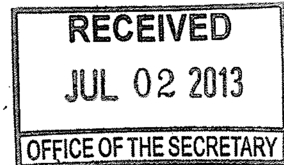

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of optionsXpress, Inc., Thomas E. Stern, and Jonathan I. Feldman, Respondents.	ADMINISTRATIVE PROCEEDING File No. 3-14848

PETITION OF JONATHAN I. FELDMAN FOR REVIEW OF INITIAL DECISION

Respondent Jonathan I. Feldman, by his attorneys, hereby submits this petition for review of the Initial Decision issued by the Chief Administrative Law Judge ("ALJ") in this proceeding on June 7, 2013 (the "Initial Decision").

I. Introduction

The Initial Decision acknowledges that Mr. Feldman was completely honest with everyone with whom he communicated, including his broker optionsXpress. Not acknowledged in the Initial Decision is that the undisputed evidence shows that optionsXpress explicitly confirmed to Mr. Feldman that optionsXpress was compliant with all delivery obligations under Reg SHO and that the SEC had approved the trading strategy. Evidence at the hearing also confirmed that the Chicago Board Options Exchange (the "CBOE") determined that optionsXpress was compliant with Reg SHO. It is thus legally deficient, factually unsupportable, and unjust to attempt to hold a retail customer liable for fraud under these circumstances. Moreover, critical policy implications are invoked by the unsettling precedent that would result if a retail customer is held liable for fraud when his broker purportedly fails to comply with complex, back-office obligations that a retail customer inherently has no ability to

control or monitor.

As explained more fully below, the Initial Decision contains several errors of fact and law, and it constitutes an exercise of discretion and an important decision of law and policy, such that Commission review is required. [1] *See* Rule 411, 17 C.F.R. § 201.411.

II. Initial Decision Makes Erroneous Conclusions of Law

This is a case about alleged violations of Reg SHO, a rule that cannot be violated by a retail customer. The wrongdoing alleged is failing to deliver in violation of Reg SHO's Rule 204 and purported fraud by submitting orders with the knowledge that Reg SHO's delivery requirements would not be complied with. No other fraud is alleged independent of the Reg SHO obligations. Accordingly, if optionsXpress did not violate Reg SHO, then Mr. Feldman did not commit fraud. Even more significantly, to find Mr. Feldman liable for fraud the ALJ found that Mr. Feldman knew not only that optionsXpress was failing to deliver, but that these failures to deliver to CNS (over which he had absolutely no control or ability to monitor) were causing optionsXpress to violate a complex and byzantine regulation. Mr. Feldman had no view into optionsXpress's back-room operations, and thus his reliance on their explicit representations of compliance was not only reasonable, but it was mandated by the industry and endorsed by the explicit language of Commission Adopting Releases. Indeed, Rule 204 was so complex that there was general confusion in the industry and among regulators as to what it required. The ALJ made numerous erroneous conclusions of law to reach the wholly unsupported conclusion that an individual retail customer committed fraud because he knew that his broker was violating Reg SHO, including the following:

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[1] Mr. Feldman reserves the right to argue that the ALJ's factual errors also constitute legal errors and vice versa. Mr. Feldman reserves the right to rely on additional record evidence if and when it briefs the merits of the issues addressed in this petition. Mr. Feldman also reserves the right to raise arguments addressed in petitions for review filed by other respondents.

A. ALJ Erred in Finding that optionsXpress Violated Rule 204

1. The ALJ erred in finding that optionsXpress violated Rule 204 of Reg SHO. The ALJ erred in finding that the "buy" portion of the subject buy-write transactions did not satisfy Rule 204's requirement to close out a fail-to-deliver position by borrowing or purchasing securities of like kind and quantity. Initial Decision at 79, 86. This finding was erroneous for the following reasons:

a. This finding erroneously fails to credit the testimony of Dr. Sirri, the Commission's former Director of the Division of Trading and Markets when Rule 204 was promulgated, who explained that the buy portion of the buy-write satisfied the closeout requirements of Rule 204. Dr. Sirri testified that Rule 204 requires only that the broker buy shares on T+4, something accomplished when the buy-write was executed. The Division presented no expert on Reg SHO to refute this testimony.

b. The ALJ erred as a matter of law when she concluded that the use of a buy-write comes within the Commission's definition of naked short selling. Initial Decision at 79. This is erroneous because Mr. Feldman's trading strategy, the particulars of which are not in dispute, does not fall within the naked short selling definition contained in Reg SHO because it did not involve an actual short sale, but rather the sale of call options. 17 C.F.R. § 242.204.

c. The ALJ erred by broadly construing Rule 204(a) as implicitly prohibiting the use of buy-writes in response to option assignments, even if the counterparties had no arrangement to circumvent the Rule. Initial Decision at 86. According to binding precedent from the United States Supreme Court, when (as here) a "statue imposes liability without fault within its narrowly drawn limits, . . . we have been reluctant to exceed a literal, 'mechanical' application of the statutory text." *Gollust v. Mendell*, 501 U.S. 115, 122 (1991). optionsXpress

satisfied a literal application of Rule 204(a) when it bought-in its customers, i.e., purchased stock of like kind and quantity, on T+4. The ALJ agreed that there were no "sham transactions" based on "arrangements" to avoid the Reg SHO delivery requirements, an element required by Rule 204(f). Thus there was no violation of Rule 204 as a matter of law.

d. The ALJ violated the canon that regulations should not be construed in a manner that renders language superfluous, a canon that "is strongest when an interpretation would render superfluous another part of the same [regulatory] scheme." *Marx v. General Revenue Corp.*, 133 S.Ct. 1166, 1178 (2013). By holding that buy-writes in response to option assignments cannot satisfy Rule 204(a), the ALJ rendered superfluous Rule 204(f)—which prohibits buy-writes only if they involve an "arrangement with another person" to violate the Rule.

e. The ALJ erred in finding that the buy-writes were sham transactions, despite the undisputed absence of any arrangement, by relying on a dictionary definition of the word "sham." Such reliance was improper because a dictionary definition cannot trump the express definition laid out in Rule 204(f), particularly for such an essential term. *Cf. Barnhart v. sigmon Coal Co.*, 534 U.S. 438, 461-62 (2002) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first cannon is also the last: 'judicial inquiry is complete.'").

f. The ALJ erred by relying on the evidence of CNS fails-to-deliver on CNS reports, instead of optionsXpress's books and records, to determine whether optionsXpress violated Reg SHO and not optionsXpress's books and records. When determining whether a broker bought securities to comply with Rule 204's closeout requirement, the appropriate inquiry

is to look to the broker's books and records, not its CNS position. This reading is clear from the language of the Rule and its Adopting Release, which provides: "[T]o meet its close-out obligation a participant also must be able to demonstrate *on its books and records* that on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail-to-deliver position and, therefore, that the participant has a net flat or net long position on its books and records on the applicable close-out date." 74 Fed. Reg. 38266, 38272 (emphasis added); *see also* Tr. at 3173:20-3174:2 (Sirri) (testifying that Rule 204 requires only the transaction—the buy of the securities—not that the broker become flat at CNS). The unrebutted evidence at the hearing showed that optionsXpress's books and records showed that "in more than 99.3% of the cases, the short stock positions (resulting from assignments) were cured by the end of T+3 through legitimate purchases of the stocks by the customers." OPX-EX-248 at 32. Thus, optionsXpress responded to its CNS failures-to-deliver by timely purchasing stock on T+4 in accordance with the plain language of Rule 204(a).

B. ALJ Erred in Finding Feldman had the Requisite Scienter for Fraud

1. The ALJ erred in finding that Mr. Feldman knew or was reckless in not knowing that his transactions caused optionsXpress to violate Reg SHO and were illegal, and committed fraud by executing these transactions with that knowledge. Initial Decision at 90. Mr. Feldman's reliance on his broker's explicit representations that the regulators had reviewed the trading strategy and approved it is a complete defense to the fraud charges against him. Mr. Feldman's reasonable reliance on his broker's representations of compliance wholly negates scienter. The ALJ erred as a matter of law in finding that Mr. Feldman's reliance on his broker was not a defense to the fraud-based charges against him. Initial Decision at 90.

2. This finding ignores caselaw and other persuasive precedent finding that

reasonable reliance by laypeople on trusted professionals negates scienter, a necessary element to a finding of fraud. *See generally S.E.C. v. Caserta*, 75 F.Supp.2d 79, 94 (E.D.N.Y. 1999) (good faith reliance on attorney or accountant provides evidence of lack of scienter); *U.S. S.E.C. v. Snyder*, 292 F. App'x 391, 406 (5th Cir. 2008) ("We find no meaningful distinction between the reliance on counsel and reliance on an accountant. Both defensive theories provide an explanation of the defendant's conduct tending to negate the element of scienter").

a. This finding also runs contrary to the plain language of the Rule 10b-21 Adopting Release, which explicitly provides for customers' reliance on their brokers for delivery obligations. Rule 10b-21 Adopting Release at 6166-61672.

3. The ALJ's finding that Mr. Feldman had the requisite scienter is premised on her erroneous finding that Mr. Feldman knew optionsXpress was violating Reg SHO by failing to deliver. Initial Decision at 90. Thus, her finding that he had scienter is legally erroneous because it is impossible to ascribe to Mr. Feldman an understanding of Reg SHO given the general confusion in the industry and among regulators as to the meaning of this complex rule. Substantial evidence adduced at the hearing and presented in the recent CBOE Order demonstrates that there was no clear guidance as to what conduct violated Reg SHO and optionsXpress's primary regulator, the CBOE, did not believe optionsXpress was violating Reg SHO:

a. The ALJ's finding violates the United States Court of Appeals for the District of Columbia's finding in *Howard v. S.E.C.*, 376 F.3d 1136 (D.C. Cir. 2004) which held that there can be no recklessness as a matter of law where: (a) "rather than red flags, [the respondent] encountered green ones"; (b) "the [applicable law] . . . has never been clear"; or (c) the theory of liability turns on whether the respondent "should have known . . . the legal

requirements" under a securities "rule whose language was silent on the subject." *Id.* at 1145, 1147-49. The "red flags" the Initial Decision identifies—the *Hazan* settlement and various e-mails concerning Rule 204 and short selling—were all sent to Mr. Feldman prior to his being told explicitly by senior officials and compliance officers at optionsXpress that the SEC had reviewed the trading strategy and found no problems with it. *Id.* optionsXpress's explicit confirmation to Mr. Feldman that his trading was compliant was a "green flag." The Initial Decision turns *Howard* on its head by finding that Mr. Feldman should have mistrusted the explicit representations by compliance executives at optionsXpress and sought "an independent opinion as to the legality of his activities." Initial Decision at 90. To find that Mr. Feldman was reckless in not seeking further independent confirmation after receiving this information plainly misapplies the burden of proof with regard to fraud.

b. The ALJ erred in finding that Mr. Feldman knew his trading was illegal and was told regulators disapproved of it because the evidence adduced at the hearing (and further corroborated by the CBOE Order) demonstrated that the regulators were in disagreement as to what conduct violated Reg SHO. Indeed, FINRA and CBOE representatives testified at the hearing that the SEC told them that the trading did not violate Reg SHO. Tr. at 3945:6-19 (Overmyer) (explaining that he was told at least 10 times by the SEC that this conduct did not violate Reg SHO and he eventually believed them because they wrote the rule); Tr. at 3991:3-22 (MacDonald) (CBOE representative testifying that the SEC's mantra was that there was no violation of Rule 204); Tr. at 2837:17-20 (Huber) (testifying that the SEC told FINRA that based on the facts optionsXpress presented the SEC determined there was no violation of Rule 204); OPX-EX-675 at 1 (FINRA representative's contemporaneous notes from call with CBOE stating that the SEC told the CBOE that the buy-write trading was "not officially violating a rule").

c. On June 11, 2013, the Commission announced a settled action against optionsXpress's primary self-regulatory organization, the CBOE. The CBOE Order found that the CBOE staff "were confused as to whether Reg SHO applied to a retail customer" and "erroneously focused on whether the member firm's customer, as opposed to the member firm itself, was in violation of Reg SHO." CBOE Order at 7. The CBOE Order notes that in addition to being confused as to how Reg SHO applied to customers, the CBOE also wrongly concluded that Reg SHO delivery failures were not occurring and lacked "a basic understanding of what a failure to deliver was." *Id.* The ALJ's finding that Mr. Feldman knew or was reckless in not knowing that his trading caused optionsXpress to violate Reg SHO is erroneous on its face because a retail customer cannot be reasonably expected to know and understand that his broker is violating Reg SHO or failing to deliver if the broker's own regulator did not determine this to be true. Mr. Feldman was a retail customer who had almost no knowledge and insight into optionsXpress's operations relative to the CBOE regulators.

d. Accordingly, the Initial Decision, if enforced, would violate Mr. Feldman's due process rights, because the SEC failed to provide "clear, rational decision making that gives regulated members of the public adequate notice of their obligations." *S.G. Loewendick & Sons, Inc. v. Reich*, 70 F.3d 1291, 1297 (D.C. Cir. 1995). For example, due process is not satisfied where, as here, "different divisions of the enforcing agency disagree about their meaning." *Gen. Elec. Co. v. E.P.A.*, 53 F.3d 1324, 1332 (D.C. Cir. 1995). As a CBOE witness testified in the context of seeking advice from the SEC's Division of Trading and Markets on the scope of Rule 204: "[W]e weren't sure what the rule was trying to express." Tr. 3983:2-9 (MacDonald).

4. The ALJ erred in finding that Mr. Feldman committed fraud because when he

wrote calls "he represented to the market as a whole and to purchasers of his deep-in-the-money calls that he was going to make delivery." Initial Decision at 89. This finding is erroneous as a matter of law because the submission of an order is not a representation to the marketplace:

a. The Commission's unambiguous Rule 10b-21 Adopting Release explicitly provides that a seller is not making a representation by submitting an order if, as here, the seller is reliant on a broker-dealer: "If a seller is relying on a broker-dealer to comply with Regulation SHO's locate obligation and to make delivery on a sale, the seller would not be representing at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due." Rule 10b-21 Adopting Release, 73 FR at 6166-6172.

b. The Rule 10b-21 Adopting Release is in accord with caselaw finding that submission of an order is not a representation. *See United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008) (submission of a trade order alone, without some additional deceptive conduct or statement, is not a violation of Rule 10b-5).

5. The ALJ erred in crediting and relying on CBOE representative Daniel Overmyer's testimony that "anyone" could violate Reg SHO. Initial Decision at 79. The Division's own witnesses, as well as Dr. Sirri, testified that only participants of registered clearing agencies, and not customers, can violate Reg SHO. *See* 17 C.F.R. §242.204(a).

6. The ALJ erred in finding that Mr. Feldman's buy-writes were equivalent to wash trades. Initial Decision at 92.

a. The ALJ erroneously found that wash trades do not involve the manipulation of stock prices. *Id.* In fact, the purpose of wash trades and matched orders is to artificially affect market activity to either increase or decrease stock prices. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 6 (1985). It is undisputed that Mr. Feldman's activity did

not affect stock prices and was not intended for that purpose. Saha Report, OPX-EX-248 at 38-39 (confirming that economic analysis showed that the stock prices were not adversely affected by the trading); *see also* Harris Report, Div. Ex. 310 at ¶ 39 (conceding that "the buy-write trades had little effect on prices in the underlying stock markets").

b. Mr. Feldman's buy-writes were not similar to wash trades and matched orders because these involve the simultaneous execution of buy and sell orders for an identical number of shares or contracts at the same or similar price. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 205 n. 27 (1976). Mr. Feldman's buy-write orders were not wash sales: the writing of the call was not a transaction in the same security—an option versus the underlying equity security. Moreover, the calls were not always options for the same number of shares bought (for example if Mr. Feldman was partially assigned) and were not at the same price as the buy.

c. The ALJ's analogy to wash sales was erroneous because wash sales involve conduct that is inherently deceptive and not dependent on the violation of another rule. Here, the purported fraud resulted from knowingly failing to deliver in violation of Reg SHO. If optionsXpress had not violated Rule 204, then there is no fraud even if there were CNS fails-to-deliver. Tr. at 3055:14-3056:4 (Sirri). The ALJ found that it was Mr. Feldman's submission of orders that he knew would result in a violation of Reg SHO that was allegedly fraudulent. Initial Decision at 88 ("Feldman took advantage of optionsXpress's policies, which this Initial Decision finds were in violation of Rule 204. The issue is whether by doing so Feldman violated the antifraud provisions of the securities statutes."). This is not analogous at all to wash trades, because the perpetration of wash trades are fraudulent alone whether or not other securities rules are violated. This is especially relevant to Mr. Feldman's liability, because his liability for fraud

is dependent on the interpretation of Rule 204, a complex rule that even regulators purportedly misunderstood.

7. The ALJ erred in finding that Mr. Feldman had sufficient control over delivery to be a primary violator. The ALJ did not give appropriate weight to, or erroneously disregarded, the undisputed evidence that Mr. Feldman had no control over delivery at CNS or over optionsXpress's decisions regarding delivery. Once Mr. Feldman placed an order, optionsXpress assumed all control, and even maintained control over Mr. Feldman's account. Thus, under *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011) and its progeny, Mr. Feldman did not have the requisite control to be a primary violator.

8. The ALJ erroneously relied on *Wharf (Holdings) Ltd. v. United Intern. Holdings, Inc.*, 532 U.S. 588 (2001) to find that Mr. Feldman acted with scienter. Initial Decision at 89. *Wharf (Holdings)* is inapposite to this case because it addressed a private sale, not the sale of securities on public exchanges, and the defendants made affirmative representations directly to the purchaser. *Id.* at 592. It is undisputed that Mr. Feldman's buy-writes were open market, arms-length transactions that were not customized in any way. Tr. at 633:7-25 (Coronado). It is also undisputed that Mr. Feldman did not know who the counterparties to his trades were and did not make any direct representations to them. *See* Tr. at 634:5-19 (Coronado); Tr. at 1215: 5-8 (Stella); Tr. at 1313:14-25 (Lapertosa). Further, it is undisputed that the exchange-traded securities at issue settled through the CNS system by brokers, not customers.

9. The ALJ erred in finding that the trading at issue here was similar to that of the trading in past SEC settlements including *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, *In the Matter of Scott H. Arenstein*, and *In the Matter of TJM Proprietary Trading LLC et al.* and that the distinguishing features were unpersuasive. Initial Decision at 83.

There were many distinguishing factors, including that all of these settlements involved arrangements between market makers trading on their own accounts —expressly prohibited by Rule 204(f)—with the sole purpose of avoiding stock delivery. No one even alleged that any such arrangement existed here.

10. The ALJ erred in finding that Mr. Feldman committed fraud because there was no evidence that anyone was deceived. A finding of fraud requires some proof of deception, and "broad as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression." *United States v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008); *see also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977) (where manipulation is not at issue, deception is required to prove a Section 10b-5 violation).

C. ALJ Erred in Finding Feldman Violated Rule 10b-21

1. The ALJ erred in finding that Mr. Feldman violated Rule 10b-21 although he did not deceive his broker-dealer. Initial Decision at 44, 93. The ALJ erred in disregarding Dr. Sirri's opinion, as well as testimony from the Commission's General Counsel when the rule was proposed, that a violation of Rule 10b-21 requires deception of the broker-dealer. *See* Div. Ex. 401 at 9 ("a key element to establish the primary violation [of Rule 10b-21] is that the broker/dealer was deceived").

2. The ALJ erred in failing to distinguish between the delivery required by Reg SHO and delivery required by Rule 10b-21. Initial Decision at 89 (Feldman represented to the market "that he was going to make delivery" when "in fact, by entering buy-writes, he did not cover his short position."). The ALJ erred in ignoring extensive evidence presented at the hearing, and the Rule 10b-21 Adopting Release, that "delivery" for the purposes of Rule 10b-21 is not delivery to NSCC but rather delivery by a seller to the broker. Sirri Report, OPX-EX-915

at ¶ 125 ("[d]elivery to NSCC by a Clearing Member is different from delivery by a customer to a broker, and these two forms of delivery occur independently of each other."). The ALJ's finding that Mr. Feldman failed to deliver is thus erroneous because the Initial Decision notes that no one accuses Mr. Feldman of failing to deliver to his broker, the only delivery relevant to Rule 10b-21. Initial Decision at 44 ("Feldman never represented to optionsXpress that he had the ability to deliver shares, and he purchased shares every time optionsXpress required him to do so.").

3. The ALJ erred in finding that Mr. Feldman violated Rule 10b-21 by failing to deliver shares. Initial Decision at 89. As noted above, no one accuses Mr. Feldman of failing to deliver shares to his broker. The ALJ ignores the evidence that Mr. Feldman was not a registered clearing member and thus could not have delivered shares to CNS.

D. The ALJ Erred in her Award of Sanctions

1. The ALJ erred in her calculation of the disgorgement figure. Initial Decision at 98. The ALJ's disgorgement amount was not a reasonable approximation of the amount Mr. Feldman profited and is purely speculative. This analysis is materially flawed for several reasons, including the following:

a. This finding assumes that Mr. Feldman would have paid hard-to-borrow fees had optionsXpress complied with Reg SHO, and it assumes that Mr. Feldman's only option would have been to borrow all the stock for the entire period. Both of these assumptions were debunked during the hearing. *See* Sirri Rebuttal, OPX-EX-924; *see also* Tr. at 2984:20-23 (Sirri).

b. The ALJ's reliance on a casual statement by Mr. Feldman that the proceeds on his IRS Form 1099 would be over $2 billion to double the profit calculated by Dr.

Harris is inappropriate and unsupported. Not only was this statement a casual comment to a broker, but it was also not relevant because it was discussing gross "proceeds," not profit.

c. The ALJ erred in finding that Mr. Feldman made "three to four million" off of his buy-writes. Initial Decision at 44. The unrebutted testimony at the hearing was that Mr. Feldman had made a guess of what his overall profits were at optionsXpress (from all of his trading, including many other strategies not at issue here such as reverse conversions, merger stocks, and other options trading) during his testimony before the Staff in 2010 but that he was unsure of what his actual profits at optionsXpress were because he had never calculated it. Tr. at 2324-2325 (Feldman).

d. The ALJ erred in finding that Brendan Sheehy's opinion that Mr. Feldman earned $877,919.00 over a six month period lends support to a disgorgement amount of $2,656,377.00. Initial Decision at 98. The ALJ triples Mr. Sheehy's calculation, thus including 18 months (from October 2008 to March 2009) in her disgorgement amount. This is erroneous because Mr. Feldman did not open an account at optionsXpress until late November 2008, did not begin using buy-writes until February 2009, and the first of the purported "red flags" the ALJ asserts should have alerted Mr. Feldman to the Reg SHO violations occurred in August 2009. Initial Decision at 90.

2. The ALJ erred in finding that a civil penalty was warranted. Initial Decision at 100. Mr. Feldman did not commit fraud for the reasons explained above and did not willfully violate any of the securities laws. Moreover, even if a civil penalty was warranted, the penalty amount awarded by the ALJ is excessive. In reaching the amount, the ALJ erroneously relied on testimony that Mr. Feldman conducted 390 buy-writes, despite that many of these buy-writes were conducted before any of the purported "red flags" the ALJ found should have alerted Mr.

Feldman that optionsXpress was violating Reg SHO.

E. ALJ Erred in Not Finding a Violation of the Dodd-Frank Act

1. The ALJ erred in rejecting Mr. Feldman's argument that the Order Instituting Proceedings and the resulting proceedings against him violated Section 929U of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Initial Decision at 74-75. The ALJ erroneously found that because the Division "acted reasonably" Section 929U was not violated. However, the Division's actions were a violation of the plain language of Section 929U because the Commission authorized the proceedings <u>before</u> the expiration of the second 180-day period but did not file within the second 180-day period.

III. Initial Decision Makes Erroneous Findings of Fact

The Initial Decision contains the following erroneous findings or conclusions of material fact:

A. ALJ Erred in Finding optionsXpress Violated Reg SHO

1. The ALJ made an erroneous conclusion of fact that Mr. Feldman's trading caused a Reg SHO violation. Initial Decision at 88-89. This finding does not give appropriate weight to, or erroneously disregards, substantial evidence in the record, including testimony from former Director of Trading & Markets Dr. Sirri, that (1) it is impossible to map a particular customer's trading to deliveries at CNS, and thus impossible to determine if Mr. Feldman's trading cause a Reg SHO violation; (2) had Mr. Feldman been optionsXpress's only customer, his trading would not have caused a violation of Reg SHO; and (3) Reg SHO does not require a broker to clear up its fail-to-deliver positions at CNS but rather only that the broker purchase shares of like kind of quantity which was fulfilled by the "buy" portion of the buy-write. Tr. at 2993:9-13, 3211:8-3212:20, 3170:11-25-3171:1-8; 3180:19-23 (Sirri). The ALJ also erred in finding unpersuasive

the substantial evidence that fails-to-deliver could remain on the books at CNS not because fails-to-deliver were uncured but because new fails-to-deliver were arising. Initial Decision at 76. Moreover, Mr. Feldman could not cause optionsXpress to violate Reg SHO—optionsXpress had control over delivery at CNS and Mr. Feldman was required to comply with optionsXpress's policies. Tr. at 2071:17-20 (Payne) (testifying that optionsXpress would not have allowed Mr. Feldman to take an action that was inconsistent with Reg SHO). Indeed, optionsXpress retained control over Mr. Feldman's account and could take action, without Mr. Feldman's consent if necessary, in order to comply with Reg SHO. Div. Ex. 98 at 5-6.

2. The ALJ made an erroneous conclusion of fact that Dr. Sirri testified that whether a buy-write causes Reg SHO is an unresolved issue. Initial Decision at 69. Dr. Sirri testified definitively that a buy-write satisfies a broker's delivery obligation under Reg SHO: "The requirement of SHO isn't that it change your CNS delivery position. The requirement is that you buy shares of like kind and quantity. And those shares of like kind and quantity and were bought when a buy-write is executed." Tr. at 3186 (Sirri).

3. The ALJ made an erroneous conclusion of fact that there was no valid economic purpose to Mr. Feldman's trading. *Id.* at 79, 93. This conclusion does not give appropriate weight to, or erroneously disregards, definitions provided by Dr. Sirri and optionsXpress's expert, Dr. Atanu Saha, that were never rebutted by the Division of Enforcement. Tr. at 4408-11-15 (Saha); OPX-EX-915 at ¶ 110; *Lyons Milling Co. v. Goffe & Carkener*, 46 F.2d 241, 248 (10th Cir. 1931) ("Hedging is lawful. It is recognized as a legitimate and useful method of insuring against loss on a contract for future delivery.").

4. The ALJ made an erroneous conclusion of fact that Mr. Feldman's trading raised concerns with the CBOE and the Financial Industry Regulatory Authority (FINRA). Initial

Decision at 92. In fact, it was trading by another optionsXpress customer (who never knew Mr. Feldman and whose trading long preceded Mr. Feldman's opening an account at optionsXpress) that raised concerns with the CBOE and FINRA, and a CBOE representative testified that Mr. Feldman's name had never come up during CBOE's investigation of optionsXpress. Tr. at 3906:12-20 (Overmyer).

5. The ALJ erroneously credited representatives from CBOE and FINRA who she believes testified that Mr. Feldman's trading violated Reg SHO. Initial Decision at 79. As the CBOE Order demonstrates, CBOE ultimately determined that the trading did not violate Reg SHO in connection with three separate reviews. OPX-EX-138, OPX-EX-151, OPX-EX-152. In fact, the evidence on the record shows there was disagreement among the regulators as to the interpretation of Reg SHO, and that the CBOE and FINRA representatives were told by the SEC that a customer could not violate Reg SHO. Tr. at 3945:6-19 (Overmyer) (explaining that he was told at least 10 times by the SEC that this conduct did not violate Reg SHO and he eventually believed them because they wrote the rule); Tr. at 3991:3-22 (MacDonald) (CBOE representative testifying that the SEC's mantra was that there was no violation of Rule 204); Tr. at 2837:17-20 (Huber) (testifying that the SEC told FINRA that based on the facts optionsXpress presented the SEC determined there was no violation of Rule 204); OPX-EX-675 at 1 (FINRA representative's contemporaneous notes from call with CBOE stating that the SEC told the CBOE that the buy-write trading was "not officially violating a rule"). Moreover, CBOE representatives testified that they did not find evidence of fraud or violations of Rule 10b-5. Tr. at 3994:18-3995:15 (MacDonald).

6. The ALJ made an erroneous conclusion of fact that there is no evidence that any broker except optionsXpress used buy-writes to satisfy CNS fail-to-deliver positions. Initial

Decision at 88. This finding does not give appropriate weight to, or erroneously disregards, unrebutted testimony from CBOE staff that other traders were executing the same strategy and using buy-writes in this manner at other broker-dealers. Tr. at 4763:14-4764:20 (Lamm).

7. The ALJ gave undue weight to and erroneously relied on Dr. Harris' interpretation of Reg SHO despite his admission that he was not an expert on Reg SHO.

8. The ALJ made an erroneous finding that a failure to deliver occurs when a customer's account does not have enough shares for optionsXpress to satisfy its delivery obligation to CNS by T+3. Initial Decision at 10. This finding is in error because a fail-to-deliver occurs if the clearing member, in this case optionsXpress, does not have sufficient shares to make delivery by T+3, and not whether a particular customer's account does not have enough shares. OPX-EX-915 at ¶ 62.

B. ALJ Erred in Finding Feldman Knew of Reg SHO Violations

1. The ALJ failed to give the appropriate weight to, or erroneously disregarded, unrebutted evidence that Mr. Feldman was told that the regulators had approved his trading strategy and found it did not violate a rule. OPX-EX-890; Tr. at 2521:15-16 (Feldman).

2. The ALJ failed to give the appropriate weight to, or erroneously disregarded, testimony from another customer of optionsXpress, Mark Zelezny, who executed the same trading strategy and also relied on optionsXpress's representations of compliance. Tr. at 4136:5-8; 4137:10-22 (Zelezny).

3. The ALJ erroneously found that Mr. Feldman failed to seek independent confirmation from regulators that his trading was compliant. Initial Decision at 90. This finding is erroneous because Mr. Feldman had no means to confirm optionsXpress's representations concerning its interactions with regulators. The finding fails to give appropriate weight to, or erroneously disregards, testimony from SEC, CBOE, and FINRA representatives that had Mr.

Feldman called them concerning their investigations of optionsXpress and the trading strategy they would have told him that they could not comment and would not have given him guidance as to whether his trading was compliant. Tr. at 2883:9-14 (Huber); Tr. at 2926:2-6 (Demaio); Tr. at 3903:25-3904:8 (Overmyer); Tr. at 2765: 16-20 (Aylward); Tr. at 3754:10-19 (Tao). This finding also disregards evidence that customers are not expected to check up on their brokers by independently contacting regulators. Tr. at 3256:20-22 (Sirri).

4. The ALJ erroneously found that Mr. Feldman knew or was reckless in not knowing that his trading violated rules and regulations. Initial Decision at 90. This finding fails to give appropriate weight to, or erroneously disregards, substantial evidence in the record that Mr. Feldman was repeatedly told in writing that optionsXpress was taking all steps necessary to comply with Reg SHO. OPX-EX-870 ("I know this seems unfair to you, but we are acting as we are required per SEC Rule 204, which I have attached for you"); OPX-EX-871 ("I apologize for this unfortunate change, but the SEC won't budge on these rules"); *see also* OPX-EX-875 ("Buywrites are okay as long as we get them filled at market-open"); OPX-EX-876 ("as long as we have a fill we can continue to work your orders, but we have to get them filled at the open . . . . That's the rule that's been implemented by our compliance department."); OPX-EX-902.

5. The ALJ failed to give appropriate weight to, or erroneously disregarded, the substantial unrebutted evidence in the record, including the testimony of the Division of Enforcement's expert witness, that Mr. Feldman would have made a profit whether or not optionsXpress complied with Reg SHO and that he did make a profit employing the same strategy at other brokers who the Division does not allege violated Reg SHO. Tr. at 1551:13-17 (Harris); Tr. at 2380:5-20 (Feldman); *see also* Tr. 4826:4-8 (Mikus). The ALJ erred in finding that Mr. Feldman's trading at other brokers was evidence of wrongdoing. Initial Decision at 100.

To the contrary, Mr. Feldman's continued trading at other brokers demonstrates that his trading strategy was not unlawful, because the unrebutted evidence shows that while Mr. Feldman was executing his strategy at these other brokers the brokers were fully compliant with Reg SHO and Mr. Feldman still made a profit. *See* Tr. at 4826:4-18; 4843:1-8 (Mikus); Tr. at 2380:5-20 (Feldman).

6. The ALJ gave undue weight to, and erroneously relied upon, the opinions of Dr. Harris and Mr. Sheehy that Mr. Feldman was only profiting because he did not have to pay the hard-to-borrow fees that optionsXpress would have incurred if it had complied with Reg SHO because these opinions did not consider that because of optionsXpress's business model, Mr. Feldman would not have had to pay hard-to-borrow fees regardless of whether optionsXpress borrowed. Tr. at 966:18-975:20 (Sheehy); Tr. at 1536:1-5 (Sirri).

7. The ALJ made an erroneous conclusion of fact that Mr. Feldman is a highly educated trader. Initial Decision at 4, 90. Mr. Feldman is not a securities professional, does not hold any securities licenses, has never worked for a broker-dealer, and does not have any background in broker-dealer compliance. Tr. at 2343:9-18, 2345:14-25 (Feldman). The ALJ erroneously relied on the fact that Mr. Feldman has degrees in computer science and was a lending officer at a bank to find that his reliance on optionsXpress was not reasonable. Mr. Feldman's degree in computer science and experience in lending are not relevant to his knowledge of securities laws.

8. The ALJ's reliance on her finding that "Penson concluded that Feldman's account was causing it to violate Reg SHO" is erroneous. Penson never communicated with Mr. Feldman directly and no one at either Penson or Terra Nova told Mr. Feldman that it had concerns about Reg SHO. Indeed, Penson did not make the determination that Mr. Feldman's

trading presented Reg SHO problems until *after* Mr. Feldman had transferred his account back to optionsXpress. Tr. at 898:9-13, 899:1-13 (Crain). Thus, Penson and Terra Nova did not ask Mr. Feldman to stop trading because of regulatory concerns but because they could not afford to pay the capital required at the OCC. Tr. at 899:1-5 (Crain); *see also* Tr. at 2233:10-17 (Feldman).

9. The ALJ erred in finding that "[t]here has been no acknowledgement of wrongdoing; rather, the effort has been made to blame regulators who never were told all the facts." Initial Decision at 96. This finding in effect punishes Mr. Feldman for presenting his defense to these charges that he relied on his broker-dealer for compliance with Reg SHO.

C. ALJ Erred in Finding Feldman Knowingly Failed to Deliver

1. The ALJ made an erroneous conclusion of fact that Mr. Feldman knew that he was not going to deliver securities if his calls were exercised and assigned and that the marketplace did not have this knowledge. Initial Decision at 89. This finding makes a fundamental error in that Mr. Feldman had no obligation to deliver to CNS and had no delivery obligation under Reg SHO. Mr. Feldman's only obligation was to deliver to his broker, and the Initial Decision acknowledges that Mr. Feldman did not fail to deliver shares to his broker. Initial Decision at 44. Thus, it is erroneous to state that Mr. Feldman knew that he was not going to deliver—no one contends that Mr. Feldman failed to deliver shares to his broker.

a. This finding also does not give appropriate weight to, or erroneously disregards, substantial unrebutted evidence in the record that Mr. Feldman did not receive CNS reports, had no view at all into optionsXpress's operations and thus could not tell if optionsXpress was failing to deliver. Tr. at 115:17-116:4-16 (Colacino); Tr. at 3103:7-13. Mr. Feldman did not have access to optionsXpress's books and records and thus could not tell if optionsXpress was net flat or if there were other reasons optionsXpress may not have to purchase

to deliver; for example, if optionsXpress had already purchased the shares itself, had shares in inventory, or had a fail to receive. Sirri Report, OPX-EX-915 at ¶¶ 131, 144. Mr. Feldman thus had no way of knowing whether or not optionsXpress was failing to deliver.

b. This finding does not give appropriate weight to, or erroneously disregards, substantial unrebutted evidence that Mr. Feldman received daily written confirmations from optionsXpress that delivery had occurred. OPX-EX-919-921.

c. This finding does not give appropriate weight to, or erroneously disregards, the unrebutted evidence in the record that optionsXpress assumed the obligation to deliver shares *in toto* and had complete control over Mr. Feldman's account so that it could take any action necessary to comply with Reg SHO. *See* Tr. at 334:19-25 (Molnar); Tr. at 637:4-8 (Coronado); Tr. at 1219:4-12 (Stella); Div. 98 at 5-6 (emphasis added); Tr. at 250:12-20 (Risley) (explaining that optionsXpress controls the customers' accounts and commonly will buy-in a customer if they do not have the shares); Tr. at 2069:1-5, 2071:17-20 (Payne) (optionsXpress would not have allowed Mr. Feldman to take actions inconsistent with Reg SHO).

2. The ALJ made an erroneous conclusion of fact that Mr. Feldman knew his deep-in-the-money calls would likely be exercised and assigned to him. Decision at 78. This finding fails to give appropriate weight to, or erroneously disregards, substantial evidence, including testimony and analysis by Dr. Sirri, that the rate of assignment was variable and that optionsXpress's random assignment policies meant that Mr. Feldman could not know for certain if he would be assigned each day. OPX-EX-915, Ex. 16.

3. The ALJ made an erroneous conclusion of fact that Mr. Feldman knew a short position would occur in his account if deep-in-the-money calls were assigned because he did not own shares and had no intention of delivering them. *Id.* at 79. This finding does not give

appropriate weight to, or erroneously disregards, substantial unrebutted evidence in the record that Mr. Feldman always bought shares as required in order to satisfy any assignment or any directive he received from optionsXpress. Initial Decision at 44.

4. The ALJ made an erroneous conclusion of fact that Mr. Feldman represented to the market as a whole and to purchasers of his deep-in-the-money calls that he was going to make delivery when he had no intention of doing so. Initial Decision at 89. This finding does not give appropriate weight to, or erroneously disregards, substantial evidence that the marketplace did not perceive Mr. Feldman, as an individual customer, as making any representations regarding delivery. No one in the marketplace could identify Mr. Feldman's trades as his because all trades were done anonymously as trades of optionsXpress. Tr. at 1238:2-20 (Lapertosa). Moreover, Feldman's submission of a trade order is not a representation to the marketplace and cannot be the basis of fraud. *See Finnerty*, 533 F.3d at 148.

5. The ALJ made an erroneous conclusion of fact that Mr. Feldman had knowledge that the marketplace did not have. Initial Decision at 89. This finding does not give appropriate weight to, or erroneously disregards, the evidence showing that the marketplace could view the open interest just as Mr. Feldman did, was aware of the daily buy-writes, high-volume trading, frequent same-day exercise of the written calls, and fails-to-deliver. Tr. at 595:7-11 (Coronado); Tr. at 1322:14-1325:2 (Lapertosa); Tr. at 3473:19-3474:17 (Strine). This finding also does not give appropriate weight to, or erroneously disregards, the unrebutted evidence that the counterparties to the trades and the market makers understood the trading because the same market makers continued to purchase the deep-in-the-money call options through the entire period at issue. Tr. at 1323:17-24 (Lapertosa) (there were only three or four market makers on the other side of the transactions).

6. The ALJ made an erroneous conclusion of fact that the buy-writes were a "hoax." Initial Decision at 86. This finding does not give appropriate weight to, or erroneously disregards, substantial evidence in the record that the "buy" portion of the buy-write satisfied optionsXpress's delivery obligations and there is no allegation of collusion with counterparties or any other kind of arrangement tending to show the transaction was not what it appeared to be.

7. The ALJ gave undue weight to the fact that Mr. Feldman did not respond to a blogger that asked him how he "got around" being bought in. Initial Decision at 90. There is no evidence in the record that Mr. Feldman ever even saw the post, and his failure to respond to an anonymous poster is not evidence of his knowledge or scienter. *See* Tr. at 2339-2340 (Feldman) (testifying that he is unsure if he ever saw this post because he was not notified in any way when other posters commented on a post).

8. The ALJ gave undue weight to an e-mail Mr. Feldman sent to a friend in early 2010 concerning the Yahoo! Message Board comments on the Sears volume spikes. Initial Decision at 91. This e-mail was sent after Mr. Feldman had learned that the SEC had reviewed the trading strategy and found it did not present any problems. Moreover, the entire e-mail chain is tongue-in-cheek, as Mr. Feldman jokes about taking "graveyard shift" and pureeing a burger and fries for his infant grandson to eat. *See* Div. Ex. 29. The ALJ's reliance on a joking e-mail between friends to find Mr. Feldman had scienter is also erroneous because given the timeline of events the comment was obviously a joking reference to the SEC's investigation of the matter, which Mr. Feldman knew at that point had ended with the SEC finding the conduct did not violate Reg SHO.

9. The ALJ gave undue weight to e-mail correspondence from Mr. Feldman to his broker at Terra Nova discussing "rolling" and "avoiding settlement." Initial Decision at 90.

This finding fails to give appropriate weight to, or erroneously disregards, substantial evidence, including unrebutted testimony that Mr. Feldman had entered into an arrangement at another broker, Terra Nova, wherein he would not have to pay hard-to-borrow fees if he bought to cover his position on the day after he sold the call (T+1) and did not wait until the settlement date (T+3). Thus, the ALJ did not appropriately consider the unrebutted testimony that Mr. Feldman was not referring to avoiding delivery in these e-mails but rather was referring to a measure of time within which he would not have to pay hard-to-borrow fees. *See* Hearing Transcript at 2475:4-25 (Feldman); Tr. at 891:1-5 (Crain); Div. Ex. 212 (Internal Penson e-mail stating that "[t]hey [Terra Nova] are covering this the day that they get their assignment report so they are processing these as we agreed.").

10. The ALJ gave undue weight to and erroneously relied on Dr. Harris' Report although Dr. Harris conflated the delivery obligations of customers and brokers throughout his Report. Sirri Rebuttal, OPX-EX-924.

11. The ALJ erroneously relied on a statement from Mr. Feldman that he was entering and canceling orders repeatedly. Initial Decision at 91. This statement was referring to opening new three-way positions, and is no way related to buy-writes or market confusion. Thus, the ALJ's reliance on this statement to find Mr. Feldman had scienter is misplaced.

12. The ALJ made an erroneous conclusion of fact in finding that Mr. Feldman failed to deliver securities or knew that he would not deliver securities. Initial Decision at 90-92. The ALJ erroneously failed to distinguish between delivery by Mr. Feldman and delivery by optionsXpress.

D. ALJ Erred in Finding Feldman Harmed the Marketplace

1. The ALJ made an erroneous conclusion of fact when she found that Mr. Feldman

executed a trading strategy that he knew or was reckless in not knowing perpetrated a fraud on the participants of the securities markets. Initial Decision at 93. This finding fails to give appropriate weight to, or erroneously disregards, substantial evidence in the record that no participants of the securities markets were deceived.

2. The ALJ made an erroneous conclusion of fact when she found that Mr. Feldman's trading harmed the market and that the transactions disadvantaged market participants. Initial Decision at 101. The ALJ failed to give appropriate weight to, or erroneously disregarded, substantial evidence, including evidence that optionsXpress received few buy-in notices, that the trading had no impact on market integrity and share prices, voting rights, and dividend rights were not affected, and the counterparties to these trades continued to place these orders knowing the trading practices involved. Tr. at 113:20-24 (Colacino); Tr. at 4425:1-25 (Saha) ('there was no impact of the buy-write transactions on the risk-reward contributions of the securities."); Tr. at 1546:12-1547:2 (Harris) (testifying that he had no data to support statement in his expert report that Mr. Feldman's trading undermined market integrity because market participants would have not traded or negotiated lower purchase prices).

3. The ALJ made an erroneous conclusion of fact when she found that Mr. Feldman's trades were essentially wash trades or matched orders. Initial Decision at 92. The purpose of wash trades and matched orders is to manipulate stock price, and it is undisputed here that stock price was not affected by Mr. Feldman's trading.

IV. Policy Issues

The Initial Decision constitutes an exercise of discretion and a decision of law and policy that is important and that the Commission should review:

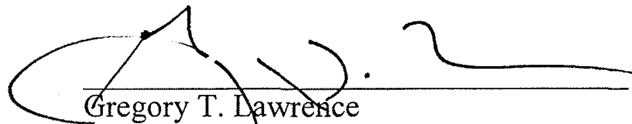
1. The ALJ's decision would require customers to contact regulators directly and

would not allow them to rely on their brokers for regulatory compliance. Such a finding would contradict both the language of the current rules and regulations and also how the industry currently functions. This finding would require a complete industry overhaul, as currently customers do not have a view into the backroom operations of their brokers and rely on their brokers' representations.

2. The ALJ's decision would prohibit buy-writes in response to option assignments, which would cause market-wide confusion and prohibit legitimate and lawful trading.

All of these issues are important and merit review by the Commission.

Respectfully submitted,



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