission of the trade violates a rule known to the public and that the public may assume is complied with (which is not Mr. Feldman's circumstance):

> Some customers may have understood that the NYSE rules prohibit specialists from interpositioning, and that <u>the rules amount to an assurance (by somebody) that interpositioning will not occur</u>. As a consequence, some customers may have expected that Finnerty would not engage in the practice. But <u>unless their understanding was based on a statement or conduct by Finnerty, he did not commit a primary violation of § 10(b)</u>-the only offense with which he was charged.

Id. at 150 (emphasis added). Mr. Feldman's conduct was wholly legitimate and far from the interpositioning in *Finnerty*, and thus the lack of deception is even more apparent in this case.[2]

Dr. Sirri further confirmed that no one was deceived by Mr. Feldman's submission of a trade order because the submission of those orders did not violate a rule:

> Q. By his submitting those orders that you reviewed by Mr. Feldman, by his submitting those orders, what deceptive conduct did you identify that he was engaged in?
>
> A. Deception you either say something or conduct that's deceptive, I think the only thing at issue with Mr. Feldman is trading as I understand it. So <u>the question is whether his trading is somehow deceptive</u>. I guess you ask the question, who is deceived by his trading? . . . [T]he allegation, as I understand the orders instituting proceeding, is members of the financial community, other members of the clearing sides, participants, other investors, people who may have traded with him. That those are the people who were deceived. Now, my understanding is for deception to occur in that context you have to have a violation of a rule as part of that and for the reasons we have talked about, <u>I don't think there's a violation of a rule associated with Mr. Feldman's trading</u>. That is, <u>I don't think the rule is violated so I don't how deception occurs because to me as I think about it, and I think I said this before, if a rule isn't violated associated with those trades of Mr. Feldman then I don't see how there's deception</u>.

Tr. at 3248:103249:3 (Sirri) (emphasis added).

Equally important, even if optionsXpress violated Reg SHO by failing to deliver as a direct result of Mr. Feldman's trades, no one in the marketplace or financial community believed that Mr. Feldman, an individual customer, was making any kind of representation about delivery.

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[2] Contrary to the Division's assertion, the holding in *Finnerty* has not been overturned or minimized. Rather, in the administrative proceeding against Mr. Finnerty, the Commission found an additional fact—that when he became an NYSE specialist, Mr. Finnerty "expressly represented to the NYSE that he would comply with its rules"—and thus engaged in deceptive conduct when he traded in violation of those rules. *VanCook v. S.E.C.*, 653 F.3d 130, 140 n.8 (2d Cir. 2011) (quoting *David A. Finnerty*, Exchange Act Release No. 59,998, 95 SEC Docket No. 2534, 2009 WL 1490212, at *3 (May 28, 2009)). Thus, the Commission's adjudicatory decision was based on a finding that Mr. Finnerty had made a prior representation that he dishonored by placing the trade orders, therefore making the order inherently misleading. No such representation is alleged here. Regardless, the *Finnerty* Court's finding that submission of a trader order is not, in and of itself, deceptive is unaffected by the later administrative proceeding.

FOF at ¶ 13. Indeed, no one in the marketplace or financial community could identify Mr. Feldman's trades as his—all trades were done anonymously as trades of optionsXpress. *See* Tr. at 1238:2-20 (Lapertosa) (OnPoint representative testifying that OnPoint, an institutional options broker-dealer, received orders only from institutional clients, like optionsXpress, and could not communicate with individual retail customers). The marketplace relied on optionsXpress to comply with any delivery requirements, and correspondingly any reliance would be on optionsXpress, not Mr. Feldman.

3. Not Paying Hard-to-Borrow Fees is Not Improper

Mr. Feldman engaged in no deception to avoid hard-to-borrow fees. The uncontested evidence showed that optionsXpress did not charge hard-to-borrow fees to any of its customers (not just Mr. Feldman). FOF at ¶ 54. Therefore, if optionsXpress lent Mr. Feldman shares to short from its other customers' accounts or by incurring borrowing fees itself, optionsXpress agreed to not charge its clients. *Id.* Indeed, several other brokers do not charge hard-to-borrow fees to customers who have a short position in hard-to-borrow stocks, including E*TRADE, Charles Schwab, TD Ameritrade, and Wells Fargo. *Id.*

The only motive the Division has presented for Mr. Feldman's alleged desire to avoid delivery was the avoidance of the hard-to-borrow fees associated with delivery. This theory was conclusively debunked during the hearing by the simple fact that Mr. Feldman would not have had to pay hard-to-borrow fees regardless of whether optionsXpress borrowed or delivered:

> Q. And [Mr. Feldman] would have made that amount whether his broker-dealer would have not delivered shares to the CNS system, right?
>
> A. That's correct.
>
> Q. And so, from Mr. Feldman's perspective, whether or not delivery occurred in the CNS system, had no effect on the amount of profit from the strategy, correct?

A. That's correct.

Tr. at 1551:13-17 (Harris).

> Q: Well, then I'll put it differently. The avoidance of delivery is not what made Mr. Feldman a profit then, correct?
>
> A: That's correct. If the shares had been delivered and the arrangement with optionsXpress remained as it was, as you represented it, then Feldman would have made these profits.

Tr. at 1552:1-13 (Harris). The Division's witness from the SEC's Division of Trading and Markets agreed that optionsXpress could have complied with Reg SHO by either purchasing or borrowing stock; neither option required approval from the customer:

> Q. And the broker-dealer no matter how frequent the trading was or how frequent the buy-writes were, the broker-dealer could have taken different alternatives to comply with those obligations, right?
>
> A. Yes.
>
> . . . .
>
> Q. And those alternatives were alternatives that it could choose on its own, right?
>
> A. To purchase or to borrow, yes.
>
> Q. And your understanding, at that time, as you had this communication, is that the customer had no ability to restrict which alternative optionsXpress may or may not take, right?
>
> A. Well, it's the broker-dealer's requirement.

Tr. at 3767:8-13, 3769:6-13 (Tao). That Mr. Feldman would still have made a profit regardless of whether optionsXpress chose to purchase or borrow stock is further confirmed by the fact that Mr. Feldman conducted his trading strategy at three other firms and made a profit there as well, though there is no allegation that those firms had fails-to-deliver at CNS or violated Reg SHO. Feldman Tr. at 2380:5-20; *see also* Tr. 4826:4-8 (Mikus). As the E*TRADE representative

testified, E*TRADE did not have a Reg SHO violation or even fails-to-deliver at CNS as a result of Mr. Feldman's trading. *See* Tr. at 4826:4-18; 4843:1-8 (Mikus).

To be sure, optionsXpress did not give Mr. Feldman special treatment by not passing on the hard-to-borrow fees, and they did not concoct any scheme to that end. optionsXpress does not charge hard-to-borrow fees to any of its customers. FOF at ¶ 54; Tr. at 233:10-22 (Risley) (optionsXpress did not pass hard-to-borrow fees on to its customers and optionsXpress' competitors have similar policies). Other brokers, namely Terra Nova/Penson, decided not to charge hard-to-borrow fees to Mr. Feldman in order to obtain his business. Tr. at 2377:19-22 (Feldman); Tr. at 901:12-18 (Crain). As a result, Mr. Feldman's profit was not impacted at all by whether his broker was borrowing or making delivery, because either way Mr. Feldman would never have to pay hard-to-borrow fees under the terms of his agreements with the various brokers.

4. <u>Buy-writes Were Not "Shams"</u>

The buy-writes were not shams but rather bona-fide arms-length transactions. *See* section III.B.1, *supra*. The term "sham reset" is an undefined characterization, but a sham transaction of any sort requires the collusion of both parties to generate an appearance that is not the actual economic substance. *See, e.g., Yoshikawa v. S.E.C.*, 192 F.3d 1209, 1212 (9th Cir. 1999) (in a sham parking transaction a firm sold stock from its own account to a customer under an agreement that the firm will buy back the stock once it has filed its report with regulators); *Regents of University of California v. Credit Suisse First Boston*, 482 F.3d 372, 377 (5th Cir. 2007) (off-balance sheet transactions to distort Enron's revenue required that both the reporting company and the counterparty agreed to the sham); *In re Charter Communications, Inc.*

Securities Litigation, 443 F.3d 987, 989-990 (8th Cir. 2006) (describing sham roundtrip transaction designed to inflate cash flows).

The circumstances here are markedly distinct from those in *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*. In *Hazan*, the Commission determined the respondent market makers were engaged in "sham reset transactions" because Hazan colluded with other market makers and acted as the counter-party to sham transactions. *See* Div. Ex. 130 at 3. In *Hazan*, the transactions were intended to maintain an open fail to deliver in the CNS system by market makers who abused their exemption and caused fails to persist. *Id.* Mr. Feldman is not a market maker, and never purported to rely on any market maker exception. Mr. Feldman had no responsibility *vis-à-vis* CNS system delivery. Mr. Feldman had a legitimate economic purpose for his buy-writes—to maintain his economic hedge. *See* section III.A.1, *supra*. The defendants in *Hazan* used FLEX options which generally require knowledge of the counter-party as the investors agree to specific set terms. In contrast, Mr. Feldman used standard options and sold them on the open market. FOF at ¶¶ 100. Mr. Feldman, unlike the defendants in *Hazan*, did not know who the counterparties were and did not prearrange terms and neither did optionsXpress.

The purpose of the buy-writes was not to avoid delivery of the stock, but exactly the opposite: The buy portion was to cover the buy-in. *See* Tr. at 3211:21-25 (Sirri) ("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."). Mr. Feldman received a Daily Position Recap each evening that showed him to have a net flat position for any buy-in he addressed with a buy-write. FOF at ¶¶ 79-80. This confirmed that delivery had actually occurred. FOF at ¶¶ 79-84. If Mr. Feldman received an assignment notice the next morning, it appeared as a new

position. *Id.* Thus, Mr. Feldman believed that his buy-writes completely satisfied any cover or delivery obligation from any buy-in because he had a new position each day. *Id.*

The Daily Position Recap confirmed to Mr. Feldman that the buy portion of the buy-write was covering the buy-in, and Mr. Feldman could do no more. Tr. at 1493:25-1494:20 (Harris). Even if optionsXpress received an assignment later that same day, optionsXpress would not assign Mr. Feldman (if at all) until the next day, and thus would not buy-in Mr. Feldman (if at all) until that day or later, depending on its own CNS position. Whether or not stock was delivered had no impact whatsoever on Mr. Feldman's strategy. *See* section III.B.3 *supra.* The fact that Mr. Feldman engaged in the buy-writes is not evidence of his scienter because he had a legitimate economic purpose for using the buy-writes. *See* section III.A.1, *supra*; *see also* Sirri Report, OPX-EX-915 at ¶ 54.

5. <u>No Collusion with Counterparties or optionsXpress</u>

Every witness asked about collusion affirmed that Mr. Feldman, and indeed no one at optionsXpress, knew who the counterparties to Mr. Feldman's trades were. FOF at ¶ 13. Similarly, optionsXpress did not have any arrangement or agreement with Mr. Feldman that the written calls would be exercised the same day Mr. Feldman sold them. Tr. at 634:20-25 (Coronado).

C. <u>The Division Did Not Prove Scienter or Negligence</u>

1. <u>Reasonable Reliance on optionsXpress' Representations of Compliance</u>

Mr. Feldman's reliance on his brokers' explicit and implicit representations of compliance defeats scienter. *See* FOF at section F.1. The Division presented no evidence to contradict Mr. Feldman's testimony that Peter Bottini, a vice-president at optionsXpress, told him that the SEC reviewed the strategy and did not find it problematic. *See* FOF at ¶¶ 59-60.

Contemporaneous e-mail correspondence confirms that Mr. Bottini made this representation. *See id.* In all the telephone calls and e-mails between Mr. Feldman and his brokers, there is not a single instance where Mr. Feldman indicated he believed optionsXpress was not complying will Reg SHO or not delivering. Nor did optionsXpress represent anything to Mr. Feldman other than that they were taking all necessary steps to comply with Reg SHO. *See* FOF at ¶ 61.

Moreover, Mr. Feldman received daily confirmations from optionsXpress that it was complying with delivery obligations in the form of "bought-to-cover trade notices" and his "Daily Position Recap," which showed him to have a net flat position concerning any buy-ins addressed with buy-writes. *See* OPX-EX-919-921. The bought-to-cover trade notices signaled to Mr. Feldman that optionsXpress was delivering because optionsXpress was buying him in to satisfy its delivery obligations:

> The fact that a broker was requesting buy-ins on a regular basis on certain securities, if anything, should give the retail customer some indication that the broker was making an effort to comply with Rule 204.

Sirri Report, OPX-EX-915 at ¶ 147. To be sure, Mr. Feldman had no view into the CNS system and no way to independently confirm that optionsXpress was delivering. FOF at ¶¶ 83, 85.

It was wholly reasonable for Mr. Feldman to rely on his broker's explicit representations that it was complying with Reg SHO. *See generally S.E.C. v. Caserta*, 75 F.Supp.2d 79, 94 (E.D.N.Y. 1999) (good faith reliance on attorney or accountant provides evidence of lack of scienter); U.S. S.E.C. v. Snyder, 292 F. App'x 391, 406 (5th Cir. 2008) ("We find no meaningful distinction between the reliance on counsel and reliance on an accountant. Both defensive theories provide an explanation of the defendant's conduct tending to negate the element of scienter"). Under similar circumstances, good faith reliance on a broker's representations that unregistered shares could be sold prevented a finding that the sellers were underwriters and

therefore did not violate Sections 5(a) and (c) of the Securities Act. *See In the Matter of OTC Live, Inc. and Mark A. Suleymanov*, Release No. 261, 83 S.E.C. Docket 2726, Release No. ID – 261, 2004 WL 2203266. Both of the Division's experts confirmed that customers rely on their broker-dealers for delivery compliance. *See, e.g.*, Tr. at 1493:25-1494:20 (Harris); Tr. at 950:12-17 (Sheehy). Indeed, Reg SHO and Rule 10b-21 anticipate that the customer will rely on the broker-dealer. *See* 10b-21 Adopting Release at 6166-61672.

After being told by multiple representatives of a reputable brokerage firm that the firm was compliant, no reasonable person would question those representations. *See* FOF at ¶ 43 (quoting Zelezny's reliance on optionsXpress). This Court questioned Mr. Feldman's reliance on optionsXpress' representations and asked him during the hearing why he did not think to call the SEC to confirm optionsXpress' representations. Hearing Tr. at 2627:5-2635:14. While Mr. Feldman may have been skeptical of optionsXpress when they imposed additional fees, he never questioned their actions with regard to regulatory compliance. Hearing Tr. at 2627:13-2628:2. Moreover, Mr. Feldman had no reason to suspect that optionsXpress would misrepresent regulatory approval to him (in order to continue making money off of his trading), because optionsXpress had demonstrated a consistent pattern of restricting trading if necessary to meet compliance obligations. Hearing Tr. at 2631:7-25 (Feldman) ("They had already shown their willingness and ability to limit the size of my trading, the amount of my trading, and they even told me afterwards that the reason was that there was a regulatory concern, and they wanted to make sure they were in compliance.").

Had Mr. Feldman attempted to independently contact regulators, they would have provided him no guidance and would have refused to even confirm the existence of an investigation or inquiry into the issue. FOF at ¶ 65. Indeed, the standard of care for a reasonable

person would not entail calling the SEC, because as Dr. Sirri testified, he had "never heard a retail customer calling about SHO compliance of a broker." Tr. at 3256:20-22 (Sirri).

Further demonstrating the reasonableness of Mr. Feldman's reliance on optionsXpress' representations of compliance is the fact that the CBOE, optionsXpress' primary regulator, did not believe the trading violated Reg SHO. Tr. at 3945:6-19 (Overmyer) (CBOE representative explaining that he was told at least 10 times by the SEC that this conduct did not violate Reg SHO and that he eventually believed them because they wrote the rule); Tr. at 3991:3-22 (MacDonald) (CBOE representative testifying that the SEC's mantra was that there was no violation of Rule 204). FINRA also concluded that the trading did not violate Reg SHO. Tr. at 2837:17-20 (Huber) (FINRA representative testifying that the SEC told FINRA that based on the facts optionsXpress presented the SEC determined there was no violation of Rule 204); OPX-EX-675 at 1 (FINRA representative's contemporaneous notes from call with CBOE stating that the SEC told the CBOE that the buy-write trading was "not officially violating a rule").

Reg SHO requires significant industry and compliance knowledge to apply, and at the very least, there was uncertainty among the regulators and brokerage compliance departments as to what conduct violated the rule. *See* Tr. at 3739:17-3740:9 (Tao) (quoting a GAO report which found that in the 10 months after Reg SHO was adopted, the industry was "inconsistently implementing" it and not receiving timely and clear interpretive guidance). John Ruth, Mr. Stern's expert, was the only testifying expert at trial with actual experience managing a broker-dealer—Goldman Sachs Execution & Clearing, L.P. ("Goldman")—where he was Vice President and Managing Director. Ruth Report, OPX-EX-250 at ¶ 3. Mr. Ruth testified that there was substantial uncertainty surrounding how Reg SHO applied to options trades, and the law is unclear as to whether it is improper to use two common options trades—the buy-write and

an in-the-money call—to comply with Reg SHO. *Id.* at ¶¶ 41-43. Moreover, the SEC has not regulated the use of in-the-money calls, and there is no guidance or industry standard on what constitutes an in-the-money or "deep" in-the-money call. *Id.*

To make its case that optionsXpress did not comply with Reg SHO, the Division relies heavily on the testimony of witnesses concerning fails-to-deliver in the CNS system, internal discussions among various backroom compliance personnel at optionsXpress and Penson, and regulatory guidance given to industry insiders. Mr. Feldman had none of this information. The Division presents this case as if there was transparency of all these components to Mr. Feldman. At best, Mr. Feldman received bits of information from optionsXpress piecemeal, and all of it reflecting (correctly) that optionsXpress was compliant. FOF ¶ 60.

The Division attempts to spin these facts by asserting that Mr. Feldman knew his trading created "regulatory concerns." DPB at 30. The Division presented e-mails sent to Mr. Feldman concerning Rule 204, *In the Matter of Hazan Capital Management, LLC et al.*, and compliance issues. Again, Mr. Feldman received this information piecemeal over many months, and <u>none</u> of this e-mail correspondence communicated that optionsXpress was circumventing or failing to comply with Reg SHO. Notably, Mr. Feldman was not given any information regarding footnote 82 of the Rule 204 Adopting Release, the basis for the Division's Reg SHO charges. FOF at ¶ 57. Moreover, nothing in Rule 204 would have alerted Mr. Feldman that his trading was problematic:

> Rule 204 does not contain any language that would have indicated to Mr. Feldman that, as a retail customer, he would have a responsibility to determine whether orders submitted to and accepted by his broker might cause his broker to violate Rule 204 or any other rule.

Sirri Report, OPX-EX-915 at ¶146.

Likewise, *Hazan* confirmed for Mr. Feldman that his trading was compliant because the problematic conduct in *Hazan*—the use of flex options, the market-maker exception, and collusion with counterparties—was absent in his trading. *See* FOF at ¶¶ 68-70.

Even if optionsXpress had shared the CNS reports it received from the DTCC with Mr. Feldman, which it did not, this still would not have alerted Mr. Feldman to the fact that his trading was resulting in CNS fails-to-deliver for two reasons. First, the CNS reports that optionsXpress received did not have an aging column that showed how many days a CNS fail supposedly persisted. Tr. at 126:7-9 (Colacino). Second, because CNS is a net system that nets together all customers' trades, Mr. Feldman would not have been able to tell if the fails-to-deliver at CNS were the result of his trading or another customer's, because CNS does not map fails-to-deliver to a particular customer. Tr. at 2993:9-13 (Sirri). In sum, Mr. Feldman did not receive any information about fails-to-deliver at CNS, but if he had it would not have alerted him that optionsXpress was violating Reg SHO because fails-to-deliver at CNS do not indicate a violation of Reg SHO.

2. Frequent Assignments Were Not "Red Flags"

Mr. Feldman's use of the strategy in the 14 other stocks that the Division ignores in the OIP is significant because it demonstrates that the Division selected periods and stocks that had a high-incidence of buy-writes while ignoring the fact that Mr. Feldman executed his strategy in many other issuers and had a much lower incidence of assignments and buy-writes. Sirri Report, OPX-EX-915 at ¶ 138. The statistical analysis conducted by Dr. Sirri demonstrates that the rate of assignment was in fact highly variable, even among the securities identified by the OIP. FOF at ¶¶ 76-77. The Division and Dr. Harris gloss over the fact that Mr. Feldman's calls often were only partially assigned on the day they were written. *Id.* Similarly, the Division ignores that

there is no way to determine if the assignment was the result of a call written that day or on a previous day. FOF at ¶ 9.

The Division points to a conversation between Jeremy Coronado, an employee on the trade desk at optionsXpress, and Mr. Feldman where Mr. Coronado said that Mr. Feldman would "normally" and "usually" be assigned, and statements from Mr. Feldman that he was being assigned every day. DPB at 29. The Division takes these statements wholly out of context. When Mr. Coronado told Mr. Feldman he was "usually" going to be assigned, he was warning Mr. Feldman that assignment was always a possibility even though the assignment process was random. Tr. at 584:20-24; 609:17-610:11 (Coronado). Similarly, the Division takes Mr. Feldman's comments regarding being assigned every night in July and September completely out of context. The full conversation demonstrates that Mr. Feldman was explaining ways to lessen assignments and that assignments were not guaranteed:

> Dean Kolocouris: what month do you recommend?
> Dean Kolocouris: july or sept
> Jonathan Feldman: it [al]most doesn't matter, JUL or SEP, as u get assigned that night anyway, so what's the diff?
> Jonathan Feldman: it seems SEP gets assigned a bit less i think.
> Jonathan Feldman: i tried selling SEP 2 calls instead of SEP 1 calls.
> Jonathan Feldman: since i saw open int is a lot higher, maybe they let u stay w the calls longer and don't get assigned.
> Jonathan Feldman: but the risk there is, the puts are .12cents. because u have no protection under $2 if u stay w the calls.. (risky idf C falls towrds 2)
> Jonathan Feldman: i just figured I'd get assigned, except maybe I'd buy an extra day or two.
> Jonathan Feldman: last night it worked, got assigned maybe 50% of my SEp 2's.

Div. Ex. 246.

Assignment was a risk that Mr. Feldman knowingly took when executing his strategy, but it was not something he wanted. FOF at ¶ 73. In a December 4, 2009 e-mail to Mr. Feldman,

Kevin Strine, optionsXpress's vice president of compliance, wrote that optionsXpress was changing its procedures to ensure compliance with Reg SHO:

> In the past, we didn't even have to issue buy-ins that early, but in this new era, with the implementation of the SEC's Reg SHO Rule 204, we have to be much more proactive.

OPX-EX-902. Mr. Feldman responded to Mr. Strine that same day:

> So, interestingly, (in simple terms), initially there are 3 days to see if you "fail", but once you "fail", then all future short sales of the SAME security are considered part of the same "fail" *w/o* even waiting the 3 days. Got it.
>
> This gives me some other food for thought. I am wondering if there might not be some different strategies I could use to avoid buyins, or "restart the clock" sometimes.

Id. While Mr. Strine never responded to this e-mail, he understood that Mr. Feldman was not asking that optionsXpress do anything illegal or seeking to avoid delivery obligations. Tr. at 3456:22-3457:25 (Strine). Rather, Mr. Feldman wanted to know if there were legitimate ways to prevent assignment. FOF at ¶ 60. The above e-mail conversations demonstrate that Mr. Feldman tried, when possible, to avoid or limit assignments as long as it did not expose him to greater risk.

There were periods where Mr. Feldman was receiving daily assignments, though these were often only partial assignments, but there were also periods where this was not the case. FOF at ¶¶ 76-77. That Mr. Feldman referred to one of these periods of frequent assignment in his conversations with others does not demonstrate that he knew every call he wrote would be assigned on the day he wrote it.

The Division also misconstrues Mr. Feldman's statements that he did not "settle" and wanted to avoid "settlement." DPB at 29. Mr. Feldman used the term "settlement" to describe a period of time, not delivery obligations. Mr. Feldman's use of the word "settlement" in

conversations with Andrew Wallin, a trader at Terra Nova, did not reflect that he was aware that stock was not being delivered. Rather, it referred to the fact that Mr. Feldman's agreement with Terra Nova was that he would not be charged hard-to-borrow fees if he bought to cover on T+1, i.e., if he did not wait until the T+3 settlement date. FOF at ¶¶ 91-92 Mr. Feldman was not communicating that his stock was not delivered, he was explaining that he always bought to cover on T+1 and never made it to the settlement date.

3. Other Brokers Did Not Reveal Regulatory Concerns to Feldman

Terra Nova, E*TRADE, and TD Ameritrade did not tell Mr. Feldman that they were not allowing him to continue his buy-write strategy because of Reg SHO violations. Rather, he was told it was the volume of his trading or the cost to the broker that caused the broker to shut down the strategy. *See, e.g.*, Tr. at 2381:4-8 (Feldman); Tr. at 899:1-5 (Crain). Indeed, Andrew Wallin, a Terra Nova employee, told Mr. Feldman that a pending settlement was sufficient to comply with CNS delivery obligations and that he believed optionsXpress thought that as well. OPX-EX-801 (audio recording between Mr. Wallin and Mr. Feldman); *see also* Tr. at 2540:1-25, 2542:20-2543:18 (Feldman); *see also* Div. Ex. 296 at 3.[3] Far from alerting Mr. Feldman that his trading was improper, Mr. Feldman's interactions with other brokers confirmed that his trading was not causing regulatory problems. *See id.*; *see also* OPX-EX-929 and OPX-EX-930 (requesting and receiving confirmation from E*TRADE representative that it was permissible to cover short calls with a buy-write).

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[3] Similarly, contrary to the Division's assertions, Mr. Wallin's statements that Mr. Feldman's buy-write trades did not "settle" meant that the trades remained unsettled for three days, not that there was a failure to deliver at optionsXpress. Feldman Tr. at 2233:8-2234:8. Mr. Wallin was not talking about this in the context of a failure to deliver, but rather in the context of Penson's collateral requirements at the OCC. *See* Div. Ex. 25 at 22.

The Division's referral to Mr. Wallin's statement that Mr. Feldman's trading made regulators "skittish" is wholly out of context. Taken as a whole, Mr. Wallin was confirming that there was no actual regulatory issue, and the real issues were business considerations—mainly capital requirements. FOF at ¶ 95. Indeed, this is consistent with what is now known regarding the regulators: CBOE and FINRA representatives believed that the trading did not violate Reg SHO. FOF at ¶ 64. That there was a dispute about whether Terra Nova and Penson were satisfying their delivery obligations and that Terra Nova and optionsXpress believed that the buy-ins were sufficient only demonstrates further that a retail customer, without the benefit of industry knowledge and compliance departments, could not know that his conduct was supposedly violating a rule.

The only testimony in the record concerning what Mr. Feldman was told by Terra Nova is Mr. Feldman's. The Division did not call Mr. Wallin or any other Terra Nova employee to testify. The Penson representative testified that he had no direct communications with Mr. Feldman, and the record is devoid of any other evidence showing that Penson communicated or interacted with Mr. Feldman at all. FOF at ¶ 90. Thus, the Division's emphasis on Penson's belief that delivery obligations were not being satisfied by Mr. Feldman's buy-ins are irrelevant to the question of Mr. Feldman's liability for fraud because it is undisputed that <u>no one from Penson ever communicated this to Mr. Feldman</u>.

Similarly, TD Ameritrade and E*TRADE did not stop Mr. Feldman's trading because it violated Reg SHO. E*TRADE did not find anything about Mr. Feldman's trades that was violative of a rule, and E*TRADE did not violate Reg SHO in executing Mr. Feldman's trades. Tr. at 4825:22-4826:1-3 (Mikus). Moreover, Mr. Feldman conducted his strategy at TD Ameritrade and E*TRADE over a year after the period at issue in the OIP. Thus, even if

E*TRADE and TD Ameritrade had shut down Mr. Feldman's trading for regulatory reasons, this does not provide any evidence of Mr. Feldman's state of mind while he was trading at optionsXpress. When Mr. Feldman began trading at E*TRADE and TD Ameritrade, he had already received an opinion from Dr. Sirri that his trading did not violate any federal securities law. FOF at ¶ 67. It is undisputed then that Mr. Feldman executed the same strategy at four brokers, but only one, optionsXpress, allegedly violated Reg SHO. Tr. at 4826:4-14 (Mikus). It is thus also an undisputed fact that Mr. Feldman's strategy could be, and was, executed without violating Reg SHO. Assuming *arguendo*, optionsXpress was in violation, Feldman would have no way of knowing this.

4. Division Did Not Prove Negligence

Mr. Feldman acted as any reasonably prudent person would under the circumstances. Indeed, he acted as all other retail customers do in relying on his broker for compliance issues. Rule 204 and Rule 10b-21 presume that retail customers will rely on their brokers for delivery and compliance with Reg SHO. *See* section III.A.3, *supra* and section III.D, *infra*. It cannot be that Mr. Feldman was reckless or negligent in acting in the very manner expected by the rules. *C.f. Simmons v. Jelniker*, 122 F. App'x 623, 626 (4th Cir. 2005) ("compliance with any applicable statutes or ordinances defeats [plaintiff's] negligence claim").

Mr. Feldman was also not negligent in relying on optionsXpress for delivery because Mr. Feldman had no alternative. Mr. Feldman could not effect delivery himself. He could not confirm that optionsXpress was delivering. *See* section III.C.1, *supra*. He also could not confirm that the SEC or other regulators had approved of his trading or optionsXpress' delivery compliance because the regulators would not have spoken to him about their findings or given him any guidance. *See* section III.C.1, *supra*. He could not confirm that optionsXpress was

being truthful when it told him that it was complying with all rules and regulations, nor did he have any doubts.

D. Division Did Not Prove a Rule 10b-21 Violation

The Division has offered no evidence (let alone persuasive evidence) that Mr. Feldman made a representation about his intention or ability to deliver shares, and thus the Division failed to prove Mr. Feldman violated Rule 10b-21. To prove the Rule 10b-21 claim, the Division had to demonstrate that Mr. Feldman: (1) submitted an order to sell an equity security; (2) while deceiving a broker or dealer, a participant of a registered clearing agency, or a purchaser; (3) about his intention or ability to deliver the security on or before the settlement date; and (4) failed to deliver the security on or before the settlement date. Rule 10b-21(a). While the Division has shown that Mr. Feldman submitted orders to sell equity securities, it failed to prove any of the other three elements.

No witness testified that Mr. Feldman communicated in any way whatsoever that he intended or was able to deliver securities to anyone. Likewise, no exhibit contained any communication that Mr. Feldman had the intention or ability to deliver shares. Instead, every witness with knowledge stated that Mr. Feldman never made a representation abut his intention or ability to deliver a security, and he never provided an "away locate." *See* FOF at ¶ 49; *see also* Tr. at 335:16-22; 336:1-17 (Molnar) (explaining that Mr. Feldman never provided an outside locate or represented he would deliver shares from an outside source, but even if he had optionsXpress would not have accepted it).

The Division can also not rest its Rule 10b-21 claim on Mr. Feldman's making an implied representation to the marketplace by submitting trade orders. The Commission itself expressly acknowledged in the Rule 10b-21 Adopting Release that an individual retail customer

lacks control, and the customer is relieved of liability if the customer is relying on his or her broker:

> If a seller is relying on a broker-dealer to comply with Regulation SHO's locate obligation and to make delivery on a sale, the seller would not be representing at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due.

10b-21 Adopting Release at 6166-61672 (emphasis added).

Finally, the Division has not shown that Mr. Feldman failed to deliver securities. As was shown multiple times during the hearing, Mr. Feldman had no actual obligation or ability to deliver securities to CNS. *See* Tr. at 116:22-117:4 (Risley); Sirri Report, OPX-EX-915 at ¶ 58. Delivery to a clearinghouse is distinct from delivery to CNS. Sirri Report, OPX-EX-915 at ¶ 125. Thus, the Adopting Release specifies that "delivery" for purposes of Rule 10b-21 does not refer to CNS delivery:

> Rule 10b-21 as proposed was not based on whether a fail to deliver occurred in CNS.
>
> . . . .
>
> . . . Thus, Rule 10b-21's focus is on whether or not there is a fail to deliver by the seller, rather than on whether or not there is a fail to deliver in the CNS system.

Rule 10b-21 Adopting Release at 61672. The customer's delivery of shares to a broker is entirely independent and distinct from the broker's delivery to CNS and does not affect the broker-dealer's obligation to deliver to CNS. Sirri Report, OPX-EX-915 at ¶ 125-127. Customers have no obligation to deliver stock unless they have made a representation that they will do so to their broker-dealer. *See* Tr. at 3018:11-3019:7 (Sirri). As Dr. Sirri explained, this could happen with institutional customers, and Rule 10b-21 was designed to prevent that:

> So the general sort of people you worried about were hedge funds institutional customers, big players. And the big players could come in and say, we want to sell short, broker-dealer who executes says, we haven't got the shares you can't sell short. The institutional customer says, you know, I've got the shares, don't

> worry about it, when they didn't. And that's my understanding of the purpose of 10b-21.

Tr. at 3222:16-3223:3 (Sirri).

In order for an individual retail customer to violate Rule 10b-21, the customer would have to make an explicit representation to the broker that the customer will deliver shares to the broker. Sirri Report, OPX-EX-915 at ¶ 127. Accordingly, the broker would have to be deceived by the customer's misrepresentation about delivering shares to the broker, a fact explained by the SEC's General Counsel, when Rule 10b-21 was proposed:

> 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.

Div. Ex. 401 at 9 (emphasis added). Here, the Division does not allege that the broker (optionsXpress) was deceived, but instead that the broker aided and abetted Mr. Feldman's violations, the very contradiction identified.

The Division speaks frequently of Mr. Feldman's "delivery obligations" and states that "Feldman was required to deliver these shares by the standard settlement date." DPB at 28. This simply is false and misleading because the only possible delivery Mr. Feldman would have been required to make was to his broker, and there is no evidence that optionsXpress requested him to deliver or that Mr. Feldman volunteered or agreed to deliver to optionsXpress. Moreover, the record evidence showed that optionsXpress timely delivered all shares, thereby defeating any claim under Rule 10b-21. Thus, the Division has failed to prove that Mr. Feldman failed to deliver securities as required by Rule 10b-21.

E. No Evidence Feldman Had the Requisite Control to be a Primary Violator

Even if the Court credits the Division's unsupported theory that Mr. Feldman submitted orders knowing that optionsXpress would not comply with its Reg SHO delivery obligations, the Division's claims fail because they have not alleged that Mr. Feldman aided and abetted optionsXpress' alleged violations of any of the federal securities laws or rules. Under the Division's factually unsupported theory, at most Mr. Feldman would be an aider and abettor of optionsXpress' fraud or Reg SHO violation assuming that optionsXpress was noncompliant. But the Division only charges him with primary liability.

The Division's charging Mr. Feldman as a primary violator is nonsensical. Mr. Feldman had no control over the alleged fraudulent conduct—the delivery failures. Mr. Feldman's lack of control was typical of an individual retail customer and expected in the industry. *See* section III.D, *supra*. Thus, even if representations concerning delivery were made by simply placing a trade (which is not the case), members of the marketplace would view those putative representations as being made by optionsXpress, who had the delivery obligation.

The Supreme Court in *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011), held that a person must have control over a misleading statement to be a primary violator. *See id.* at 2301-2302. The *Janus* Court determined that to "make" means having "ultimate control" over the allegedly misleading statement, including its content and dissemination. Id. at 2301-2302 ("Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right"); *see also In the Matter of Flannery et al.*, Adm. Proc. File No. 3-14081 (Initial Decision Dated Oct. 28, 2011) (applying the *Janus* standard to charges brought under Section 10b of the Securities Exchange Act and Section 17(a) of the Securities Act).

To be sure, Mr. Feldman's agreement with optionsXpress gave Mr. Feldman's brokers complete authority regarding whether to allow a short sale and whether to do a buy-in (with or without Mr. Feldman's consent):

> If we make a sale of any securities and/or other property at your direction, and if you fail to deliver to us any securities and/or other property that we have sold at your direction, <u>we are authorized to borrow or otherwise obtain the securities and other property necessary to enable us to make delivery, and you agree to be responsible for any cost or loss we may incur, including the cost of borrowing and obtaining the securities and other property</u>.
>
> . . . .
>
> . . . Any sell order will be deemed a long sale unless, at the time the order was entered, <u>you expressly request and receive permission from optionsXpress to place the order as a short sale</u>. In order to complete a short sale, we must be able to borrow the security you sold and did not own. In the event that we are unable to borrow the security you have sold short, <u>you will be subject to a buy-in of the security for your Account without prior notice and at your expense</u>. You understand that although you may receive confirmation of a 'locate' in order to sell short, <u>you remain subject to buy-in at any time in the event that the shares become no longer available for borrowing or loan</u>.

Div. Ex. 98 at 5-6 (emphasis added).

The testimony from optionsXpress confirms that Mr. Feldman had no authority or control over assignment, buy-ins, or delivery. FOF at ¶¶ 47-48. Mr. Feldman's lack of control was further confirmed by experts for both the Respondents and the Division. FOF at ¶ 45. Mr. Feldman had no control over the alleged instruments of deception and thus he cannot be a primary violator. This conclusion is further bolstered by the fact that Mr. Feldman engaged in the exact same trading strategies at three other brokers, and there is no evidence or allegation that <u>anyone</u> was defrauded by that identical trading. FOF at ¶ 99.

F. <u>Division Has Not Proved Ill-Gotten Gains</u>

A court "may order disgorgement only as to property causally related to the wrongdoing." *S.E.C. v. One or More Unknown Traders in Common Stock of Certain Issuers*,

853 F. Supp. 2d 79, 83 (D.D.C. 2012) (internal quotations omitted); *see also In re Ronald S. Bloomfield, et al.*, SEC Rel. No. 416A, 2011 WL 1591553, at *35-36 (April 26, 2011) (Murray, Chief ALJ). The Division bears the burden of showing the causal relationship between the wrongdoing and the illegally obtained funds. *One or More Unknown Traders*, 853 F. Supp.2d at 83. While disgorgement need only be a reasonable approximation of profits causally connected to the violation, a "defendant may legitimately avoid an order of disgorgement by establishing a clear break or considerable attenuation in the causal connection between the wrongdoing and the illegally obtained funds." *Id.* at 83-84; *see also S.E.C. v. Robinson*, 00 CIV.7452 RMB AJP, 2002 WL 1552049 (S.D.N.Y. July 16, 2002) (the SEC's disgorgement figure was not reasonable because it did not present evidence that the amount only included funds from defrauded investors).

In determining the disgorgement amount, a court must offset the disgorgement figure by costs and fees, such as brokerage commissions and other transaction costs, that the defendant incurred in effecting a fraudulent transaction. *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc.*, 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990) ("To require disgorgement of all fees and commissions without permitting a reduction for associate expenses and costs constitutes a penalty assessment and goes beyond the restitutionary purpose of the disgorgement doctrine."). Here, the Division's disgorgement calculations are entirely specious, speculative, and unsupported. The Division asks the Court to accept these calculations on their face despite obvious and egregious errors.

1. No Illicit Profit Based on Not Paying Hard-to-Borrow Fees

The core of Dr. Harris' disgorgement analysis is the assumption that Mr. Feldman made an illicit profit because he avoided hard-to-borrow fees that he would have been charged had optionsXpress borrowed the stock:

> Q. And so, you are saying that Mr. Feldman avoided hard-to-borrow fees and profited – and obtained a gross amount of $4.56 million by doing so, right?
>
> A. Yes.

Tr. at 1550:11-15 (Harris). Dr. Harris admitted, however, that Mr. Feldman could have legally profited if his arrangement with optionsXpress provided that he would not pay hard-to-borrow fees:

> Q. And so, the fact that Mr. Feldman, in fact, had an arrangement where he would not pay hard-to-borrow fees, he could have realized that profit without paying hard-to-borrow fees?
> . . .
> A. That's correct.
>
> Q. And so, Mr. Feldman [engaging] in his trading strategy without paying hard-to-borrow fees would have netted that amount, right?
>
> A. That's correct.
>
> Q. And he would have netted that amount whether his broker-dealer had delivered shares to the CNS system, right?
>
> A. That's correct.
>
> Q. And he would have made that amount whether his broker-dealer would have not delivered shares to the CNS system, right?
>
> A. That's correct.
>
> Q. And so, from Mr. Feldman's perspective, whether or not delivery occurred in the CNS system, had no effect on the amount of profit from the strategy, correct?
>
> A. That's correct.

Thus, the "illicit profit" based on avoidance of hard-to-borrow fees is in fact zero:

> Under the logic of you didn't pay fees, but he said I'm never paying fees because that's my business arrangement and that's the business model with respect to me, then the damages would be zero under that kind of understanding.

Tr. at 2982:18-22 (Sirri) (emphasis added).

Even setting aside this fundamental flaw in Dr. Harris' disgorgement assessment, Dr. Harris' calculations are flawed because they assume that Mr. Feldman's only option would have been to borrow all the stock for the entire period. FOF at ¶ 138. This is the most expensive alternative scenario, but not the most likely one. As Dr. Sirri demonstrated, Mr. Feldman had various alternatives, including: (1) buying to cover, waiting for one day, and then re-establishing a new hedge; (2) hedging with options that were less in-the-money and had a lower chance of being assigned; or (3) writing a customized call option with European-style exercise (an option that could not be immediately exercised and assigned). OPX-EX-924; *see also* Tr. at 2984:20-23 (Sirri). Thus, while Dr. Harris considers only the most expensive alternative, "[a]n appropriate damages methodology would compare Feldman's actual profits to what his profits would have been had he followed the best alternative available to him that did not create liability." Sirri Rebuttal, OPX-EX-924 at 10.

Another significant flaw in Dr. Harris' calculations is that he includes in the disgorgement all of the buy-write activity, even before any pattern emerged. If repeated assignments alerted Mr. Feldman that optionsXpress was not delivering (which is not the case), then the disgorgement calculation associated with this should begin only after the pattern became evident. *See* Tr. at 2987:18-2988:6 (Sirri). Thus, Dr. Harris' disgorgement calculation is flawed because it should have omitted the early portion of the period before the pattern became evidence. Sirri Rebuttal, OPX-EX-924 at 11.

Even if Dr. Harris is correct that hard-to-borrow fees should be included in a disgorgement calculation for Mr. Feldman, he incorrectly assumes that all brokers pay the same lending rate for each stock. *Id.* In fact, "the lending rate can be different across brokers, and for the same broker, it can be different for different customers." *Id.* Dr. Harris would have had to use a methodology that analyzed whether optionsXpress would have paid a borrow fee, what the actual fee was, and what portion of the fee would have been passed to Mr. Feldman:

> Q. So we wouldn't even know if, in this scenario of damages calculation, if optionsXpress would have paid a borrow fee to anyone, correct?
>
> A. It's more than I know in this situation, that is correct.
>
> Q. Then we would have to find out what portion, if any – we're assuming they would pass on some in Dr. Harris' calculation, right? He's assuming that. What portion of that fee optionsXpress would then in turn have attempted to charge Mr. Feldman, right?
>
> A. Right. These are things that we discussed before. It may be that the broker, optionsXpress, is charged a fee by another broker. What amount gets passed on to Mr. Feldman, higher, lower, zero, that's as I've said before, that's a business matter. That's negotiated. We don't know what that is. The calculation that's made here makes a very specific assumption about what's passed on.

Tr. at 2990:4-22 (Sirri). Dr. Harris did not conduct any such analysis and thus his damages calculation is purely speculative:

> Well, I think I would summarize the points that I made, which are that his calculation is grounded in a hard-to-borrow fee for which there's no basis because of his arrangement. Having said that, even setting that aside and looking at what he did, the process he used, that is the way I would say the normally the but-for world he constructed or what would have been done, doesn't really have a basis. I would say more work needs done to establish that basis. Picking this hard-to-borrow fee is not really what I would have done.

Tr. at 2991:3-13 (Sirri).

2. Dr. Harris' Analysis Erroneously Assumes T+3 Delivery Obligation

Dr. Harris asserts that Mr. Feldman was profiting illicitly from trades that were not settling at CNS by T+3. Tr. at 4949:13-25 (Harris). Dr. Harris opined that purchasers expected to receive shares on T+3 and were harmed when they did not receive them on that date. Tr. at 4950:9-15 (Harris). As explained above, this proposition is simply not true: Rule 204 allows for delivery on T+3 or purchasing or borrowing on T+4, which means that delivery can occur consistent with Reg SHO on T+7. *See* section III.A.1. Thus, no purchasers had a basis to expect shares would be delivered on T+3, particularly because the record shows that they frequently were not delivered on or before T+3. FOF at ¶ 34. Dr. Harris did not analyze how many purchasers received their shares after T+7. Tr. at 1490:1-6 (Harris). Thus, Dr. Harris' damages calculation is based on a wholly unsupported and wrong metric for "harm," which would result in a grossly overstated disgorgement figure.

3. Dr. Harris' Revised Calculations Are Still Flawed

In his rebuttal report, Dr. Harris' revised disgorgement still wrongly assumes that Mr. Feldman would have paid hard-to-borrow fees, his only option was to borrow, and all lending fees were the same. Dr. Harris also incorrectly calculated damages based on a 100% assignment rate and 100% fail-to-deliver rate, and he admitted as much during his testimony:

> Q. So this analysis assumes 100 percent delivery failure every day for all these trades, correct?
>
> A. Yes.
>
> Q. And we know that's false, don't we?
>
> A. Yes, it wasn't 100 percent. I don't personally know that, but I can't imagine that it was.
>
> Q. Because, in fact, even based on whatever logic you're employing, there was not 100 percent assignment to Mr. Feldman for his calls, correct?

A. That's correct.

. . .

Q. And you didn't do any analysis to determine what amount should that 100 percent be reduced by, did you?

A. So the question -- the answer is no, but I don't believe such analysis was necessary.

Tr. at 4976:6-25, 4977:1 (Harris). Even assuming any CNS fail was an appropriate factor to determine disgorgement (which it is not), Dr. Harris could not ascribe any CNS fail to Mr. Feldman because CNS is a net delivery system and not tied to an individual customer. Tr. at 2993:9-13 (Sirri); Tr. at 4977:17-23 (Harris). It is impossible to map any CNS fail-to-deliver to Mr. Feldman. As a result, Dr. Harris' new calculation is overstated because it holds Mr. Feldman to account for fails-to-deliver caused by other customers of optionsXpress.

Dr. Harris' revised calculations also improperly include data for issuers that Mr. Feldman did not even execute a buy-write in after December 1, 2009. *See* Harris Rebuttal Exhibit 23-R; *see also* Tr. at 4985:13-21 (Harris). Although Dr. Harris' revised damages analysis purports to only include profits Mr. Feldman made after December 1, 2009, it in fact includes profits Mr. Feldman made for AIG, APWR, C, OSIR, SHLD, TXI, and UA before December 1, 2009. *See* Harris Rebuttal Exhibits 20-R through 23-R; OPX-EX-938. The revised amount of damages then is admittedly false and unreliable. Tr. at 4999:14-23 (Harris). Thus, Dr. Harris' total disgorgement calculation is, on its face, overstated and unreliable.

G. No Basis for Civil Penalty

The Commission may only impose a civil penalty if Mr. Feldman acted with extreme recklessness (*see Howard v. SEC*, 376 F.3d 1126, 1143 (D.C. Cir. 2004) or willfully aided and abetted a violation by another person; ***and*** if doing so serves the public interest. *See* 15 U.S.C.

§§ 78u-2, 80b-3(i), and 80a-9(d). The Division failed to demonstrate either component. As discussed previously (*see* section III.C, *supra*), the record is devoid of any evidence showing that Mr. Feldman acted with extreme recklessness or with scienter, and the Division has not charged Mr. Feldman with aiding and abetting. For this reason alone, the Court should deny the Division's request for a civil penalty. Moreover, the Court should not order a civil penalty because the Division has made no showing that such a penalty would serve the public interest, or even that the public was harmed in any way by his trading. *See* 15 U.S.C. § 78u-2(c).

Finally, the Division has adduced absolutely no evidence of what the civil penalty should be. According to the Division, a third-tier penalty of $150,000 is appropriate for Mr. Feldman for "each of their multiple violations." DPB at 44. In its Proposed Findings of Fact, the Division states that Mr. Feldman "conducted 390 buy-writes." DFOF at ¶ 316. The Division does not identify which of these buy-writes was violative of any rule however, and it cannot show which of the buy-writes resulted in a fail-to-deliver position at CNS because it is impossible to map fails-to-deliver to particular customers' trades. *See* section III.A.2, *supra.* Thus, using the buy-writes as the measure for a civil penalty is entirely inappropriate.

H. No Basis for a Cease and Desist Order

There is no basis for a cease and desist order because, as was demonstrated at the hearing, Mr. Feldman was asked to stop his strategy at TD Ameritrade in early 2012 and has not conducted this strategy at any broker-dealer since then. Moreover, the Division has not been able to identify a victim or a harm that occurred to the marketplace, 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).

I. These Proceedings Violate the Dodd-Frank Act

These proceedings violate the Dodd-Frank Act because the Commission failed to file within the second 180-day period despite authorizing the proceedings before the expiration of the second 180-day period. Section 929U of the Dodd-Frank Act, codified as Section 4E of the Exchange Act, requires that within 180 days after it provides a written Wells notification the Commission's Staff either file an action against the person or provide notice of its intent to not file an action:

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

15 U.S.C. § 78d-5(a)(1) (2012).

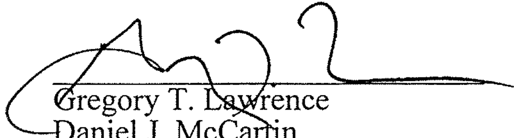
The undisputed facts demonstrate that in this instance the Commission authorized the Staff to file an action against Mr. Feldman on October 20, 2011, before the expiration of the second Dodd-Frank deadline on October 24, 2011. Therefore, the Commission Staff was required by law to file the action before the expiration of the second Dodd-Frank 180-day deadline. The plain language directs that the Commission Staff "shall" file an action authorized within the Dodd-Frank 180-day period or any extension thereof. The Staff and the Commission could not rely on a further extension of the second Dodd-Frank deadline to actually file against Mr. Feldman because the action was indisputably authorized within the second 180-day period.

IV. CONCLUSION

For the reasons stated above, the Division failed to show that Mr. Feldman committed fraud or otherwise violated any rule or regulation.

Dated: January 11, 2013

Respectfully submitted,



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