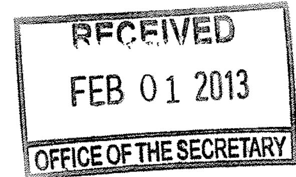

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

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

Respondents.

DIVISION OF ENFORCEMENT'S POST-HEARING REPLY BRIEF IN SUPPORT OF ITS CASE AGAINST RESPONDENT OPTIONSXPRESS, INC.

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The Division of Enforcement ("Division") respectfully submits this Reply Brief in Support of Its Case Against Respondent optionsXpress, Inc. ("optionsXpress").

INTRODUCTION

optionsXpress violated the plain language of Rule 204 and its predecessor, Rule 204T. Rules 204 and 204T are clear – optionsXpress is required to deliver securities to CNS (the registered clearing agency) by settlement date (T+3) or in the event it fails to deliver securities on time, to "immediately ***close out*** its fail to deliver position." 17 C.F.R. § 242.240(a) (emphasis added). optionsXpress did not deliver securities to CNS by settlement date and then failed to immediately close out its resulting failure to deliver position. This is a clear violation of the rules.

In its post-trial brief ("Br."), optionsXpress does not contest that its employees understood they were allowing a "vicious cycle" of failures to deliver at CNS to continue. Nor could it, for the evidence demonstrates that optionsXpress knowingly allowed Feldman and its other Customers to continue their trading in the face of numerous red flags and scrutiny from regulators. Indeed, optionsXpress was even warned by the SEC that their customers "may be engaging in fraud." After reading reports of SEC settlements involving similar trading, optionsXpress' traders' first reaction was the right one – "I'm not placing any trades today." Nonetheless, despite repeated red flags, optionsXpress was not deterred. Instead, optionsXpress chose to ignore its regulatory responsibilities and in turn reaped nearly $2 million in commissions and avoided paying over $7 million in hard-to-borrow fees.

Courts have long held that it is not "unfair to require that one who deliberately goes perilously close to an area of proscribed conduct shall take the risk that he may cross the line." *United States v. Kay*, 513 F.3d 432, 442 (5th Cir. 2007) (citing *Boyce Motor Lines, Inc. v. United States*, 342 U.S. 337, 340 (1952)). optionsXpress should be held to account for deliberately crossing the line.

Because it cannot claim that it did not know what it was doing, optionsXpress instead attempts to escape liability through a creative interpretation of Rule 204. However, that creative interpretation ignores the plain language of the rule – brokers are required to "***close out***" fail to deliver positions. Other brokerage firms had no problem understanding their delivery obligations and immediately closed out their fails. It was only optionsXpress who claims not to know what the rule was. optionsXpress can point to no other firm that allowed such a vicious cycle of failures to deliver to persist at CNS. Tellingly, optionsXpress' continuous failures to deliver at CNS dwarfed that of all other market participants. The evidence proves that every other firm that confronted identical trading by Feldman promptly stopped it. optionsXpress, on the other hand, chose to ignore its regulatory responsibilities.

Indeed, if the Court were to follow optionsXpress' strained reading of Rules 204 and 204T, there would be no rule. Under optionsXpress' reading of the rule, a clearing firm that has a failure to deliver at CNS in the amount of 100 shares can simply place a wash sale, *i.e.,* an order to "buy" those 100 shares while at the exact same time selling 100 shares – resulting in no shares being delivered. According to optionsXpress, simply because a purchase "transaction" has taken place, it has met its obligations under Rules 204 and 204T. This "interpretation" ignores the plain language of those rules – *i.e.*, that a broker must "close out" its failure to deliver position. If optionsXpress had its way, no broker would ever be required to deliver shares to "close out" their failures to deliver at CNS. This illogical proposition must be rejected and the Court should enforce the law as written (and understood by other market participants) and rule in favor of the Division.

ARGUMENT

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

optionsXpress claims that it did not violate Rules 204 or 204T because (1) the use of buy-writes "satisfied the plain language of Rule 204" (Br. at 3-7); (2) the evidence of optionsXpress' continuous failures to deliver at CNS is allegedly irrelevant (Br. at 9-13); (3) violations of Rule

204 cannot be based on footnote 82 of the adopting release and are largely limited to collusion between market participants (Br. at 13-17); and (4) even if footnote 82 carried legal weight, optionsXpress allegedly satisfied it (Br. at 18-23). optionsXpress also claims that the Division's case violates its due process rights (Br. at 28-32). Each of optionsXpress' arguments is without merit.[1]

A. The Purpose of Rule 204 Was to Reduce Failures to Deliver at CNS.

The Respondents do not dispute (nor can they) that Reg. SHO was designed to reduce failures to deliver at registered clearing agencies – namely CNS. Throughout the adopting release, the Commission made clear that it was enacting Rule 204 to reduce failures to deliver at registered clearing agencies:

- "These amendments are intended to help further our goal of ***reducing failures to deliver by maintaining the reductions in fails to deliver*** achieved by adoption of temporary Rule 204T." 74 Fed. Reg. 38266, 38266 (July 31, 2009).
- "Our adoption of temporary Rule 204T ***followed a series of other steps aimed at reducing fails to deliver*** and addressing potentially abusive 'naked' short selling." *Id.*
- "Preliminary results from the Commission's Office of Economic Analysis indicate ***that our various actions to further reduce failures to deliver***, and, thereby, address potentially abusive 'naked' short selling are having their intended effect." *Id.*
- "[L]arge and persistent ***fails to deliver*** may deprive shareholders of the benefits of ownership, such as voting and lending." *Id.* at 38277.
- "[I]ssuers may believe that they have suffered unwarranted reputational damage due to investors' ***negative perceptions regarding fails to deliver in the issuer's security***." *Id.* at 38268.
- "Because Rule 204 is based on a ***participant's fail to deliver position at a registered clearing agency***, it is consistent with current settlement practices and procedures and with the Regulation SHO framework regarding delivery of securities." *Id.* at 38272.

[1] "DFOF" refers to the Division's Proposed Findings of Fact filed December 7, 2012. "Tr." refers to the amended transcript of the hearing in this matter dated January 16, 2013. "Reply FOF" refers to the Consolidated Reply Findings of Facts filed by the Division with its Reply Briefs against each of the Respondents on February 1, 2013. The "Customers" refer to Feldman and the other five customer accounts that engaged in the trading at issue in this case. DFOF ¶ 47.

The adopting release to Rule 204 notes that some market participants fail to deliver securities in an effort to illegally profit from the extra time they take to make delivery. The Commission even stated that "[s]ellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security, ***or possibly avoid borrowing costs associated with short sales, especially when the costs of borrowing are high.***" 74 Fed. Reg. at 38267 (emphasis added); *see also* 73 Fed. Reg. 61706, 61707-08 (Oct. 17, 2008). This is exactly what happened in this case. Rather than pay the millions it would have cost to borrow the shares of hard-to-borrow stocks that it was failing to deliver, optionsXpress allowed its customers to use buy-writes in an attempt to circumvent delivery. These buy-writes did not actually result in shares being delivered to CNS (and in turn to other market participants) because the "write" portion was almost always exercised and assigned right back to optionsXpress. The CNS Account Summaries confirm that optionsXpress' failures to deliver persisted for months on end. These are facts that optionsXpress cannot credibly contest.

B. optionsXpress Violated the Plain Language of Rules 204 and 204T By Not Closing Out Its Failures to Deliver.

The Commission's goal of reducing failures to deliver at registered clearing agencies is clearly and pointedly reflected in Rule 204(a). A broker-dealer, such as optionsXpress, is required to deliver securities to CNS (the registered clearing agency) by settlement date (T+3) or in the event it fails to deliver securities on time, to "immediately ***close out*** its fail to deliver position." 17 C.F.R. § 242.204(a) (emphasis added).

Because it cannot contest that the CNS Account Summaries demonstrate it had persistent failures to deliver that were not being closed out, optionsXpress argues that those CNS reports are irrelevant. However, the plain language of Rule 204(a) says otherwise:

> A participant of a registered clearing agency ***must deliver securities to a registered clearing agency for clearance and settlement*** on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency ***has a fail to deliver position at a registered clearing agency*** in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, ***immediately***

> ***close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity*** . . . ."

17 C.F.R. § 242.204(a) (emphasis added). Under Rule 204(a), participants of CNS like optionsXpress must make delivery by settlement date to CNS ("must deliver securities to a registered clearing agency for clearance and settlement"); and compliance with the rule is based on whether optionsXpress "has a fail to deliver position at a registered clearing agency."

The evidence at the hearing demonstrated that as a result of the buy-write activity optionsXpress (1) had failure to deliver positions at CNS, and (2) was not making delivery to CNS. Without delivery to CNS, there is no delivery and thus, no Rule 204(a) close-out.

The evidence also proved that optionsXpress' employees were aware from the onset of the vicious cycle of failures to deliver caused by the buy-writes. For example, on October 15, 2008, less than one month after the Commission issued its emergency order for Rule 204T, optionsXpress employees recognized that the firm's customers had "short positions on hard to borrow stocks where the ***customer has to buy in every day***," adding that customers were "buying back the short and writing in the money calls which are ***assigned on a daily basis***." DFOF ¶ 128. The next month, optionsXpress employees noted that the trading activity was creating perpetual failures to deliver: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, ***we are in a vicious cycle***." *Id.* ¶ 131. This vicious cycle of what optionsXpress employees called "perpetual," "chronic," or "rolling" failures to deliver, continued into and beyond August 2009, when an optionsXpress employee confirmed that its customers, including Feldman, persisted in remaining "[a]lways short, cover[] [their] buys by buying [sic] short options deep in the money, so they get assigned. More or less, their trade date position stays constant, ***settled position never closes or goes long***." *Id.* ¶¶ 85, 163. optionsXpress did not close out its failures to deliver at CNS until it finally stopped the buy-writes in March 2010. Consequently, there should be no question that the buy-

writes caused optionsXpress to have failure to deliver positions in multiple securities at CNS which were not closed out for months on end. *See* Reply FOF at § I.B.

1. optionsXpress' Interpretation of Rule 204(a) Would Lead to Absurd Results.

While not denying that it was aware of the vicious cycle caused by its Customers' use of buy-writes, optionsXpress contends that all that is required to satisfy the "close-out" language of Rule 204 is an attempt to "borrow or purchase securities," regardless of whether that activity ultimately results in shares being delivered to CNS (*e.g.*, further sales of the same security by the same customer). This reading of the rule ignores a clearing broker's strict requirements to "***close out its*** fail to deliver position" at a "registered clearing agency" (*i.e.*, CNS). Moreover, this reading of the rule would lead to absurd results and would effectively eliminate the phrase "immediately close out its fail to deliver position" from Rule 204(a). optionsXpress' reading of the rule is wrong and defies generally accepted tenets of statutory construction.

In interpreting a statute or rule, courts must read all parts of the rule together and avoid readings that would render part of the rule meaningless. *See Miccosukee Tribe of Indians of Florida v. United States*, 2008 WL 2967654, at *18 (S.D. Fla. July 29, 2008). Statutes and rules should also be read to avoid any construction that would produce an unreasonable or absurd result. *Id.; Compton Unified School District v. Addison*, 598 F.3d 1181,1184 (9th Cir. 2010); *Gomez v. Campbell-Ewald Co.*, 2010 WL 7345680, at *3 (C.D. Cal. Nov. 5, 2010). Courts determine the "plain meaning of a statute by looking at the particular language at issue, as well as the language and design of the statute as a whole." *Id.*

If optionsXpress' interpretation was accepted, broker-dealers would never be required to "close out" their failure to deliver positions at CNS rendering the statutory language moot. Instead, as long as they bought stock – *even if they sold it one second later* – their obligation would be satisfied. For example, a customer could place a limit order to sell and buy the same amount of shares and the broker could cross that trade in the customer's brokerage account – otherwise known as a "wash sale." Or a customer could place market orders to buy and sell the

same amount of shares. Inevitably, the trades would be executed and no delivery would take place because the customer bought and sold the exact same thing.

In short, under optionsXpress' interpretation of Rule 204(a), anyone who wanted to short stock for any reason – good or bad – could do so without ever having to actually deliver stock. All you need, according to optionsXpress, was a "buy" on the firm's books. Indeed, there would be no need to ever deliver stock. It is likely that because there would be no need to deliver stock, people would not do so and the exact harms that the Commission was concerned about – deprivation of the benefits of ownership, use of naked short selling to improperly depress the price of securities, and issues with the proper pricing of securities – would come to fruition and market integrity would suffer. DFOF ¶¶ 23, 294, 304.

2. optionsXpress' Interpretation Ignores Regulatory Guidance.

Although Rule 204T was enacted in September 2008 and Rule 204 in July 2009, the concept of a bona fide "close-out" or transaction has existed in other Commission rules. For years preceding the enactment of Rules 204T and 204, the Commission notified market participants that combined purchase-and-sale transactions (such as buy-writes) cannot be used to avoid timely delivery of securities. For example, in 2003, the SEC issued guidance to "disabuse traders of any notion" that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). As the Commission noted back then, "[e]ven viewed in the most favorable light, these married put transactions appear to be nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." *Id.* "The Commission has previously indicated that where transactions involve no market risk and serve no purpose other than rendering a person an owner of a security in order to accomplish indirectly what was prohibited directly, the activity may violate the federal securities laws." *Id.*

Prior to the enactment of Rule 204T, other regulatory guidance further confirmed the Commission's stated policies. In July 2007, the American Stock Exchange ("AMEX") fined several entities and individuals for violating Reg. SHO Rule 203 (which also imposed close-out obligations by certain deadlines) based on trading activity similar to what the Customers did here. *In the Matter of Scott H. Arenstein and SBA Trading, LLC* (July 20, 2007); *In the Matter of Brian A. Arenstein and ALA Trading, LLC* (July 20, 2007). In the *Arenstein* cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation of Rule 203. *Id.*

In August 2007, AMEX sent guidance to its members about conduct that could violate Reg. SHO. Div. Ex. 384. This guidance provided that "a purchase of stock paired with one or more short term option transactions such as, for example, a one day in-the-money FLEX option, or a married put or ***buy-write transaction whereby the short stock position is only temporarily covered and does not result in actual delivery of the shares*** in question may not satisfy the Regulation SHO close out requirement and will invite regulatory scrutiny of both sides of the transaction . . . ." *Id.* (emphasis added). This guidance further provided that:

> The use of a buy write with a one-day, deep-in-the-money FLEX option to nominally close out a fail to deliver position and then shortly thereafter reestablish or 'reset' the fail to deliver position ***is not the only means by which an aged fail can be reset***. Other transactions that can result in ***an improper 'reset' of an aged fail include***, but are not limited to, married puts, ***buy-writes***, conversions, flexes, ***or other delta neutral short term strategies matching options with stock***.

Id. at n.11 (emphasis added). optionsXpress' compliance personnel reviewed the *Arenstein* case and the AMEX guidance at the time they were issued. DFOF ¶ 260.

Following the release of the *Arenstein* cases, the Chicago Board Options Exchange ("CBOE") sent a regulatory circular to its members, including optionsXpress, "strongly cautioning" its members that transactions "pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset

arrangements that do not satisfy the Regulation SHO close-out requirement." CBOE Regulatory Circular RG07-87 (Aug. 9, 2007).

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

Id. (emphasis added). CBOE proceeded to explain that while its examples involved market-makers, "the same analysis would apply to similar arrangements between any market participants." *Id.* The following year, CBOE reiterated its caution: "When accompanied by certain option transactions, stock purchases that are intended to effect close-outs of fail to deliver positions may bring into question ***whether a bona-fide purchase has occurred.***" CBOE Regulatory Circular RG08-63 (May 19, 2008) (emphasis added).[2]

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

> [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.

[2] While CBOE noted that it was permissible to re-establish a short position ***the business day following a close-out***, "if the underlying stock purchase was not bona-fide or did not completely satisfy any close-out requirement, a pre-borrow of stock is required for the subsequent establishment of the new short stock position on the following business day until the close-out is satisfied." *Id.*

74 Fed. Reg. at 38272 n.82 (emphasis added).[3] In other words, footnote 82 provides the industry guidance on what type of transactions will constitute a valid or bona fide "purchase" of securities sufficient to meet the Rule's close-out requirement.

optionsXpress claims that this footnote "has no legal effect." Br. at 14. But optionsXpress' argument rests on a faulty premise. optionsXpress claims that the Division is trying to use the explanation of what constitutes a valid "close-out" in footnote 82 to expand the definition of sham transaction that is otherwise contained within Rule 204(f). Br. at 15. The Division is attempting no such thing and a fair review of the adopting release refutes optionsXpress' argument. Indeed, footnote 82 is in the section of the release describing Rule ***204(a)'s*** close-out requirement. *See* 74 Fed. Reg. at 38272. There is an entirely separate section of the release relating to Rule 204(f) and "sham close-outs" that relates to market participants who collude with each other. *See id.* at 38278.

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

3. Dr. Sirri's Testimony Is Irrelevant.

optionsXpress relies heavily on the testimony of Dr. Erik Sirri ("Sirri") to support its interpretation of Rule 204(a). Br. at 5. But Dr. Sirri's testimony on this point is entitled to no weight for the following reasons:

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[3] Less than a month later, the SEC brought settled enforcement actions against several entities and individuals for violations of Rule 203 based on options trading similar to what the Customers did here. *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, Exchange Act Release. No. 34-60441 (Aug. 5, 2009); *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, Exchange Act Release No. 34-60440 (Aug. 5, 2009). In the *Hazan* and *TJM* cases, the respondents engaged in a series of sham reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203.

First, as noted above, optionsXpress' interpretation of the rule would lead to absurd results and is inconsistent with the actual language of the rule.

Second, the issue of the meaning of Rule 204 is a legal issue for the Court to decide. Opinion testimony on this issue is irrelevant and improper. *Densberger v. United Techs. Corp.*, 297 F.3d 66, 74 (2d Cir. 2002) ("It is a well-established rule in this Circuit that experts are not permitted to present testimony in the form of legal conclusions."); *Pfizer, Inc. v. Teva Pharm. USA, Inc.*, 2006 WL 3041097, at *2 (D.N.J. Oct. 26, 2006) (excluding expert testimony that either explains the law in general or offers legal conclusions "that follow from the facts presented at trial"); *In re Methyl Tertiary Butyl Ether ("MTBE") Products Liability Litig.*, 643 F. Supp. 2d 482, 498-501 (S.D.N.Y. 2002) (opinion testimony about ultimate legal conclusion not permissible).

Third, the fact that Dr. Sirri used to work at the SEC does not mean that his views are those of the Commission. For example, even if Dr. Sirri had made similar statements when he was the Director of the Division of Trading & Markets (which he never did), his statements would not bind the Commission. *See Sidell v. Commissioner of Internal Revenue*, 225 F.3d 103, 111 (1st Cir. 2000) ("statements by individual IRS employees cannot bind the Secretary [of Treasury]"); *Connecticut General Life Ins. v. Commissioner of Internal Revenue*, 177 F.3d 136, 145 (3d Cir. 1999) ("reliance upon remembered details from officials who lacked the ultimate authority to issue any proposed regulation has little support in the law."); *Irving v. United States*, 162 F.3d 154, 166 (1st Cir. 1998) (en banc) ("[C]ourts customarily defer to the statements of the official policymaker, not others, even though the others may occupy important agency positions."); *In re MTBE Products Liability Litig.*, 643 F. Supp. 2d at 501 ("Evidence expressing the view of only one actor in the legislative or regulatory process – offered after the bill has passed or the agency has promulgated the regulation – expresses the witness's 'interpretative preference,' but that preference cannot overcome the language of the statute and the related considerations.") (quoting *Chickasaw Nation v. United States*, 534 U.S. 84, 93 (2001)); *SEC v.*

Nat'l Student Marketing Corp., 68 F.R.D. 157, 160 (D.D.C. 1975) (staff views at the SEC and "the views of an individual Commissioner will not invariably reflect the position of the agency as a whole"). Indeed, Dr. Sirri's opinion in this matter is not even being given as an employee of the Commission – it is the opinion of a very highly paid consultant to Respondent Feldman.

Fourth, although Dr. Sirri was the Director of Trading & Markets at the time Rule 204 was enacted, he is not a Reg. SHO "expert" as the Respondents claim. *See* Tr. at 2078-79, 2084-85 (Sirri was not familiar with either *Arenstein* or *Hazan* during his time working at the Commission). In fact, Dr. Sirri is not even listed as a staff member to contact regarding Rule 204 in the adopting release (even though multiple SEC employees are). *See* 74 Fed. Reg. 38266 (July 31, 2009) (listing seven employees, including Josephine Tao ("Tao"), in Trading & Markets "Office of Trading Practices and Processing" as people to contact for "further information"). Ms. Tao, the staff member who helped write the rule, testified that the use of a buy-write to address a close-out is likely a violation of the rule:

> Q: So what you were discussing with CBOE was that if you couple that buy with a write, you're still buying in, right?
>
> A: ***No, because that would not be a bona fide purchase.***
>
> Q: Just because it's a buy-write?
>
> A: ***Because the buy-write is an economically flat position or at least that has been the case in the cases we have seen buy-writes being used.***
>
> Q: Just to make sure I understand, are you saying that you can never use a buy-write to respond to an option assignment?
>
> A: ***I'm saying that when you're using a buy-write, you're probably not in compliance with Reg. SHO.*** I have no opinion on the opposite.

Tr. at 3634:5-19 (Tao) (emphasis added). In September 2009, Ms. Tao told FINRA the same thing:

> ***The SEC also stated that if the calls were deep-in-the-money, there was a pattern of this type of activity, and OXPS was involved in the execution of the activity, and would, therefore have reason to know that the activity was occurring, then OXPS would be in violation of 204.***

Div. Ex. 237 (emphasis added).

Finally, Dr. Sirri's interpretation is not found in the expert report he submitted which was supposed to contain all the opinions he was expressing in this case. In any event, Dr. Sirri made clear that he was not offering any opinions about whether optionsXpress complied with Rule 204:

> Q: And you are not offering any opinions here, legal opinions, that optionsXpress did or did not comply with Regulation SHO, correct?
>
> A: ***I'm not offering any opinions about whether optionsXpress complied with SHO.***
>
> Q: Right. Because those issues are issues for the judge to decide, correct?
>
> A: They're certainly that and I don't have the information to do it even if I were to try. But they're certainly as you said.

Tr. at 3265:25-3266:9 (Sirri) (emphasis added).

C. optionsXpress' Arguments Regarding CNS Are Misleading and Irrelevant.

optionsXpress claims that "the Division attempts to assert that a participant is in violation of Rule 204 if its fail-to-deliver position at CNS does not net to zero." Br. at 6. The Division has never contended this. Guidance from Trading & Markets makes clear that there are various reasons why a firm may have a periodic failure to deliver at CNS. *See* Division of Trading & Markets Responses to Frequently Asked Questions No. 7.3 for Reg. SHO, available at http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm ("Many times the member will experience a problem that is either unanticipated or is out of its control, such as (1) delays in customer delivery of shares to the broker-dealer; (2) an inability to borrow shares in time for settlement; (3) delays in obtaining transfer of title; (4) an inability to obtain transfer of title; and (5) deliberate failure to produce stock at settlement which may result in a broker-dealer not receiving shares it had purchased to fulfill its deliver obligations."). optionsXpress' failures to deliver at CNS were unquestionably the result of the buy-write activity, however, and not some activity "out of its control" or not anticipated. As the pattern of repeated assignments due to the

buy-writes in this case emerged, optionsXpress could reasonably recognize and anticipate (as they did) that there was going to be a vicious cycle of failures to deliver. optionsXpress could have easily stopped this cycle had it simply "closed-out" the positions of its customers engaging in the buy-writes. This is exactly what Penson, TD Ameritrade and E*Trade did when they notified Feldman that his business was no longer welcome.

optionsXpress claims that the relevant inquiry is whether its own books and records indicate it was net flat and not CNS'. Br. at 10. Unfortunately, for optionsXpress, this argument ignores both the facts and the law.

First, optionsXpress' argument ignores the law because Rule 204(a) does not reference the clearing firm's books and records – it references CNS. The only reference to a firm's books and records in 204(a) is found in 204(a)(1) which relates to "fail to deliver position result[ing] from a long sale." 17 C.F.R. § 242.204(a). Long sales are not at issue in this case.

Second, it ignores the facts because optionsXpress' own books and records were never introduced at the hearing to demonstrate that optionsXpress was somehow "net flat." There is good reason for this. As Respondent Stern admitted, if there was an assignment from a written call, that assignment would be reflected in optionsXpress' books and records the day of the assignment (and in turn the day of the alleged "buy" if there was a buy-write). Tr. at 1664 (Stern). Thus, optionsXpress' own books and records would demonstrate that at the end of that calendar day it would once again be short securities.[4] This is why optionsXpress needed to continue the vicious cycle of buying the Customers in day after day after day.

Likewise, optionsXpress' argument that "it is entirely possible for a fail to exist each day even though timely purchases occurred each day to cure existing fails," (Br. at 12) is misleading

[4] On page 10 of its brief, optionsXpress claims that "Dr. Saha thus relied on the firm's books and records' to confirm compliance through stock purchases." Br. at 10. However, Dr. Saha testified that he actually only looked at the firm's books and records as they related to the six accounts of the Customers. Dr. Saha did not look at all trading at optionsXpress. Tr. at 4437, 4442-43 (Saha) (testifying that he looked at only the six accounts, not optionsXpress' entire books).

and irrelevant. optionsXpress relies on testimony from its expert, Dr. Atanu Saha ("Saha"), that it is ***possible*** for a failure to deliver to exist at CNS for a lengthy period of time because a purchase "will take three days (*i.e.,* until settlement) to resolve a CNS fail." Br. at 10. This analysis ignores that no delivery was actually made to CNS by optionsXpress. *See* Tr. at 4894:11-13 (Harris) ("From the CNS data, it appears very clear to me that optionsXpress did not deliver shares to close out its CNS failures because the failures continued."); *Id.* at 4903-06 (detailing how buy-writes do not cure failures to deliver at CNS); Div. Demonstrative Ex. 502 at pp. 17-20 (same); Reply FOF at § I.B.iii.

The CNS data confirms that optionsXpress' use of buy-writes did not cure its failures to deliver and that ***no delivery*** was being made to CNS. As Louis Colacino from DTCC explained, deliveries to CNS are reflected in "ALLOC/RECYC" column. Tr. at 64-66, 136-38; DFOF ¶ 40, 84. A quick review of the CNS data shows that shares were simply not being delivered by optionsXpress.[5] *Id.*; *see also* Reply FOF § I.B.iii. For example, the CNS Account Summary for Sears (SHLD) excerpted below demonstrates the fact that there was no delivery by optionsXpress (as indicated in the ALLOC/RCYC column) and the failure to deliver position increased by almost 33,000 shares in a single day (comparing "Open Position" to "Closing Position" columns and which is reflected in the "Sett Trades" column as a negative number):

Sec-Dtcc-E-0007244

DATE: 12/30/2009
TIME: 15:19:41

NATIONAL SECURITIES CLEARING CORPORATION
CNS ACCOUNTING SUMMARY
PROCESS DATE: 2009-12-30
FOR SETTLEMENT ON: 2009-12-30

PAGE: 21,738

ISIN: US8123501061 SEARS HOLDINGS CORP CURRENCY: USD

BROKER SUBACT	AGE	OPEN POSITION	SETT TRADES	MISC/DIVID	ALLOC/RCYC	CLOSING POS	PRICE	MARKET VALUE
	0	0	3-	0	3	0	84.7100	0.00
	2	100	0	0	0	100	84.7100	8,471.00
	185	836,901-	32,900-	0	0	869,801-	84.7100	73,680,842.71-
	0	0	18,793-	0	18,793	0	84.7100	0.00

[5] *See also* Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries); Tr. at 64-65 (Colacino) (CNS Account Summary reflects the shares that are delivered to it in the "ALLOC/RECYC" column). In its proposed findings of fact, optionsXpress cites the testimony of Jay Risley ("Risley") for the proposition that "optionsXpress's purchase of shares resulted in the delivery of shares into the CNS settlement cycle on settlement date." OPXS FOF at ¶ 279. As the CNS reports make clear, however, Risley is mistaken. No delivery or settlement was taking place. Reply FOF at § I.B.iii.

Div. Ex. 18 at 613 (SHLD CNS Account Summary); *see also* Reply FOF at § I.B.iii.

Furthermore, this is not a case where thousands of separate trades from thousands of separate customers constituted the failures to deliver at CNS and one day's failures may not be related to the previous day's failures. Reply FOF ¶ I.B.ii. This is a case where a limited number of customers engaged in a buy-write strategy that had a predictable outcome. Tr. at 4904:15-17 (Harris) ("it's highly predictable that the deep-in-the-money call is going to be exercised resulting in a sale"). Notably, optionsXpress' failures to deliver at CNS dwarf those of other firms – negating any claim that the failures to deliver were somehow due to regular market activity.[6]

For example, Feldman's trading in China Sky One Medical, Inc. (CSKI) demonstrates how his repeated buy-writes did not cure any failures to deliver at CNS – because he was repeatedly assigned 100% of the call portion of his buy-write the same day the buy-write was executed:

Jonathan I Feldman and Judith S Feldman [JTWROS] (Continued)
Underlying Security: CSKI

Trade Date	Weekday	Trade Day Sequence #	Trade Type	Put/Call/Stock	Side	Trade Size (100's)	Trade Value	Strike	Close Price	Moneyness	In OIP Period
06JAN10	Wednesday	320	Synthetic Long	Put & Call	B	204	$26,807	25	23.06		
			Syn Long Hedge	Call	S	204	$271,312	10	23.06	57%	
			Assigned Call	Stock & Call	B	147	$338,982	10	23.06	57%	
11JAN10	Monday	323	Option Trade	Call	B	102	$0	10	22.60	56%	
			Assignment	Stock	S	102	$102,000	0	22.60		
12JAN10	Tuesday	324	Buy-Write	Stock & Call	S	147	$316,491	10	21.53	54%	Yes
			Assigned Call	Stock & Call	B	35	$75,355	10	21.53	54%	Yes
13JAN10	Wednesday	325	Buy-Write	Stock & Call	S	137	$286,193	10	20.89	52%	Yes
			Assigned Call	Stock & Call	B	137	$286,193	10	20.89	52%	Yes
14JAN10	Thursday	326	Buy-Write	Stock & Call	S	137	$280,987	10	20.51	51%	Yes
			Assigned Call	Stock & Call	B	137	$280,987	10	20.51	51%	Yes
15JAN10	Friday	327	Buy-Write	Stock & Call	S	137	$276,740	10	20.20	50%	Yes
			Assigned Call	Stock & Call	B	204	$412,080	10	20.20	50%	Yes

[6] For example, optionsXpress was by itself responsible for 64% of all shares that all 273 clearing brokers failed to settle in the CNS system during the periods and the stocks identified in the Order Instituting Proceedings ("OIP"). DFOF ¶ 104; *see also* Reply FOF ¶¶ 9-10. Moreover, during these same periods, optionsXpress ranked first among all 273 clearing brokers for the largest failures in 26 of the 44 periods in the OIP, and it was ranked among the top three clearing brokers in 38 of the periods. In 38 of the periods, it ranked first in the average age of its continuous settlement failures. DFOF ¶ 105.

19JAN10	Tuesday	328	Buy-Write	Stock & Call	S	204	$443,904	13	21.76	43%	Yes
			Assigned Call	Stock & Call	B	204	$443,904	13	21.76	43%	Yes
20JAN10	Wednesday	329	Buy-Write	Stock & Call	S	204	$424,524	13	20.81	40%	Yes
			Assigned Call	Stock & Call	B	204	$424,524	13	20.81	40%	Yes
21JAN10	Thursday	330	Buy-Write	Stock & Call	S	204	$399,636	13	19.59	36%	Yes
			Assigned Call	Stock & Call	B	204	$399,636	13	19.59	36%	Yes
22JAN10	Friday	331	Buy-Write	Stock & Call	S	204	$382,908	13	18.77	33%	Yes
			Assigned Call	Stock & Call	B	204	$382,908	13	18.77	33%	Yes
25JAN10	Monday	332	Buy-Write	Stock & Call	S	204	$390,252	13	19.13	35%	Yes
			Assigned Call	Stock & Call	B	204	$390,252	13	19.13	35%	Yes
26JAN10	Tuesday	333	Buy-Write	Stock & Call	S	204	$374,136	13	18.34	32%	Yes
			Assigned Call	Stock & Call	B	204	$374,136	13	18.34	32%	Yes
27JAN10	Wednesday	334	Buy-Write	Stock & Call	S	204	$384,744	13	18.86	34%	Yes
			Assigned Call	Stock & Call	B	204	$384,744	13	18.86	34%	Yes
28JAN10	Thursday	335	Buy-Write	Stock & Call	S	204	$373,320	13	18.30	32%	Yes
			Busted Sell	Call	S	408	$320,076	13	18.30	32%	Yes
			Assigned Call	Stock & Call	B	204	$373,320	13	18.30	32%	Yes
29JAN10	Friday	336	Buy-Write	Stock & Call	S	204	$360,672	10	17.68	43%	Yes
			Busted Sell	Call	S	204	$166,974	10	17.68	43%	Yes
			Assigned Call	Stock & Call	B	204	$360,672	10	17.68	43%	Yes

Div. Ex. 310 (Harris Report at Ex. 6 p. 20); *see also* Tr. at 4906 (Harris) (explaining the CSKI trading). Because optionsXpress did not close Feldman's position out, optionsXpress' failure to deliver position at CNS (which, as reflected above, was nearly identical to the volume in Feldman's buy-write activity) did not change.

optionsXpress' CNS Position in CSKI Did Not Go To Zero

Date	Open Position	Close Position
1/19/2010	-13,976	-13,876
1/20/2010	-13,876	-13,991
1/21/2010	-13,991	-20,641
1/22/2010	-20,641	-20,544
1/25/2010	-20,544	-20,530
1/26/2010	-20,530	-20,430
1/27/2010	-20,430	-20,580
1/28/2010	-20,580	-20,330
1/29/2010	-20,330	-20,684

Div. Dem Ex. 502 at 20; Div. Ex. 47 (CSKI CNS Account Summary); Tr. at 4911-12 (Harris) (explaining that as a result of Feldman's buy-write trading optionsXpress continued to have a failure to deliver at CNS). Rather, than making incremental improvements on its failure to deliver position at CNS, optionsXpress allowed its failure to deliver position to grow

substantially. *See, e.g.,* Div. Ex. 18 (SHLD CNS Account Summary) (demonstrating the firm's failure to deliver went from 12,962 on September 30, 2008 to 866,456 on January 29, 2010).

Further, the fact that different people were owed shares on different days does not indicate that optionsXpress was ***actually delivering*** shares to CNS. Br. at 13. Each day the failure to receive was allocated to different clearing firms because CNS allows firms with aged failures to receive to move themselves up in priority to receive shares. Reply FOF ¶ 63. Other member firms delivered the shares that went to these counterparties – ***not optionsXpress.*** Tr. at 4890-91, 4894-97 (Harris) (explaining that Dr. Saha's testimony conflates "purchase" with "delivery");[7] *see also* Tr. at 71, 139 (Colacino) (explaining that CNS sends a notice of intent to buy-in to the firm with the oldest failure to deliver); DFOF ¶¶ 296-302; Feldman FOF at ¶ 40 ("There is no correlation between a firm that fails-to-deliver at CNS and a firm that fails-to-receive, because the firms that have fails-to-receive are constantly changing as they move up the priority list."); Reply FOF at ¶¶ 63-64.

D. optionsXpress' Arguments Regarding Rule 204(f) Are Misplaced.

Even though the Division is not claiming that optionsXpress violated Rule 204(f), optionsXpress spends pages of its brief discussing this provision. Br. at 7-8, 13-18. For example, optionsXpress contends that the Division cannot expand the definition of "sham close-out" in Rule 204(f) by relying on footnote 82. The Division is not doing so.

As noted above, footnote 82 does not reference Rule 204(f) or the collusion of parties. 74 Fed. Reg. at 38272. Instead, it provides guidance on how to comply with Rule 204(a)'s requirement to "close out" with a bona fide purchase of securities of like kind and quantity. optionsXpress also claims that footnote 82 "has no legal effect" because it is part of the release

[7] In its proposed findings of fact, optionsXpress grossly mischaracterizes the record and claims "Dr. Harris even agreed that 98.4% of all failures to deliver settled within five days from T+3, within one day of the date on which they should receive them." OPXS FOF at ¶ 281. optionsXpress cites Dr. Harris' report at paragraph 196 for this proposition. Paragraph 196 does not say anything about "failures to deliver." Rather, it discusses "failures to receive." This misrepresentation to the Court is inexcusable particularly when Dr. Harris testified to this very point during his rebuttal testimony. Tr. at 4890, 4893-97 (Harris).

and "not the rule itself." Br. at 14. But this misses the point. Footnote 82 does not change the plain language of Rule 204(a) which states that a broker such as optionsXpress must "***close out its*** failures to deliver" at CNS. Footnote 82 merely explains the concept of what a proper or bona fide close-out entails.

The Commission is free to explain the purpose of its rules and the reasoning behind its rules in adopting releases. In fact, courts often rely on Commission statements outside of the explicit language of a rule to discern the Commission's intent. *See, e.g., Marrie v. SEC*, 374 F.3d 1196, 1203-04 (D.C. Cir. 2004) (reviewing comments by the Commission in the "adopting release" and the language of a Rule 102(e) to determine the standard for when an accountant "is deemed to have engaged in 'improper professional conduct'"); *Otto v. Variable Annuity Life Ins. Co.*, 814 F.2d 1127, 1133-34, 1142 (7th Cir. 1987) (relying in part on "a discussion of Rule 151 [by the Commission] that was released with the rule's enactment" to discern the rule's meaning); *cf. Booker v. Edwards*, 99 F.3d 1165, 1168 (D.C. Cir. 1996) (relying in part on the preamble to a HUD rule to determine the intent of the rule).

optionsXpress cites *Wyoming Outdoor Council v. U.S. Forest Service*, 165 F.3d 43 (D.C. Cir. 1999) for the proposition "that language placed in explanatory footnotes certainly 'does not enlarge or confer powers on administrative agencies or officers.'" Br. at 14. The *Wyoming Outdoor* case, however, did not discuss footnotes at all and recognizes that comments made in the adoption of a rule by an agency that is ambiguous "may serve as a source of evidence concerning contemporaneous agency intent." *Wyoming Outdoor*, 165 F.3d at 53. The court also recognized that "[a]n agency's interpretation of its own regulations is entitled to substantial deference" and its "construction of its own regulation is controlling 'unless it is plainly erroneous

or inconsistent with the regulation.'" *Id.* at 52 (citations omitted).[8] Thus, the Court may rely on footnote 82 to discern the Commission's intent.[9]

Next optionsXpress claims that "regulatory history confirms that a 'sham close-out' under Reg. SHO was intended to require an 'arrangement.'" Br. at 15-16. Again, this argument misses the mark. While an arrangement has long been recognized by the Commission as an improper attempt to circumvent Reg. SHO, it does not follow that an arrangement is the only way a clearing firm can fail to "close-out" a failure to deliver. For example, Goldman Sachs was found to have violated Rule 204T by incorrectly allocating its failures to deliver and in turn "failing to timely close out fail to deliver positions." *In the Matter of Goldman Sachs Execution and Clearing, L.P.*, Exchange Act Release No. 34-62025, 2010 WL 1782448, at *1 (May 4, 2010); Tr. at 4240 (Court taking judicial notice of the settlement). This violation of Reg. SHO did not involve an improper "arrangement" at all.

In making its argument, optionsXpress greatly distorts the record. optionsXpress suggests that Ms. Tao of Trading & Markets recognized that the conduct at issue in this case did not meet the definition of Rule 204(f) and was therefore compliant with Rule 204 because she wrote an email that stated "Should we propose a rule that would add a circumvention with no economic purpose rule?" Br. at 17 (citing Resp. Ex. 559). Ms. Tao testified credibly at the hearing that her email was a reference to ***a customer*** violating Rule 204 and had nothing to do

[8] The court also noted that "we have often recognized that the preamble to a regulation is evidence of an agency's contemporaneous understanding of its proposed rules." 165 F.3d at 53. And if a rule or statute is ambiguous, then the preamble "may aid in achieving a 'general understanding' of the statute." *Id.*

[9] The other cases relied on by optionsXpress are similarly inapposite. Br. at 14-15 (citing *McElroy Elecs. Corp. v. FCC*, 990 F.2d 1351, 1366 (D.C. Cir. 1993); *Meese v. Keene*, 481 U.S. 465, 484 (1987); *L.R. Wilson & Sons, Inc. v. Donovan*, 685 F.2d 664, 675 (D.C. Cir. 1982)). In *McElroy*, the court simply found that an agency did not "state its directives in plain and comprehensible English." 990 F.2d at 1353. Here, other market participants all understood Rule 204(a) as they refused to allow Feldman to continue his trading when it was about to cause failures to deliver at CNS for their firms. DFOF ¶¶ 279-90. And optionsXpress' own compliance personnel recognized the importance of footnote 82 in determining whether a close-out actually took place. *Id.* ¶¶ 16, 169 (Hoeh referring to footnote 82 as "a very pertinent section in the final rule [204] release" in response to a question regarding buy-writes). In *Meese*, the Supreme Court refused to find that Congress' use of the term "propaganda" had an unstated "pejorative connation" that raised constitutional concerns, 481 U.S. at 484, clearly not an issue in this case. Finally, *Donovan* stands for the unremarkable proposition that regulations need to be adequately expressed. Rule 204(a) and the accompanying adopting release more than adequately express that failures to deliver at CNS need to be "closed-out" immediately.

with a clearing firm's responsibilities under Rule 204(a). *See* Tr. at 3662 (Tao) ("Presumably for customers who are not under Reg. SHO."); Reply FOF ¶¶ 154-55. Moreover, in that same email Ms. Tao indicated that a Division of Enforcement attorney ***would bring the case*** if CBOE referred it. Resp. Ex. 559. This is hardly a comment someone who views the conduct as not violating any rules would make.

optionsXpress also claims that the *Hazan*, *TJM* and *Arenstein* cases are all distinguishable from the conduct at issue in this case. Br. at 17-18. The distinctions that optionsXpress attempts to draw from those cases are unavailing. Notably, as soon as optionsXpress' traders read summaries of the *Hazan* case they realized that those cases were nearly identical to Feldman's and the other Customer's trading. One trader went so far as to email his boss that he was "not going to place any trades today" and both traders then forwarded their boss' response directing them to do the trades to their home email accounts for their "personal records" – *i.e.*, so that they had cover when regulators came calling. DFOF ¶¶ 188-90. Other industry participants also easily noted that the conduct at issue in *Hazan* was nearly identical to what Feldman was doing and promptly made sure that the conduct stopped. *Id.* ¶ 285; Tr. at 825-27 (Crain) (finding a memo outlining the *Hazan* case and coming to the conclusion it was nearly identical to what Feldman was doing). Simply put, it is hard to fathom what other type of guidance optionsXpress would have needed to put a stop to the trading at issue other than a direct order from this Court.

E. The Buy-Writes Lacked a Legitimate Economic Purpose.

optionsXpress claims that even if footnote 82 applied in this case, it did not violate Rule 204 because (1) there was no "sale transaction" (Br. at 19-21) and (2) the buy-writes had a legitimate economic purpose (Br. at 21-23). optionsXpress is wrong on both counts.

First, optionsXpress' argument that the writing of a call does not result in a "sale transaction" defies common sense. The writing of the call means you are giving someone else

the option to make you ***sell them shares***, if they so desire. DFOF ¶ 41. Thus, when a call is exercised the counterparty is making you sell them shares.

optionsXpress also contends that the writing of a deep-in-the money call cannot be a "'sale transaction' unless that call were guaranteed to be exercised and assigned back that very same day." Br. at 19. This strawman argument is facially ridiculous. Under optionsXpress' theory, even if 99.99% of the calls were assigned to a single customer, then a "sale transaction" has not taken place. There is no reason to read Rule 204(a) or footnote 82 so narrowly. In reality, if 99.99% of the options were assigned back, then 99.99% of the options resulted in the sale of stock. Indeed, the random nature of assignments might make it highly unlikely that 100% of assignments would end up at the same firm. Despite this fact, at least 91.9% of the buy-write calls closed by assignment were assigned back to optionsXpress on the same day they were sold.[10] Div. Ex. 310 (Harris Report) at Ex. 17. In fact, in many cases, 100% of the calls written by Feldman were assigned to him that very day. Whenever the call options were immediately assigned back to optionsXpress and its Customers, there was a sale that resulted in optionsXpress not "closing-out" its failure to deliver. 17 C.F.R. § 242.204(a). In short, optionsXpress' argument defies common sense and the plain language of the Rule.

Second, the buy-writes did not have a legitimate economic purpose. As the Division noted in its opening brief, just because the Customers had *an* economic purpose – to "make a profit" – does not make it a *legitimate* economic purpose, any more than the same economic purpose – to "make a profit" – legitimizes check-kiting, stock-kiting, or other forms of securities violations. *See, e.g., United States v. Jimenez*, 513 F.3d 62, 72 (3d Cir. 2008) (check kiting is fraud); *Graham v. SEC*, 222 F.3d 994, 1001-03 (D.C. Cir. 2000) (stock kiting scheme was securities fraud). Here, the Customers' economic purpose was to make a profit by extending their short position without delivering shares – and optionsXpress knew that its "perpetual,"

[10] In fact, at least 96.9% were assigned on the same day they were sold or the day after. Div. Ex. 310 (Harris Report) at Ex. 17.

"chronic," and "rolling" failures to deliver meant that shares were not being delivered to CNS. This is the same non-legitimate economic purpose that was found in cases like *Hazan*, *TJM*, and *Arenstein* – all of which optionsXpress reviewed at the time they were issued. *See* 74 Fed. Reg. at 38267 (explaining that Rule 204 was enacted in part to prevent failures to deliver arising from a trading strategy that is designed "to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high"); *see also* DFOF ¶¶ 111-24; OPXS Ex. 678 (optionsXpress compliance officer stating the "end result in all situations [for Hazan/TJM and the Customers' trading] is similar: the shares are bought-in, ***but the subsequent exercise or assignment of the option that night results in a continuation of the fail.***") (emphasis added).

optionsXpress claims that the Customers had no motive to avoid borrowing costs because optionsXpress never charged its customers borrowing fees. Br. at 23. But this is a complete red herring. As an initial matter, optionsXpress did not charge its Customers borrowing fees because ***optionsXpress did not pay to borrow any shares.*** If optionsXpress wanted to pay to borrow the shares and then allow their Customers to not reimburse the firm the cost of borrowing, then this would be a business decision it could have made. But this is not what happened in this case. optionsXpress allowed the buy-writes so that neither optionsXpress nor its Customers would have to pay to borrow the shares.

Moreover, optionsXpress' own Customers admitted that their trading strategy would only work if they avoided paying hard-to-borrow fees. Tr. at 2127 (Feldman). Thus, it is completely disingenuous for optionsXpress to claim its Customers were not avoiding the cost of borrowing.

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

optionsXpress' argument that it was closing out its failure to deliver positions on T+1, in excess of what Reg. SHO required, Br. at 26, is meritless for another reason. Rule 204 contains a specific provision relating to "early" or "pre-fail" close-outs – *i.e.,* close-outs that occur on T+1, T+2, or T+3. 17 C.F.R. § 242.204(e).

Rule 204(e) allows a participant of a registered clearing agency who has not closed out a fail to deliver position by settlement date at CNS, to qualify for a "pre-fail credit" if the broker-dealer purchases or borrows the securities, and if: (1) the purchase or borrow is ***bona fide***; (2) the purchase or borrow occurs on T+1, T+2, or T+3; (3) the purchase or borrow is of a quantity sufficient to ***cover the broker's entire failure to deliver position at CNS***; and (4) the broker can demonstrate that it has a ***net flat or net long position*** on its books and records on the day of the purchase or borrow. 17 C.F.R. § 242.204(e). Despite, optionsXpress' arguments to the contrary (Br. at 26-28), optionsXpress did not meet the requirements of this provision.

First, optionsXpress does not qualify for the pre-fail credit because the "purchases" associated with the buy-writes were not bona fide as no delivery took place. The buy-writes merely served to perpetuate failures to deliver. *See* Reply FOF § I.B; 12/7/12 Div. Post-Hearing Br. at Section I.C.

Second, because the buy-write is not a bona fide transaction, the "purchase" did not occur on T+1 (or T+2 or T+3) but rather on T+11, T+33, T+45, etc. *See* Reply FOF § I.B; 12/7/12 Div. Post-Hearing Br. at Section I.D.

Third, optionsXpress does not qualify for the pre-fail credit because the "purchase" was not of a quantity sufficient to cover the entire amount of optionsXpress' failure to deliver position at CNS. 17 C.F.R. § 242.204(e). Once again, optionsXpress argues that CNS is irrelevant. However, as stated above, this argument has no merit. Rule 204(e) specifically provides that the purchase must be of a sufficient quantity to "cover the entire amount of that broker's or dealer's fail to deliver position ***at a registered clearing agency*** [CNS] in that security." As discussed above, optionsXpress' alleged "purchase" did not cover the fail to deliver position at CNS because the buy-writes resulted in no delivery of shares. *See, e.g.*, DFOF ¶¶ 69, 81, 84, 96; Reply FOF § I.B.iii.

In addition, the evidence that optionsXpress cites for the proposition that it covered its entire failure to deliver position does not actually provide this proof. Exhibits 9A to 9D of Dr. Saha's report merely show charts of optionsXpress' "trade balance" for four securities. These charts at most show that optionsXpress' "trade balance" was somewhat similar to optionsXpress' CNS fails to deliver amount. It does not show that optionsXpress made purchases that were actually the same as or more than optionsXpress' CNS failures to deliver as required by Rule 204(e). Moreover, Exhibits 9A to 9D only reference four stocks, not all of the securities at issue in this case. Also, since Dr. Saha testified that he did not look at anyone's trades other than the six Customers, it is hard to imagine how he determined what optionsXpress' "trade balance" was for the entire firm. Tr. at 4437, 4442-43 (Saha). Further, it is impossible to tell whether Dr. Saha determined the "trade balance" before or after option assignments were calculated. Based on the evidence from CNS, however, it would appear that he did not include option assignments. DFOF ¶ 38; Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries). Lastly, optionsXpress argues that Dr. Saha found that 99.3% of the short stock sales were "cured within the T+3 window." Br. at 27. However, Dr. Saha's number assumes that the buy-writes were actually "closing out" the failures to deliver. Reply FOF § V, ¶ 120. As discussed above, they were not. *See id.* at § I.B.iii.

Fourth, optionsXpress does not qualify for the pre-fail credit because it has provided no evidence that it had a net flat or net long position on its books and records on the day of the purchase or borrow.[11] optionsXpress argues that Dr. Saha showed that the firm as a whole was net flat on its books and records, but this is simply not true. Dr. Saha testified that he looked only at the six accounts, not optionsXpress' entire books and records. Tr. at 4437, 4442-43 (Saha). Further, the only trading records produced at the hearing were those of the six accounts, not the

[11] The burden of showing that it had a net flat or net long position on its books and records belongs to optionsXpress. Pursuant to Rule 204(e) optionsXpress is required to "demonstrate that it has a net flat or net long position on its books and records on the day of the purchase or borrow."

entire books and records of optionsXpress. Thus, optionsXpress has not offered any proof that it, as a whole, had a net flat or net long position on its books and records. DFOF ¶ 47; Div. Ex. 1 (trade detail) (only relates to six customer accounts). Indeed, it is unlikely that optionsXpress would have been able to do so, because the evidence that was introduced – the CNS Account Summaries – shows that optionsXpress did not end the day net flat or net long but instead ended each day with a failure to deliver, as evidenced by its daily closing position ("CLOSING POS" column) on the CNS reports. DFOF ¶ 38; Div. Exs. 11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53 (CNS Account Summaries).

Fifth, optionsXpress' argument that it complied with Rule 204(e)'s purpose is without merit. As the Release to Rule 204 states: "The purpose of Rule 204(e) is to encourage broker-dealers to ***close out*** fail to deliver positions prior to the close-out date." 74 Fed. Reg. at 38276 (emphasis added). Even the guidance cited by optionsXpress to support its position recognizes that the purpose of Rule 204(e) was to "allow broker-dealers to obtain pre-fail credit if they ***close out*** their fail to deliver position. . . ." Rule 204 Small Entity Compliance Guide (Aug. 3, 2009) (available at www.sec.gov/divisions/marketreg/tmcompliance/34-60388-secg.htm) (emphasis added). As discussed above, optionsXpress did not "close out" its failure to deliver at CNS. Instead, it allowed its Customers to do buy-writes knowing that the calls the Customers sold would be exercised and assigned resulting in no delivery of shares and consequently a long-term failure to deliver at CNS.

G. optionsXpress Violated Rules 204 and 204T When the Buy-Writes Were Not Executed at Market Open.

The primary issue in this case is whether the "buy" portion of a buy-write constitutes a valid "purchase" for "close-out" purposes under Rule 204(a). As the Division stated in its opening brief, the issue of timeliness of buy-writes is only relevant if the Court somehow concludes that the buy-writes do not otherwise violate Rules 204T and 204. Div. Br. at 20. Despite this statement from the

Division, optionsXpress claims that the Division's challenge of the timing of the trades "amounts to a concession that in fact purchases ***were made***." Br. at 24 (emphasis in original). This is just another example of optionsXpress spinning the words of its regulators out of context to suit its own purposes.

optionsXpress' attempt to refute the fact that 97% of the buy-writes executed before August 20, 2009 were after 10:00 a.m. lacks merit. optionsXpress does concede that "its policies did not specifically encourage buy-ins to occur on T+1 until August 20, 2009." Br. at 25. Despite this concession, optionsXpress claims that the data prepared by its expert demonstrates that the "firm hardly ever waited until T+4 to buy its customers in, even before August 20, 2009." *Id.* This argument ignores the documentary evidence and testimony of fact witnesses in this case.

Before August 20, 2009, optionsXpress allocated buy-ins to customers based on failures to deliver at CNS. *See* Reply FOF § IV.A-D. Failures to deliver do not occur until the end of the day on T+3. In fact, the person in optionsXpress' Clearing Department responsible for allocating the failures to deliver admitted that he calculated the failures to deliver on a T+4 basis:

> Q: Okay. Focusing on the report you prepared that you are going to send to the trading desk that deals with buy-ins, that is something you prepare and *the customers you put on that list are ones who have a short position as of at least T+4*?
>
> A: Right. I just wanted to state not for every security will we always have a customer account to buy in.

Tr. at 370:16-24 (Tortorella) (emphasis added); *See* Tr. at 1647 (Stern) ("[W]e started out on T+4 which was the – what the rules said that we had to have coming down from T+11, and then at some point later on, I believe it was in August of 2009 . . . we went to buying in on T+1.").

For the Customers' buy-writes executed prior to August 20, 2009, which Stern and Tortorella testified were no earlier than T+4, almost all of them were executed after the beginning of regular trading hours, and thus, were not in compliance with Rules 204 and 204T. DFOF ¶¶ 157-59 (97% executed after 10:00 am ET); Reply FOF § IV.G. One of the reasons for

these late buy-writes is that on a number of occasions, the Clearing Department was unable to email the T+4 buy-in list to the trading desk by market open. DFOF ¶ 145; Reply FOF § IV.G. This was primarily due to the amount of time it took for the Clearing Department to review the OX Reconcile-CNS Fail Report and determine which failures to deliver were on a T+4 timetable and thus, needed to be included on the "CNS fail buy-in" email:

> A: No. We didn't have – we didn't have more than a basic report at that time, so it was more work sorting out *what number of shares were in T+4.*
>
> Q: All right. And that meant more time on your end trying to figure that out?
>
> A: Yes.
>
> Q: And that would be one of the reasons why you wouldn't be able to get the report done by market open?
>
> A: Yes.

Tr. at 386:25-387:10 (Tortorella); Reply FOF ¶ 89.

A review of the trading records demonstrates that Tortorella's testimony on this point was accurate. As demonstrated more fully in the Reply FOF there were numerous occasions that the Customers executed buy-writes at least four days after they were assigned both before and after August 20, 2009. And these buy-writes were not executed at market open as required by Rules 204T and 204. Reply FOF § IV.G-I.

optionsXpress claims that Dr. Saha found that 99.3% of the time "short stock positions resulting from assignments were cured through stock purchases before T+4." Br. at 25. But even if it were true, which it is not, Dr. Saha's analysis is completely irrelevant to the issue of whether all the buy-writes were executed in a timely manner because Dr. Saha's calculation is volume based. Reply FOF ¶¶ 112-18. Dr. Saha did not calculate buy-writes on a transaction by transaction basis as Dr. Harris did. *Id.* Nor did Dr. Saha even try to calculate how many buy-writes were executed before 10:00 a.m. This lapse is crucial because, as Dr. Saha's own report

indicates, the volume of buy-writes was much larger after August 2009. *See, e.g.*, Resp. Ex. 248 at 31 (Figure 1), Exs. 9A, 9B, 9D. This fact could greatly distort Dr. Saha's statistics. The following example demonstrates how misleading Dr. Saha's analysis is for the issue of whether buy-writes were executed on time: If pre-August 20, 2009, nine buy-writes for 10,000 shares each were executed after 10:00 a.m. on T+4 (*i.e.,* nine trades that violate Rule 204) and post-August 20, 2009, one buy-write for 1,000,000 shares was executed on T+1 (*i.e.,* one trade that complies with Rule 204), using Dr. Saha's methodology, less than 9% of these trades would be late although in reality 90% (nine of ten) were. As a result, optionsXpress' reliance on Dr. Saha's calculations is misleading and does not refute the documentary evidence that multiple buy-writes were executed after 10:00 a.m. both before and after August 20, 2009. Reply FOF § IV.G-I, ¶¶ 114-18. Indeed, for the 1,205 buy-writes executed before August 20, 2009, 97% of the buy-writes were executed after 10:00 a.m. eastern time. DFOF ¶ 159; Div. Ex. 497 (Harris Rebuttal) at Ex. 26. Thus, even if the Court were to decide that optionsXpress is correct that the buy-writes were legitimate, optionsXpress still violated Reg. SHO on numerous occasions by not executing the trades before 10:00 a.m. *See also* Reply FOF § IV.G-I.

H. optionsXpress' Due Process Argument Is Without Merit.

optionsXpress claims that the Division's theory of the case violates its due process rights. This argument is without merit for three main reasons.

First, courts have long held that it is not "unfair to require that one who deliberately goes perilously close to an area of proscribed conduct shall take the risk that he may cross the line." *United States v. Kay*, 513 F.3d 432, 442 (5th Cir. 2007) (*citing Boyce Motor Lines, Inc. v. United States*, 342 U.S. 337, 340 (1952)). After seventeen days of hearings, optionsXpress should be held to account for not only going close to the line but for actually crossing the line. Rules 204T and 204 are straightforward – optionsXpress was required to immediately close out its failures to

deliver at CNS. optionsXpress cannot seriously contend it did not realize this was the point of the regulation or that the conduct at issue was causing perpetual failures to deliver at CNS.

optionsXpress was aware of the buy-write activity and its effect from the inception of Rule 204T. optionsXpress' own head trader read an article in the *Wall Street Journal* noting that regulators were cracking down on the type of trading at issue in this case. DFOF ¶ 132. optionsXpress compliance personnel told the traders that the firm should "absolutely not" process the buy-writes because regulators may view the trades as "sham transactions as the SEC did with the two fined prop trading institutions [*Hazan* and *TJM*]." *Id.* ¶¶ 169-72. Employees of the clearing department recognized that the buy-writes were causing "vicious cycles" of failures to deliver and even warned that allowing the trading may come back to hurt the firm:

> Phil [Hoeh, Head of Complaince] basically said the same thing. Cannot cover a short as a buy-write. The orders must be placed separate. ***Don't want to get anyone in trouble, but somewhere down the line this is going to bite us*** . . ."

Div. Ex. 131 (emphasis added); DFOF ¶ 131 (Div. Ex. 41) ("Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle.").

Yet, the trading continued at optionsXpress. By contrast, Feldman could not conduct his trading at any other firm for more than a few months. For instance, within days Penson realized that Feldman's buy-writes were not resulting in the delivery of shares. DFOF ¶¶ 280-85. As a result, Penson immediately began borrowing shares to cover Feldman's trades – satisfying the firm's Rule 204 responsibilities. This demonstrates that other market participants were able to identify with "ascertainable certainty" that the buy-write trading could lead to Rule 204 issues. Br. at 29 (citing cases stating that an agency must pass regulations that a regulated party can identify with "ascertainable certainty"). Because there was plenty of guidance (besides the plain language of the rule) that the buy-write activity would violate Reg. SHO, there is no due process issues. *Howmet Corp. v. EPA*, 614 F.3d 544, 553-54 (D.C. Cir. 2010) ("If, by reviewing the regulations and other public statements issued by the agency, a regulated party acting in good

faith would be able to identify, with 'ascertainable certainty,' the standards with which the agency expects parties to conform, then the agency has fairly notified a petitioner of the agency's interpretation. This court has held that published agency guidance may provide fair notice of an agency's interpretation of its own regulations.") (citations omitted).

Second, optionsXpress never sought any written guidance from the SEC or any other regulator. optionsXpress was aware of the buy-write activity before Rule 204T was even enacted. DFOF ¶ 125. Yet, optionsXpress never submitted a comment to the Commission indicating that it had issues with the wording of the rule while Rule 204 was under Commission consideration. optionsXpress also never submitted a "no action" request to the staff of the Commission. Indeed, optionsXpress never submitted any written request for guidance to the SEC or FINRA, even after FINRA instructed it to do so. DFOF ¶ 206; *SEC v. Gemstar-TV Guide Int'l, Inc.*, 401 F.3d 1031, 1047-48 (9th Cir. 2005) (denying constitutional challenge and noting that "regulated enterprise may have the ability to clarify the meaning of the regulation by its own inquiry, or by resort to an administrative process") (quoting *Village of Hoffman Estates v. Flipside Hoffman Estates, Inc.*, 455 U.S. 489, 498 (1982). Furthermore, optionsXpress was specifically warned by Ms. Tao that its customers might be engaging in a fraud or doing "sham transactions." This did not deter optionsXpress. Instead, optionsXpress plowed ahead with the trading.

Finally, optionsXpress' assertion that the Division has not stated where the line is drawn is nonsense. Rule 204(a) clearly states that a clearing firm must "close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity." A firm does not "close out" a position if it allows its customers to continue to execute buy-writes day after day after day resulting in no delivery of shares to CNS. Everyone else figured this out. optionsXpress could have too.[12]

[12] optionsXpress cites the testimony of Dr. Saha and John Ruth ("Ruth") for the proposition that "persistent fails are commonplace and were not limited to optionsXpress." Br. at 32 n. 7. Tellingly, neither Dr. Saha nor Mr.

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

A. There Was a Primary Violation of the Anti-Fraud Provisions of the Federal Securities Laws.

Feldman's primary violations are more fully addressed in the Division's Reply Brief in Support of Its Case Against Feldman, which the Division respectfully incorporates by reference. The Division will only address those issues raised by optionsXpress that are not fully addressed in that reply brief.

optionsXpress claims that there can be no fraud because "[t]he record also was completely devoid of any evidence that any market participant was harmed. . . ." Br. at 34. This argument is wrong both as a legal and factual matter.

First, it is wrong as a factual matter because there were numerous notices of intent to buy-in issued by other market participants who had failures to receive at CNS on days when optionsXpress had failures to deliver. DFOF ¶¶ 300-02; Div. Ex. 54 (Notices of Intent to Buy-In issued to optionsXpress); *see also* Reply FOF § III. This indicates that other participants did not receive their shares when they otherwise anticipated. A former employee of Penson and an employee of E*Trade both testified that failing to receive shares can cause firms financial and regulatory problems. Tr. at 4811-13 (E*Trade) (if E*Trade does not receive shares in a timely fashion "it could run the risk of having possession and control impact"); Tr. at 785-86 (Penson) (failures to receive shares can cause issues with collateral capabilities and obligations). Consequently, firms submit notices of intent to buy-in to make sure that they receive the shares to which they are entitled. Thus, optionsXpress' claim that there is not a "single letter of complaint from a counterparty" (Br. at 34) simply ignores this evidence. Indeed, the evidence

Ruth provided any data to support this conclusion. By contrast, Dr. Harris compared how optionsXpress' failures to deliver at CNS compared to other clearing members. optionsXpress' failures to deliver dwarfed that of other firms for the securities at issue in the OIP in terms of both quantity of fails and age of fails. Div. Ex. 310 (Harris Report) at ¶¶ 191-95; *see also* Reply FOF ¶¶ 9-10.

shows that multiple broker dealers complained on at least 161 occasions.[13] Div. Ex. 54 (CNS Notices of Intent to Buy-In issued to optionsXpress).

Furthermore, Dr. Harris' report describes how the scheme in this case relied on slicing a small amount of profit from numerous market participants. Div. Ex. 310 (Harris Report) at ¶ 200. Because the Respondents profited by extracting small profits from all types of market participants, the fraud could go undetected by those parties. *Id.*

Second, optionsXpress' argument is wrong as a legal matter because the Division does not have to prove actual harm. *SEC v. Wolfson*, 539 F.3d 1249, 1256 (10th Cir. 2008) (SEC is not required to prove "injury in enforcement actions"); *SEC v. Savino*, 2006 WL 375074, at *15 (S.D.N.Y. Feb. 16, 2006) ("The SEC is not required to prove reliance or actual harm or damages resulting from conduct violating the securities laws in order to obtain relief.") (citations omitted). In another abusive short selling case, the Supreme Court held that under Section 17(a)(1) there is no requirement that the government prove an impact on an actual investor. *U.S. v. Naftalin*, 441 U.S. 768, 776 (1979). As the Court in *Naftalin* recognized:

> Moreover, the welfare of investors and financial intermediaries are inextricably linked-frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole. *See generally* Securities and Exchange Commission, Report of the Special Study of the Securities Markets, H.R.Doc.No.95, 88th Cong., 1st Sess., pt. 1, pp. 9-11 (1963). ***Fraudulent short sales are no exception. Although investors suffered no immediate financial injury in this case because the brokers covered the sales by borrowing and then "buying in," the indirect impact upon investors may be substantial.*** "Buying in" is in actuality only a form of insurance for investors and, like all forms of insurance, has its own costs. Losses suffered by brokers increase their cost of doing business, and in the long run investors pay at least part of this cost through higher brokerage fees. ***In addition, unchecked short-sale frauds against brokers would create a level of market uncertainty that could only work to the detriment of both investors and the market as a whole. Finally, while the investors here were shielded from direct injury, that may not always be the case. Had the brokers been insolvent or unable to borrow, the investors might well have failed to receive their promised shares.***

[13] In addition, market makers complained to CBOE regarding the activity. Tr. at 3816-18, 3896 (Overmyer) (CBOE investigation was prompted by market makers who complained about the trading activity).

Id. at 776-77 (emphasis added). In this case, market participants did fail to receive their promised shares in a timely fashion. And as the Supreme Court recognized in *Naftalin*, when a firm is unable or unwilling to cover its delivery obligations, investors who failed to receive their promised shares are harmed. In addition, all broker-dealers and customers end up paying for unchecked short sale fraud in the form of "market uncertainty," *i.e.* harm to market integrity. Div. Ex. 310 (Harris Report) at ¶¶ 15, 83-88.

B. optionsXpress Caused and Willfully Aided and Abetted Feldman's Violations.

optionsXpress asserts that it cannot be liable for causing or willfully aiding and abetting Feldman's fraud because (1) "regulators gave optionsXpress multiple 'green' flags" (Br. at 36-37); (2) any violation was far from "clear" (Br. at 37-38); and (3) optionsXpress "proactively contacted its regulators to determine whether the trading violated Reg. SHO." Br. at 39-49. These arguments fail.

1. There were no "green flags" only red flags.

optionsXpress did not receive any "green flags" from regulators that the buy-write activity was permissible. To the contrary, the evidence demonstrates the exact opposite. optionsXpress encountered numerous ***red flags*** that the trading was highly irregular, problematic and potentially unlawful, including:

- **August 6, 2004:** In the adopting release for Reg. SHO, the SEC reiterated guidance that a transaction that lacks legitimate economic purpose cannot be used to circumvent regulatory requirements – in this instance Regulation M. The adopting release discussed an example of a "sham transaction" not involving pre-arrangement with another party in which the covering transaction "is structured such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk . . . ." SEC Release No. 34-50103; 69 Fed. Reg. 48008, 48021 (Aug. 6, 2004). The adopting release gave the example of an individual trader that "places limit orders to sell and buy the same amount of shares, and the transaction is crossed in the individual's brokerage account. There is no change in beneficial ownership and no market risk associated with the transaction; i.e., these are 'wash sales.'" *Id.* at 48021 n.126. This is essentially what occurred with the Customers' use of buy-writes at optionsXpress.

- **<u>July 2007</u>:** AMEX fined several entities for trading similar to the Customers' in the *Arenstein* cases. AMEX issued a regulatory circular to the industry that warned that the "use of a buy-write with a one-day, deep-in-the-money FLEX option to nominally close out a fail to deliver and then shortly thereafter reestablish or 'reset' the fail to deliver position is not the only means by which an aged fail can be reset. ***Other transactions that can result in an improper 'reset' of an aged fail include***, but are not limited to, married puts, ***buy-writes***, conversions, flexes, ***or other delta neutral short term strategies matching options with stock***." Div. Ex. 384 (emphasis added). optionsXpress' compliance personnel reviewed this circular at the time it was issued. Tr. at 3314-16.

- **<u>Irregular Trading of Buy-Writes</u>:** Buy-writes typically involve out-of-the-money or near-the-money calls. DFOF ¶¶ 72-73. The buy-writes used by optionsXpress' Customers were atypical in that they involved deep-in-the-money calls. Indeed, they had to pay counterparties (generally between 1 and 2 pennies per share) to accept the buy-write trade. *Id.* ¶¶ 75-76. Every witness who testified at the hearing who was not either employed by optionsXpress or retained as an expert by Respondents testified that the Customers' use of buy-writes with deep-in-the-money calls is highly unusual and not normal market activity. *Id.* ¶ 77.

- **<u>Early 2008</u>:** Because a buy-write with a deep-in-the-money call is atypical, optionsXpress' Anti-Money-Laundering surveillance captured Zelezny's use of buy-writes in early 2008. DFOF ¶ 125. Zelezny's trading appeared on the surveillance because he was losing money on every buy-write that he executed. *Id.* This was a fact that optionsXpress' compliance personnel and traders were aware of. *Id.*

- **<u>Frequency of Assignments</u>:** The frequency at which the call portion of the buy-writes was assigned was highly unusual market activity. DFOF ¶¶ 77, 83; Div. Ex. 375 (Sheehy Report) at ¶¶ 61, 64 ("because Feldman was systematically assigned on the deep in-the-money calls [in SHLD] on his first three-way trade . . . the pattern of early assignment should have been predictable almost immediately"); Div. Ex. 310 (Harris Report) at Ex. 17 (91.9% of the buy-write calls closed by assignment were assigned on the same day they were sold). optionsXpress understood that the pattern was likely to repeat day after day after day. *See, e.g.,* Div. Ex. 253 (Coronado email) ("the customer has short positions on hard to borrow stocks where the customer has to buy in every day. Our customer is buying back the short and writing in the money calls which are assigned on a daily basis.").

- **<u>October 14, 2008</u>:** The SEC adopted Rule 204T and noted that "the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement." 73 Fed. Reg. at 61715 n. 78.

- **<u>November 5, 2008</u>:** optionsXpress knew that it was in a "vicious cycle" of failures to deliver at CNS in Sears as a result of the buy-writes. Div. Ex. 41 (Molnar to Bottini email: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a ***vicious cycle***. . . . If we were able to get the CNS fail to zero for one day, the Reg SHO clock would get reset to a new

10 days. Unfortunately now we have to cover any CNS fail immediately.") (emphasis added).

- **November 13, 2008:** optionsXpress' head trader sent an email to the head of the Clearing Department, Risley, about a *Wall Street Journal* article describing the trading activity in the *Arenstein* case and noting that FINRA had several cases involving similar activity: "There is an article in the WSJ about how short sellers in SHLD are using options to circumvent the SEC cover rule. I think we need to review this." Risley immediately emailed back: "[The Customers are] definitely doing this." Div. Ex. 255.

- **February 26, 2009:** optionsXpress was notified by CBOE that it was investigating Zelezny's trading to determine whether SEC Rule 204T has been violated. Div. Ex. 431.

- **May 2009:** FINRA initiated its first investigation of optionsXpress related to compliance with Rule 204T. DFOF ¶ 140.

- **July 2009:** The SEC adopts Rule 204 and reiterates its previous guidance: "Where a participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement." 74 Fed. Reg. 38266, 38272 n. 82.

- **August 5, 2009:** The *Hazan* and *TJM* cases are issued by the SEC. Div. Ex. 130 (*Hazan*); Div. Ex. 135 (*TJM*). In those cases, the respondents were engaging in trading very similar to that being done by optionsXpress' customers.

- **August 6, 2009:** An optionsXpress compliance officer, Kevin Strine ("Strine"), circulated an email to multiple individuals at optionsXpress regarding the *Hazan* and *TJM* cases. Strine noted that the similarities between the trading in *Hazan* and *TJM* and the Customers' were "troublesome." Strine also noted that ultimately the result in the *Hazan* and *TJM* cases and the Customers' was essentially the same: "the end result in all situations is similar: the shares are bought-in, but the subsequent exercise or assignment of the option that night results in ***a continuation of the fail.***" Resp. Ex. 678 (emphasis added).

- **August 19, 2009:** optionsXpress adopts procedures to deal with the "chronic," "perpetual" or "rolling fails" that it is experiencing. Div. Ex. 128. The new procedures stated that there would be a separate list for the Customers' fail to deliver positions where "the fail is continuously open due to customers being assigned in the money short calls" – *e.g.,* the "chronic," "perpetual," or "rolling fails" list. These procedures did not resolve optionsXpress' failure to deliver position at CNS. DFOF ¶ 168.

- **August 20, 2009:** Strine told optionsXpress' traders that the firm should not engage in the buy-writes. Div. Ex. 104 ("***the answer is absolutely not.*** We do not want to be an active party in the call transactions. We are fulfilling our obligation to issue the buy-in. ***If we process the buy-write, regulators could consider the buy-ins as sham transactions.***") (emphasis added). Strine forwarded his email to the Chief Compliance Officer and stated "we do not want to be an active participant in the call trade. They will

need to do that trade on their own. I believe that if we do the buy-write for them, auditors [like FINRA or SEC] will consider them sham transactions as the SEC did with the two fined prop trading firms [Hazan and TJM]." Div. Ex. 105. According to Strine he had told the traders earlier in 2009, that the firm should not execute buy-writes. DFOF ¶ 172. Nevertheless, optionsXpress allowed the trading to continue.

- **September 23, 2009:** A trader read the *Hazan* case and sent an email to his supervisor and co-trader with a summary of the case because he wanted his supervisor to be aware of the case's similarity to the Customers' trading. Tr. at 1149-50; Div. Ex. 149. Immediately after receiving the email with a summary of *Hazan*, the other trader emailed that same supervisor and stated "I am not placing any orders today." Div. Ex. 35. After the traders were told by their supervisor to continue with the trades, the traders immediately forwarded the message to their personal email accounts. Div. Ex. 35; Div. Ex. 149; *see also* DFOF ¶¶ 188-90.

- **September 23, 2009:** An employee in the Clearing Department emailed Strine and reiterated that compliance had earlier said the buy-write trading should stop. "Phil [Hoeh] basically said the same thing. Cannot cover a short as a buy-write. The orders must be placed separate. ***Don't want to get anyone in trouble, but somewhere down the road this is going to bite us. . . .***" Div. Ex. 131 (emphasis added).

- **September 24, 2009:** In a call with employees of Trading & Markets, optionsXpress is told that their Customers may be engaging in a fraud. Tr. at 3588 (Tao). The notes of this call from optionsXpress' in-house counsel state "we do not fall into the sham transaction → the customer may." Resp. Ex. 729. Nevertheless, the trading continued.

- **October 2, 2009:** Trading & Markets tells optionsXpress that it can provide "no comfort" that the trading is lawful. DFOF ¶¶ 204-09. Trading & Markets also tells optionsXpress that FINRA is finding an entirely different set of facts than what optionsXpress had previously represented was occurring. *Id.*

- **December 1, 2009:** Feldman returns from Terra Nova after less than a month trading there. optionsXpress takes Feldman back but raises his rates for buy-ins by $.005 per share. Feldman is told that this increase in rates is due to the fact that optionsXpress is interacting with the regulators about the trading. DFOF ¶ 223.

- **January 14, 2010:** optionsXpress has a call with FINRA regarding the buy-write activity. At no time does FINRA tell optionsXpress that the trading is lawful. DFOF ¶¶ 227-31.

- **February 2010**: optionsXpress began charging the Customers an increased commission. In explaining the increased commission to one of the Customers, an optionsXpress employee said that the buy-writes were so large the regulators might start to notice. Div. Ex. 248 (call between Coronado and Nielson); *see also* Tr. at 597-98 (Coronado).

In analogous cases where brokers have encountered a similar amount of red flags, courts have found those brokers liable for aiding and abetting a fraud. For example, in *Graham v. SEC*, 222 F.3d 994 (D.C. Cir. 2000), the court held a broker liable for aiding and abetting a customer's

fraud. *Id.* at 1004-05. The broker in *Graham* executed 60 trades that were part of a manipulative scheme. The broker had "noticed numerous suspicious circumstances" with the trading activity but executed the trades anyways. *Id.* The broker also realized that the trades at issue were "economically irrational." *Id.* Here, just like in *Graham*, there were numerous suspicious circumstances and the buy-writes were economically irrational (because the customers *paid* $.01/.02 a share to place the trade). optionsXpress knew the pattern would repeat day after day after day and optionsXpress knew that delivery was not taking place at CNS. As a result, optionsXpress should be found liable for aiding and abetting Feldman's fraud. *See also Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595 (10th Cir. 1979) (holding that a broker willfully aided and abetted manipulative wash and match trades scheme when he "knew or had reason to know that such trading was economically irrational").

Further, the facts that optionsXpress lists in its brief for support of its argument (Br. at 36) that it encountered "green flags" are incomplete, wrong or irrelevant:

- **September 23, 2009**: optionsXpress claims that CBOE's letter of caution means that CBOE found "no violation of Reg. SHO." Br. at 36. optionsXpress' claim is wrong. optionsXpress was not informed by CBOE that Zelezny's trades did not violate Reg. SHO. Reply FOF ¶ 159; DFOF ¶ 187. On the contrary, CBOE's witnesses confirmed that they never once told optionsXpress the conduct did not violate Reg. SHO. *Id.*

- **September 24, 2009**: optionsXpress claims that Trading & Markets told it to keep doing what you are doing, keep closing out. Br. at 36. optionsXpress' stated fact is incomplete. As noted above, on this call Ms. Tao informed optionsXpress that their customer may be engaging in a fraud or sham transaction. Tr. at 3591-92 (Tao). Also, anything Ms. Tao communicated to optionsXpress was based on the fact pattern given to her by the entity and based on an assumption that optionsXpress was actually "closing out" the customers. At the time, Ms. Tao was not told by optionsXpress that it had a failure to deliver at CNS for over 120 days in Sears. DFOF ¶ 39. In any event, a week later, Ms. Tao informed optionsXpress that Trading & Markets could provide no comfort. In addition, just a day prior to the September 24 call, FINRA had informed optionsXpress that they continued to have optionsXpress under investigation.

- **December 2 and 10, 2010**: optionsXpress claims that CBOE found no violations. Br. at 36. optionsXpress' stated fact is irrelevant. The letters from CBOE relied on by optionsXpress were received well ***after the trading activity had concluded***. Thus, optionsXpress in no way could have relied on these letters to justify its conduct. In addition, as established at the hearing, a single CBOE staffer did only a cursory review of

information sent to him by optionsXpress before sending these letters. That staffer did not understand the rule and had no Reg. SHO training. Reply FOF ¶¶ 168, 171. As a result, these letters should be given no weight.

According to optionsXpress, unless they were told specifically by a regulator to stop the buy-write trading, they had a green light to continue. *See* Br. at 37. This ignores the fact that regulated entities are always responsible for making sure they comply with the law. *See, e.g., In the Matter of Stephen J. Horning*, AP File No. 3-12156, 2006 WL 2682464, *22 (Sept. 19, 2006) (Murray, A.L.J.) (holding that "persons in the securities industry cannot blame the Commission for their failure to carry out their responsibilities"), *aff'd, Horning v. SEC*, 570 F.3d 337 (D.C. Cir. 2009); *In the Matter of Certain Broker-Dealers Who Failed to File All or Part of Form BD-Y2K*, AP File No. 3-9759, 1999 WL 557616, *12 (Aug. 2, 1999) (Murray, A.L.J.) ("It is established that a broker-dealer cannot shift its responsibilities for compliance with applicable requirements to the . . . Commission."); *In the Matter of Quest Capital Strategies, Inc.*, AP File No. 3-8966, 2001 WL 1230619, at *8 (Oct. 15, 2001) ("We have repeatedly pointed out that a broker-dealer cannot shift its responsibility for compliance with applicable requirements to…us."); *In re W.N. Whelan & Co.*, 50 S.E.C. 282, 284, 1990 WL 312067, at *2 (Aug. 28, 1990) ("A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation.").

The *Graham* case is instructive on this issue as well. 222 F.3d at 1006-07. In *Graham*, the defendants claimed they should not be held liable because the NASD had reviewed the trading and the SEC had allegedly blessed the NASD's view that there was no violation. *Id.* The court, however, disagreed noting that the NASD, like CBOE here, did not give the trading a "clean bill of health." *Id.* Instead, a NASD examiner, like CBOE here, had reviewed the trading found that it "didn't smell right" and it was "fishy" and concluded in an internal memo that it did not violate a NASD rule. *Id.* The defendants claimed that the SEC also blessed the trading by relying on the testimony of the NASD examiner who testified that someone at the SEC

"basically agreed" with his interpretation that there was no violation. *Id.* The court in *Graham* held that:

> ***[W]hat we have here in this case is nothing more than a series of investigations into [the defendant's] trades***, which ultimately provided the SEC with sufficient understanding of the underlying scheme to file the complaint now before us. Neither [the defendant] ***nor the petitioners can be said to have been cleared along the way.*** And the SEC's failure to prosecute an earlier stage does not estop the agency from proceeding once it finally accumulated sufficient evidence to do so.

Id. at 1008 (emphasis added). Simply put, just like in *Graham*, optionsXpress encountered more than enough "red flags" to prove it either caused or aided and abetted Feldman's violations.

2. The violation was clear.

Any reasonable market participant would have realized that Feldman's pattern of trading would lead to failures to deliver at CNS if his positions were not shut down. Feldman tried to do his trading at three firms besides optionsXpress. Each of these firms quickly shut him down. For example:

- **<u>Penson</u>**: As soon as Feldman's trades started clearing through Penson, Penson went out and borrowed shares to satisfy its failures to deliver caused by Feldman. Tr. at 778-79 (Crain) ("we had no choice but to borrow shares and assess any costs associated with those to the account holder"); *see id.* at 790-91, 796 (Penson borrowed shares to cover Feldman's failures to deliver). Penson then researched Feldman's trades and quickly determined that his trading was nearly identical to the trading in *Hazan*. Tr. at 823-25 (Crain); DFOF ¶ 285. Feldman was then asked to shut his trading down immediately. *See* Tr. at 2305-06 (Feldman) (Feldman's representative at Terra Nova asking him how much time he needs to close the accounts down and informing him that he cannot make any promises as to how long they will give him to do so). All told, Feldman was able to trade through Penson for less than a month.

- **<u>E*Trade</u>**: Within a short period of time after Feldman began trading at E*Trade, employees of the firm noticed "the pattern that was starting to emerge where the customer was engaging in this covering strategy almost daily and we were having to go out to close out the positions or use other means to facilitate delivery of the shares." Tr. at 4797 (Mikus). This means that E*Trade had to find shares to deliver to CNS because Feldman's buy-writes caused his position to remain constant. E*Trade had regulatory concerns about the trading – specifically Rule 204. Tr. at 4807 (Mikus). As a result, Feldman was informed that he needed to discontinue the buy-write activity. Tr. at 4808; *see also* DFOF ¶¶ 287-90.

- **TD Ameritrade**: Feldman also tried his trading strategy at TD Ameritrade in late 2011 and early 2012. Feldman was only able to do his trading there though for about two to three months. DFOF ¶ 286. In an email dated January 20, 2012, TD Ameritrade told Feldman that his "strategy that continues to be executed creates operational risk, market risk and potential ***regulatory risk for the clearing firm***. The nature of frequent assignment of the short calls creates an obligation for delivery of shares that lags the closing transaction of the short position by one day. In several instances over the last two months, ***these fails have continued to age as new calls are written simultaneously with the closing transactions***. As a result of these frequent sizable and aged fails to deliver, the firm has absorbed significant market, economic, ***and regulatory risk to allow this activity to continue***." Div. Ex. 416 (emphasis added).

Thus, every other market participant who was exposed to Feldman's trading shut down the activity. optionsXpress by contrast is the only firm that did not act in a manner expected of regulated entities.

optionsXpress claims that it is unclear whether options trading is even governed by Rule 204. Br. at 37. This position is absurd. Options market makers and other option industry participants realized Rule 204's application to options assignments as demonstrated by the various comment letters they submitted to the Commission. *See* 74 Fed. Reg. 38270 at n. 48, 53 (Rule 204 adopting release listing comments received from CBOE and other options exchanges). optionsXpress itself recognized that when options are assigned the resulting short sale is governed by Reg. SHO – evidenced by a question Stern sent to CBOE on the day the Rule was issued. Div. Ex. 326. Further, much of the Reg. SHO guidance discussed above relates directly to options. In addition, optionsXpress implemented procedures to deal with the continuous failures to deliver arising from the buy-writes in August 2009. If options are not governed by Rule 204, why did optionsXpress change its procedures?

Next, optionsXpress relies on a misleading and incomplete review of the record to assert that Trading & Markets came to the conclusion the trading did not violate existing law. Br. at 37-38. For example, optionsXpress cites "facts" from the following dates:

- **May 20, 2009**: optionsXpress asserts that Trading & Markets told CBOE that if there is no fail there is no violation. Br. at 38. What optionsXpress fails to comprehend, however, is that is a correct statement of the law. The critical fact that optionsXpress

omits is that Trading & Markets never told CBOE that optionsXpress' conduct was compliant with Rule 204. Reply FOF ¶ 134.[14]

- **June 2009:** optionsXpress claims that CBOE found that it did not violate Rule 204. Br. at 38. This is not accurate. *First*, the memo cited by optionsXpress does not indicate whether there was any failure at CNS – the starting point for any Rule 204 violation. *Second*, CBOE's conclusion did not come from Trading & Markets. *See* Reply FOF ¶¶ 133, 135, 140. *Third*, CBOE's internal deliberations are irrelevant to the issue of whether optionsXpress complied with the law. *See Graham*, 222 F.3d at 1006-07, n.24 (rejecting the contention that an internal NASD memo provided a defense but noting that "even if the NASD had done something to bind itself, that would not have bound the SEC").

- **August 5, 2009**: optionsXpress claims that Ms. Tao recognized Rule 204 did not "cover the trading at issue" in this case. Br. at 38. While Ms. Tao did write an email asking her colleague whether they should propose a rule regarding circumvention with no economic purpose in it, Ms. Tao explained that this email related to whether a customer (as opposed to a firm) could violate Reg. SHO. Tr. at 3661-62 (Tao). Importantly, optionsXpress omits the portion of the email where Ms. Tao stated "[An enforcement attorney] might bring this case if they are going to refer to it" and Ms. Tao's colleague replied "This is very similar to the Arenstein, Hazan, TJM cases – resetting the clock." OPX 559. These are hardly the comments of individuals who did not think there was a violation of the law.

- **October 2, 2009**: optionsXpress claims that Trading & Markets told FINRA that optionsXpress' activities did not violate Rule 204. Br. at 38. optionsXpress recited only a portion of FINRA's notes and omits to cite the portion of the notes that read ***"The SEC also stated that if the calls were deep-in-the-money, there was a pattern of this type of activity, and OXPS was involved in the execution of the activity, and would, therefore have reason to know that the activity was occurring, then OXPS would be in violation of 204.*"** Div. Ex. 237 (emphasis added). Given that this is exactly what happened at optionsXpress, there should be no doubt that optionsXpress clearly violated the law.

- **February 3, 2010**: optionsXpress claims that a letter from CBOE to the SEC demonstrates that Trading & Markets had told CBOE that "there was not a Regulation SHO violation." Br. at 38. There was no testimony about this letter from CBOE. Thus, there is no basis to conclude that anything the letter said about Trading & Markets was accurate. In fact, Ms. Tao credibly testified that she never told CBOE that optionsXpress was not in violation of Rule 204. Tr. at 3612-13 (Tao) ("No, no, we wouldn't have said that."); *see also* Reply FOF at ¶¶ 134, 140.

optionsXpress then argues that because its compliance officers reviewed the buy-write activity it acted in good faith. Br. at 38. But optionsXpress fails to acknowledge that the only compliance officer it called as a witness testified that it was his recommendation that the firm

[14] Trading & Markets also never told CBOE that the Customers' were engaging in proper hedging. *See* Reply FOF at ¶¶ 136, 149.

stop the buy-writes. Tr. at 3512-13 (Strine) (his advice as a "conservative" compliance officer was that the firm should not allow the buy-writes). Indeed, this compliance officer at the time the trading was occurring wrote that the firm should "absolutely not" allow the buy-writes. Div. Ex. 104 ("the answer is absolutely not. We do not want to be an active party in the call transactions. . . . If we process the buy-write, regulators could consider the buy-ins as sham transactions."); Div. Ex. 105 ("I believe that if we do the buy-write for them, auditors [like FINRA or SEC] will consider them sham transactions as the SEC did with the two fined prop trading institutions [*Hazan* and *TJM*]."). However, the compliance officer's recommendation was repeatedly ignored. Not following the recommendation of one of your compliance officers is hardly evidence of a conservative compliance culture, much less good faith.[15]

3. optionsXpress cannot rely on regulators as a defense.

optionsXpress asserts that it "proactively contacted its regulators to determine whether the trading violated Reg. SHO." Br. at 39. This is not what happened.

First, CBOE contacted optionsXpress because CBOE was investigating activity relating to Zelezny. Thus, optionsXpress did not "proactively contact" CBOE regarding the use of buy-writes to "close-out" a failure to deliver at CNS.

[15]On page 38 of its brief, optionsXpress claims that expert testimony from Dr. Sirri and Mr. Ruth supports its claim that it did not act with recklessness or negligence. optionsXpress is wrong. As noted above, Dr. Sirri's testimony on Reg. SHO should be afforded no weight. Similarly, Mr. Ruth's testimony that Reg. SHO "was not clear, particularly as it applied to options trading" is unavailing. First, this is improper expert testimony. *Densberger v. United Techs. Corp.*, 297 F.3d 66, 74 (2d Cir. 2002) ("It is a well-established rule in this Circuit that experts are not permitted to present testimony in the form of legal conclusions."); *Nationwide Transp. Fin. v. Cass Info. Sys.*, 523 F.3d 1051, 1058 (9th Cir. 2008) ("[A]n expert witness cannot give an opinion as to her legal conclusion, i.e., an opinion on an ultimate issue of law."); *JIPC Management, Inc. v. Incredible Pizza Co., Inc.*, 2009 WL 8591607, at * 4 (C.D. Cal. July 14, 2009) ("The expert's legal conclusions are unhelpful because they 'suppl[y] the jury with no information other than the witness's view of how the verdict should read.") (citing 4 WEINSTEIN'S FEDERAL EVIDENCE § 704.4[2][a] at 704–12). Second, Mr. Ruth's opinion ignores the fact that other firms immediately shut Feldman's trading down. Third, Ruth's opinion is unreliable because he also opined that optionsXpress got "comfort" from its regulators that the trading was legal. There is no record evidence supporting that contention. DFOF ¶¶ 204-09, 227-31; Reply FOF ¶¶ 159-60, 177-78. Each regulator testified they never told optionsXpress the conduct complied with Reg. SHO.

Second, FINRA also contacted optionsXpress because FINRA was investigating the buy-write activity. Again, optionsXpress did not "proactively contact" FINRA about the buy-writes. On the contrary, optionsXpress went so far as to inform FINRA that they did not know their customers' motivation for entering into the buy-writes despite evidence that they did in fact know. DFOF ¶ 267; Div. Ex. 101 ("OXPS did not know – and could not know – the customers' motive for selling calls. . . . We do not know, and cannot speculate, as to the motive for the strategy employed by our customers. Therefore, although maintenance of a short position in GHL may have been a result of the customers' actions, OXPS does not know the customers' motives during the review period.").

Third, the email Strine wrote that is relied on by optionsXpress does not just note distinguishing factors from the *Hazan* and *TJM* cases. Instead, Strine recognized that some of the activities are "similar" to "the activities our customers engaged in" and found that "troublesome." Resp. Ex. 678. Strine also recognized that "the end result" in *Hazan/TJM* and the customers' activity at optionsXpress "is similar." That is, "the shares are bought-in, but the subsequent exercise or assignment of the option that night ***results in a continuation of the fail.***" *Id.* (emphasis added). Thus, optionsXpress' own compliance officer recognized that the fails were continuing and yet the activity still was allowed to continue.

Fourth, optionsXpress was warned by Ms. Tao that their customers might be engaging in a fraud or sham transaction. Tr. at 3585-86. Then a week later she called optionsXpress back and said she would give them no comfort. She also told them that FINRA was finding a different set of facts than what optionsXpress had earlier told her. DFOF ¶ 204. Again, these facts demonstrate that optionsXpress' communications with regulators do not justify its conduct.

C. optionsXpress Caused and/or Aided and Abetted Feldman's Violation of Rule 10b-21.

For the reasons stated in the Division's Reply Brief in Support of Its Case Against Feldman, Feldman's trading scheme violated Rule 10b-21 because he deceived market participants regarding his intention to deliver securities he sold and then failed to deliver. Feldman did not intend to deliver the shares he sold short – instead he intended to do another buy-write which would ensure delivery did not take place. As noted above, this scheme harmed market participants who did not timely receive shares they were due. *Cf. Graham*, 222 F.3d at 1003 ("When the music stops, the firm left without a chair (payment or collateral) does not simply leave the game. 'Losses suffered by brokers,' whether or not covered by insurance, 'increase their cost of doing business, and in the long run investors pay at least part of this cost through higher brokerage fees.") (quoting *Naftalin*, 441 U.S. at 776). Without optionsXpress' assistance, Feldman would not have been able to conduct this scheme – he needed a broker-dealer that would ignore its regulatory obligations.

optionsXpress contends that the Division's claim fails because a broker-dealer cannot deceive itself and optionsXpress was not deceived by Feldman. Br. at 43. This defense is wrong. *First*, Rule 10b-21 states that any broker-dealer, a participant of a registered clearing agency, or a purchaser can be deceived. *Second*, Rule 10b-21's adopting release states that broker-dealers can be liable for aiding and abetting a customer's fraud. 73 Fed. Reg. at 61673. Thus, the Commission specifically contemplated that broker-dealers may aid and abet their customers' violations of Rule 10b-21.

optionsXpress also contends that Rule 10b-21 does not apply to the "assignment of option contracts." Br. at 43. But according to the plain language of Rule 10b-21 it applies to the sale of "an equity security." Section 3(a)(11) of the Exchange Act defines "equity security," as that term is used in Rule 10b-21, to include "any stock or similar security; or any security future

on any such security; . . . or carrying any warrant ***or right to subscribe to or purchase such a security; or any such warrant or right.***" 15 U.S.C. § 78c(a)(11) (emphasis added). A call option is by definition the right, but not the obligation, to buy a specified amount of an underlying security at a specified price within a specified time. Furthermore, under Rule 3a11-1 of the Exchange Act, the term "equity security" includes "any put, call, straddle or other option." 17 C.F.R. § 240.3a11-1. Therefore, a call option is an "equity security" under Rule 10b-21.[16]

Finally, as demonstrated above, optionsXpress' claim that it delivered securities is simply not true. Thus, its argument that it did not aid and abet Feldman because it delivered securities is without basis.

III. THE COURT SHOULD ORDER DISGORGEMENT, PENALTIES AND OTHER EQUITABLE RELIEF AGAINST OPTIONSXPRESS

A. optionsXpress Should Be Ordered to Pay Disgorgement.

Under Rule 204(a), optionsXpress should have closed its failures to deliver out by either "borrowing or purchasing securities of like kind and quantity." 17 C.F.R. § 242.204(a). It did not do so and as a result it avoided paying hard-to-borrow fees and earned substantial commissions.

Disgorgement of losses avoided is an appropriate means of disgorgement. *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995); *SEC v. Pentagon Capital Mgmt. PLC,* 844 F. Supp. 2d 377, 425 (S.D.N.Y. 2012). Even though losses avoided are an appropriate means of disgorgement (a legal issue uncontested by optionsXpress), optionsXpress contends that net profits is the only appropriate disgorgement amount in this case. Br. at 44. optionsXpress is wrong.

By failing to comply with its regulatory obligations, optionsXpress ***avoided paying*** $7,214,977 of hard-to-borrow fees. Div. Ex. 310 (Harris Report) at ¶¶ 41, 188, 199. The amount of hard-to-borrow fees is a reasonable amount for disgorgement because had optionsXpress

[16] Feldman conceded he "submitted orders to sell equity securities." Feldman Br. at 37.

actually purchased shares to close out its failures to deliver the buy-write activity would have immediately stopped. This is because the customers' trading strategy would not have been profitable. Further, because optionsXpress ***never actually purchased shares*** (but instead allowed the customers to do buy-writes), the cost of purchasing is uncertain and likely far higher than the hard-to-borrow fees. *See id.* at ¶ 185. Thus, the amount optionsXpress avoided paying to borrow the shares is an appropriate disgorgement amount. optionsXpress should not be able to limit the amount it pays in disgorgement when its own conduct limited what can be reasonably calculated. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989) (any doubts regarding the amount of disgorgement are resolved against defendants as any "risk of uncertainty should fall on the wrongdoer whose illegal conduct created the uncertainty."); *SEC v. Randy*, 38 F. Supp. 2d 657, 674 (N.D. Ill. 1999) ("In determining the amount of disgorgement, all doubts should be resolved against the defrauding party.").

If the Court concludes that the appropriate measurement of disgorgement is the commissions optionsXpress earned, then optionsXpress should be ordered to disgorge $1,908,744 plus prejudgment interest. Div. Ex. 310 (Harris Report) at ¶ 42. optionsXpress claims this amount should be reduced because it includes trades "other than the buy-writes." Br. at 45. But optionsXpress fails to inform the Court that the other trades are predominantly the reverse conversions and three-ways. Div. Ex. 310 (Harris Report) at ¶ 190; Div. Ex. 1 (trading records for Customers). If optionsXpress had not allowed the buy-writes, these trades would not have been profitable and the trading would have stopped. Thus, including the commissions for these trades is reasonable.

optionsXpress also claims that the Court should reduce the disgorgement amount to reflect its gross profit margin. Br. at 45. Courts routinely reject these types of arguments by defendants. *See SEC v. Hedgelender LLC*, 786 F. Supp. 2d 1365, 1371-72 (S.D. Ohio 2011) (refusing to decrease disgorgement amount to include "offsets"); *SEC v. Solow*, 554 F. Supp. 2d 1356, 1365 (S.D. Fla. 2008) (ordering disgorgement of gross profits and refusing to offset the

amount of disgorgement by sums the wrongdoer paid to others); *SEC v. Hughes Capital Corp.*, 917 F. Supp. 1080, 1087 (D.N.J. 1996) ("[T]he overwhelming weight of authority holds that securities law violators may not offset their disgorgement liability with business expenses."); *SEC v. Great Lakes Equities Co.*, 775 F. Supp. 211, 214 (E.D. Mich. 1991) (finding deductions for overhead, commissions and other expenses not warranted). This Court should do the same.

B. optionsXpress Should Pay a Substantial Civil Penalty.

optionsXpress should be ordered to pay a substantial civil penalty to deter others in the industry. *See SEC v. Pentagon Capital Mgmt. PLC*, 2012 WL 1036087, at *2, 9 (S.D.N.Y. Mar. 28, 2012) ("Civil penalties are designed to punish wrongdoers and deter future violations of the securities laws."). There should be no doubt that optionsXpress at the very least recklessly disregarded its regulatory requirements. Thus, at a minimum optionsXpress should be ordered to pay a second tier penalty. 15 U.S.C. § 78u-2(b)(2) (second tier penalties may be assessed "if the act . . . involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.").

optionsXpress claims that any civil penalty is unwarranted because any violation was "technical and victimless." Br. at 46. This hyperbole lacks support. The Commission has never indicated that it views Reg. SHO as a "technical and victimless" rule. For example, an entity that ***self-reported*** a Reg. SHO violation paid $550,000 in penalties to regulators for failing to timely close out failures to deliver. *In the Matter of Goldman Sachs Execution & Clearing L.P.*, Release No. 34-62025, AP File No. 3-13877 (May 4, 2010) (46 inadvertent untimely close outs under Rule 204T due to a calculation error over a two week period of time). optionsXpress' failures to deliver greatly exceeded the ones in the Goldman Sachs settlement. In addition, the Division established that market integrity was harmed by optionsXpress' conduct, Div. Ex. 310 (Harris Report) at ¶¶ 83-88, and that numerous firms had to request shares that they did not timely receive. Div. Ex. 54.

optionsXpress' claims that a penalty of only $75,000 would be warranted. Br. at 48. optionsXpress also claims that even though it earned close to $2 million in commissions through the conduct at issue this does not mean that it "greatly profited." Br. at 47. These statements demonstrate just how little optionsXpress thinks of its regulatory responsibilities and why it should be punished for its wrongful conduct. *Pentagon Capital*, 2012 WL 1036087, at *2 (civil penalties are used to punish wrongdoers).

optionsXpress also claims that the Division is seeking close to $1 billion in penalties. Br. at 46. The Division merely pointed out, however, that this would be the maximum amount of penalties on a per violation basis. *Pentagon Capital*, 2012 WL 1036087 at *2 (noting that the maximum penalty in a market timing case was multiplying the tiered penalty amount against the "10,052 late trades" and determining the maximum penalty exceeded $6 billion for an entity). The Court always has discretion in fashioning the appropriate civil penalty to punish optionsXpress for its conduct. *See id.* at *9-10 (ordering $38 million in penalties for a two and a half year late trading scheme).

C. optionsXpress Should Be Ordered to Cease-and-Desist.

optionsXpress claims that it should not be ordered to cease-and-desist because the Division did not "identify a single victim." Br. at 48. As noted above, this is incorrect. Numerous market participants had to repeatedly submit notices of intent to buy-in at CNS in an attempt to get shares they did not receive in a timely manner. Div. Ex. 54.

A cease-and-desist order is appropriate because the record evidence demonstrates that optionsXpress' corporate culture is one where red lights are ignored and consequences disregarded. In optionsXpress' view, the only way they would ever stop is if a regulator orders them to. optionsXpress just does not get it. The Commission expects much more from regulated entities who deal on a daily basis with other people's money. Regulated entities need to be diligent on their own accord to make sure their conduct meets all their regulatory responsibilities. optionsXpress cannot shirk its duties and blame the regulators. *See, e.g., In the Matter of*

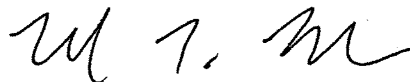
Stephen J. Horning, AP File No. 3-12156, 2006 WL 2682464, *20 (Sept. 19, 2006) (Murray, A.L.J.) (holding that "persons in the securities industry cannot blame the Commission for their failure to carry out their responsibilities"), *aff'd*, *Horning v. SEC*, 570 F.3d 337 (D.C. Cir. 2009). If a cease-and-desist order is not entered, investors and the marketplace will continue to be at risk from optionsXpress' conduct. *See In the Matter of Ofirfan Mohammed Amanat*, Exchange Act Rel. No. 54708, 2006 WL 3199181, at *12 (Nov. 3, 2006) (Commission ordering a respondent to cease-and-desist from his violations).

CONCLUSION

As the foregoing demonstrates, optionsXpress willfully failed to live up to its regulatory responsibilities. optionsXpress caused and willfully aided and abetted Feldman's abusive naked short selling, and in the process violated its delivery obligations under Reg. SHO. The Court should order disgorgement from optionsXpress, enter a cease-and-desist order, and impose a substantial civil penalty to punish optionsXpress for its wrongful conduct.

Dated: February 1, 2013

Respectfully submitted,



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