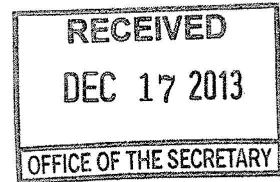

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

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

Respondents.

RESPONDENT OPTIONSXPRESS, INC.'S OPENING BRIEF TO THE COMMISSION

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INTRODUCTION

This case concerns an ALJ ruling that improperly expands the limited scope of a strict-liability rule the regulators themselves have found confusing. The Commission should vacate the Initial Decision, which held that optionsXpress, Inc. violated Rules 204T and 204 ("Rule 204") of Regulation SHO in executing retail customer orders, and aided and abetted a purported fraud related to that trading.

The primary issue is whether the Court applied "*a literal, 'mechanical' application of*" strict-liability Rule 204, as required by the Supreme Court in *Gollust v. Mendell*, 501 U.S. 115, 122 (1991). It did not. The Court completely ignored this controlling authority, holding instead that optionsXpress violated what the Court perceived to be the *spirit of the rule*—finding that "[i]f something looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck." (Decision 86.) The role of the Court was to apply the rule as written, not to rewrite or expand the rule. The Initial Decision violates this fundamental tenet.

The trading at issue was initiated by Respondent Jonathan Feldman, a self-directed retail customer of optionsXpress. Feldman used a hedged option trading strategy designed to yield a profit from small differences in options prices for the same security—a classic arbitrage. Feldman offset what is known as a synthetic long (options intended to mimic the economic effect of purchasing stock) with a deep in-the-money call option. He made money due to the small price discrepancies for various options of different dates if the options proceeded to expire at maturity. But, through a random process, he often was "assigned" to produce stock to a holder of the in-the-money call who exercised the option. This assignment caused Feldman to incur transaction costs that could (and sometimes did) defeat the purpose of his strategy and result in trading losses. And it also created a short position in Feldman's account, triggering optionsXpress' obligation under Rule 204(a) to "purchase securities . . . by no later than the

beginning of regular trading hours on" the fourth day following the assignment (i.e., T+4). 17 C.F.R. § 242.204(a).

The Court's decision focused on what happened next. It is undisputed that optionsXpress purchased stock, referred to as a "buy-in," as required by Rule 204(a). It is also undisputed that, at the same time, Feldman often wrote a replacement deep in-the-money call option to reestablish his hedged trading position. Had he not immediately done so, he would have been subject to the risk of directional market movements in the stock price and could have incurred significant losses. To comply with its legal obligation to achieve the best price and minimize trading risk for its customers (a duty called "best execution"), optionsXpress combined the "buy" and the "write" into a transaction called a "buy-write"—a common transaction that is used frequently in the securities industry.

The "buy" component of the buy-write satisfied the plain language of Rule 204(a). But instead of applying the rule's actual language, the Court focused on the policy underlying Rule 204(a) of preventing naked short selling, i.e., trading that artificially depresses stock prices. According to the Court, this policy (but not the rule's language) imposed an *affirmative duty* on optionsXpress to prevent Feldman's use of buy-writes. While the Division's own expert conceded that Feldman's trading did not artificially depress stock prices, the Court nonetheless found that, as a matter of public policy, optionsXpress should have barred Feldman from bundling his in-the-money call options with the firm's Rule 204(a) stock buy-in.

The Court characterized Feldman's buy-writes as a "sham," but its theory of liability conflicts with Rule 204 when read as a whole. According to the Initial Decision, the "writes" canceled out the "buys" and thus Feldman's open market buy-writes were "sham closeouts." (Decision 86.) But the Court's decision ignores the import of Rule 204(f), which expressly

defines and addresses sham closeouts. That subsection prohibits stock purchases from satisfying Rule 204(a) as a sham *only* "where the participant enters into an *arrangement with another person*" to circumvent that rule's close-out requirements. 17 C.F.R. § 242.204(f) (emphasis added).

Critically, as the Initial Decision confirms, "[t]he Division is not claiming that optionsXpress violated Rule 204(f)"—the sole provision in the rule addressing sham closeouts. (Decision 84.) Indeed, the Division acknowledged in open court that there was no arrangement in this case. (Tr. 4195:11-17, 4193:7-17.) Nor did the Court find any such violation given that all trading here involved open market orders with anonymous counterparties. Instead, the Initial Decision interpreted Rule 204(a) as defining a new type of sham—namely, *any* "[u]se of a buy-write transaction" to close out a short position, regardless of whether counterparties arranged to avoid the closeout requirements. (Decision 79.)

In so ruling, the Court usurped the Commission's rulemaking authority by expanding Rule 204(a) and reading subsection (f) out of the rule. This novel reading, if affirmed, would strictly prohibit the use of buy-writes in response to option assignments regardless of whether an "arrangement" existed between counterparties—despite the clear language of Rule 204(f) requiring that element. The Initial Decision thus violated Supreme Court precedent that requires strict-liability rules like Rule 204 to be narrowly construed, improperly rendered Rule 204(f) superfluous, and trampled the due process rights of optionsXpress by applying a brand new standard without prior notice.

Compounding its error, the Court also found that Feldman's buy-write trading constituted a fraud that was aided and abetted by optionsXpress. But there was no regulatory violation here, much less a fraud. Indeed, FINRA and the Chicago Board Options Exchange ("CBOE") each

independently investigated the trading at issue here for months while it was ongoing without ever suggesting that optionsXpress stop allowing its self-directed customers from bundling call options with Rule 204(a) buy-ins. On the contrary, CBOE, optionsXpress' primary regulator, notified the firm that the regulatory investigation found no Rule 204 violation. As internal regulatory documents confirm, CBOE relied on advice from SEC's Division of Trading and Markets to find that "*no [Rule 204] violation has occurred*" (Tr. 3901:10-14); and CBOE also found "*a possible 10b-5 charge just wasn't lining up with the facts*" (Tr. 4001:3-15).

The record demonstrates that after obtaining this green flag from CBOE for the trading, optionsXpress voluntarily and proactively sought further guidance from its other two regulators: FINRA and the SEC. FINRA referred the firm to the SEC lawyers at Trading and Markets who wrote Rule 204 and were already familiar with the trading at issue based on their conversations with CBOE. According to contemporaneous notes, these SEC lawyers told optionsXpress that the subject "*activity would not be considered a violation of 204*" (DX237), and thus the firm should "*keep doing what you're doing*" (OPX729; Tr. 2437:8-23). While Trading and Markets later retracted its guidance in deference to pending FINRA inquiries, none of these regulators ever responded to optionsXpress' requests for advice by advising the firm it should disallow Feldman's trading strategy.

The Court thus erred when it found that optionsXpress aided and abetted a fraud by allowing the precise trading the firm's primary regulator reviewed and cleared. To be sure, optionsXpress acted reasonably, and certainly not with fraudulent intent, given that it proactively disclosed the trading to its regulators; its regulators found neither a Rule 204 violation nor fraud; and they allowed the trading to continue. The Court's finding of liability in this situation violates the D.C. Circuit's holding in *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004), which

held that there cannot be any "aiding and abetting liability" where, as here, the respondent "encountered green" flags, and the "law applicable to [the securities case] has never been clear." *Id.* at 1143-45, 1147.

The Commission's recent settlement with CBOE concerning this precise trading confirms that CBOE cleared the firm of Rule 204 liability (clearly a "green flag"), and the regulators themselves found the rule confusing (i.e., the rule "has never been clear"). These findings, themselves, demonstrate that optionsXpress allowed the trading to continue in good faith, in reliance on action (or inaction) from its regulators.

For these and other reasons discussed below, the Initial Decision should be vacated.

BACKGROUND

optionsXpress: optionsXpress is a Chicago-based online brokerage firm (the Charles Schwab Corporation purchased optionsXpress in September 2011, after the trading at issue in this case concluded). Founded in 2001, optionsXpress is now one of the largest options-centric firms in the country.[1] The firm services self-directed retail customers who trade in all types of investment products, and it specializes in providing tools and support for customers who engage in sophisticated options strategies.[2] optionsXpress is not a market maker nor does it trade on its own account, and it does not provide trading advice of any kind to its customers.[3]

[1] Tr. 3278:9-12.

[2] Tr. 3278:2-12.

[3] Tr. 3278:13-17, 633:15-22.

optionsXpress is regulated by several entities, including CBOE, FINRA, and the SEC. CBOE, which has specific expertise in options trading, is optionsXpress' designated self-regulatory organization and its primary regulator.[4]

Rule 204: On September 17, 2008, the SEC adopted the Rule 204T Emergency Order, which gave the financial industry a single day to implement procedures to comply with its requirements.[5] And on July 31, 2009, the Commission adopted the final Rule 204, which is materially identical to Rule 204T except for adding subsection (f).[6]

Rule 204(a) requires, in pertinent part, that a participant of a registered clearing agency (e.g., optionsXpress) deliver shares when it has a fail to deliver position according to the continuous net settlement (or "CNS")[7] data resulting from a "short sale transaction" in an equity security. 17 C.F.R. § 242.204(a). To satisfy this duty to deliver shares, Rule 204(a) requires that "the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date [T+4], immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity." *Id.* The "beginning of trading hours" is generally understood to mean at or before 10:00 a.m. EST.[8]

According to its adopting release, Rule 204 is meant "to help further [the Commission's] goal of addressing abusive 'naked' short selling." Rule 204 Adopting Release, 74 Fed. Reg.

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[4] Tr. 3986:12-19; 3308:25-3309:2.

[5] Tr. 3289:10-3290:18; OPX656.

[6] DX141.

[7] Stock trades are cleared and settled through the National Securities Clearing Corporation ("NSCC") through its CNS system. OPX915 ¶ 58. A firm's end-of-day CNS position is an amalgamation of all trading that settled that day—including transactions completely unrelated to the trading that triggered a Rule 204 close-out obligation. *Id.* at 59.

[8] *See* Tr. 4866:16-4867:7.

38266, 38266 (July 31, 2009). The adopting release explains that fails-to-deliver that are part of manipulative naked short selling "could be used as a tool to drive down a company's stock price" which "may undermine the confidence of investors." *Id.* at 38268-69 (internal citation omitted). But here, the unrebutted evidence showed that "the stock prices did not fall as a result of the buy-write transactions."[9] Indeed, the Division's own expert admitted that he had "no expectation" that the buy-write transactions would affect the price of the underlying securities.[10]

Trading at issue: The trading here, explained in more depth in Respondents' expert reports, occurred between October 2008 and March 2010.[11] The customers' trading strategies used standardized call options that were sold on the open market by optionsXpress' retail customers to reestablish a hedged option position as part of a delta-neutral trading strategy.[12] The Division's case against optionsXpress involves at least four customers, but the Division named only one, Jonathan Feldman, as a respondent.[13] (For convenience, this brief focuses on

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[9] OPX248 at 38-39; Tr. at 1557:19-25.

[10] Tr. 1557:19-25.

[11] Dr. Erik Sirri, Feldman's expert, served as Director of the Division of Trading and Markets at the SEC (2006-09), and was the SEC's Chief Economist (1996-99). Since 2009, Dr. Sirri has been a Professor of Finance at Babson College in Wellesley, Massachusetts, where he previously held the same position (1999-2006). He was an Assistant Professor of Finance at Harvard Business School (1989-95). He has also served as a Governor of the Boston Stock Exchange, and as a member of the regulatory board of the Boston Options Exchange. He holds an M.B.A. from the University of California, Irvine; and a Ph.D. in Finance from the University of California, Los Angeles. *See* OPX915.

Dr. Atanu Saha, optionsXpress' expert, is the Senior Vice President and Head of the New York Office of Compass Lexecon. He holds a Ph.D. from the University of California, Davis, with applied economics and econometrics as his fields of specialization. He was previously a professor at Texas A&M University where he taught Ph.D.-level courses in econometrics and applied economics. *See* OPX248.

John Ruth, Respondent Thomas Stern's expert, was a Vice President and Managing Director at Goldman Sachs Execution & Clearing L.P. ("GSEC") (2000-12). He holds an M.B.A. in finance. *See* OPX250.

[12] *See* OPX250 ¶ 28; OPX915 ¶ 9; OPX248 at 9-10.

[13] *See* OIP ¶¶ 5, 10; *see also* Initial Decision at 3.

Feldman's trading, which is virtually identical to the trading strategies executed by the other customers.)[14]

The customers' strategies, all of which involved call and put options, included "reverse conversions," "box spreads," and "three-way spreads." [15] These strategies had a capped upside potential and also the potential for monetary loss.[16] Critically, unlike short sellers, Feldman and the other customers did *not* benefit from downward movement in the price of the underlying securities; thus, this case does not involve any allegation that the trading depressed stock prices through short selling.[17]

The strategies at issue here were neither novel nor exotic.[18] For example, a box-spread strategy involves four options, two pairs of puts and calls, which create what is known as a "synthetic long" and a "synthetic short."[19] By taking these offsetting positions, the customers could profitably lock in pricing discrepancies among the options contracts without actually shorting stock.[20]

For the most part, the trading at issue involved a variant of a box spread referred to as a "three-way" strategy. Unlike a reverse conversion (where the synthetic long is hedged by

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[14] *See* OIP ¶¶ 5-7; *see also* Initial Decision at 3.

[15] OPX915 ¶¶ 9, 27-39; OPX248 at 9-12.

[16] OPX248 at 16.

[17] OPX250 ¶¶ 20, 28; OPX248 at 38-39; Tr. 1557:19-25.

[18] OPX248 at 9-10. Dr. Saha submitted a tutorial explaining the nature of these transactions that may be helpful background for the Commission. *See* OPX248, App'x C. The court struck this tutorial from the record (Tr. 3800:20-3801:93794:20-3795:9), but it is available to the Commission under Rule 460. 17 C.F.R. 201.460(c).

[19] OPX248 at 10.

[20] OPX248 at 33-35.

shorting stock) or a box spread (where the synthetic long is hedged by a synthetic short), a three-way position hedges the synthetic long with a deep in-the-money call, where the stock price is significantly higher than the option strike price.[21] This three-way strategy involves fewer transactions than a box-spread strategy (three instead of four) and thus lower transaction costs, but the position is not perfectly hedged.[22] That is, the customer faced directional risk if the stock price dropped below the strike price of the call, explaining why the strategy used call options with low strike prices.[23] Such deep in-the-money calls are traded actively in the marketplace.[24]

Through these strategies, the customers hoped to profit by identifying mispricing in options, a classic arbitrage approach.[25] Such mispricing can occur for various reasons, such as when securities are "hard to borrow"—that is, when it becomes difficult for investors to borrow stock to sell it short.[26] Some brokers charge "hard-to-borrow fees" when a customer sells such a stock short, and the market may take this fee into account when pricing options.[27]

Other brokers, however, do not charge customers a hard-to-borrow fee.[28] optionsXpress—like other brokerage firms catering to self-directed retail customers—did not pass hard-to-borrow fees on to its customers, a practice that is legitimate and legal.[29] Price

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[21] OPX915 at ¶¶ 24-47; OPX248 at 19; n.29.

[22] OPX248 at 12, 19.

[23] OPX248 at 12; Tr. 4181:18-4182:16.

[24] OPX250 ¶ 25.

[25] OPX248 at 33-37.

[26] OPX248 at 34; DX310 ¶ 45.

[27] Tr. 1542:7-13, 1554:6-10.

[28] Tr. 1542:7-13.

[29] Tr. 234:5-13; 3076:23-3077:3; 2979:24-2980:17; 5002:23-5003:6; 266:16-25.

disparities caused by a hard-to-borrow stock may provide an arbitrage opportunity for a customer who does not have to pay additional fees to borrow the stock.[30]

Feldman, a self-directed customer of optionsXpress and other brokers, was attracted to optionsXpress because he initially contemplated shorting stock for his strategies and the firm did not charge customers hard-to-borrow fees.[31] He neither sought nor obtained any trading advice from optionsXpress.[32]

The data reflect that often, but not always, Feldman was assigned a call option exercise within a few days of his writing a deep in-the-money call (as explained below, the assignment process is random and thus there is no way to confirm if the traders whose calls were assigned to Feldman originally purchased them from Feldman).[33] When Feldman was assigned a call, this converted his written call option to a short position in his account.[34] Rule 204—and optionsXpress' internal policies—required Feldman to purchase stock no later than the morning of T+4 to close out that short position.[35] On August 19, 2009, optionsXpress voluntarily and conservatively revised its policies to require certain securities to be bought-in on T+1—up to three days before the T+4 deadline in Rule 204.[36]

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[30] OPX248 at 34; DX310 ¶ 45; OPX915 ¶ 114; Tr. 2213:11-2214:1.

[31] Tr. 2212:22-2213:6, 2384:22-2385:17; 2116:25-2117:3.

[32] Tr. 2625:1-20; 1199:12-1200:3; 633:15-22.

[33] OPX248 at 25.

[34] OPX248 at 9.

[35] Tr. 312:22-313:22; 443:10-17; 3292:25-3293:5; 3374:20-3375:2; 3378:11-16; DX141; OPX242; DX202; OPX518; DX128; OPX484; OPX485.

[36] OPX518; DX128; Tr. 3374:20-3375:2; 313:1-22; 3378:11-16.

Feldman decided to fulfill this "forced buy-in" requirement through a buy-write transaction that combined the stock purchase, which satisfied Rule 204(a), with a new deep in-the-money call that immediately reestablished his hedged position.[37] The firm bundled these separate market orders based on its internal procedures[38] and "legal duty to seek to obtain best execution of customer orders."[39] The unrebutted evidence showed that combining the "buy" and the "write" was the most cost-effective way to process the trade and minimize Feldman's market exposure if his trading position became unhedged.[40] Put simply, buy-writes allowed for best pricing and the least risk.[41]

Because Feldman's strategy involved standard options sold on the open market (as opposed to customized FLEX options, discussed below), the counterparties to all of his buy-write transactions were anonymous.[42] Indeed, the Division never showed that Feldman, or any of the other customers at issue, or optionsXpress knew the identity of counterparties to the option trades.[43] And it is undisputed that Feldman had no arrangements of any sort with any counterparties, much less arrangements to exercise the call options he wrote.[44] It is also

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[37] OPX248 at 9, 17-21, 40-41; OPX250 ¶ 30; Tr. 3217:13-24.

[38] OPX102 at 123.

[39] Adopting Release to Regulation NMS, 70 Fed. Reg. 37496, 37537 (June 29, 2005); FINRA Rule 5310(a)(1), Best Execution and Interpositioning (May 31, 2012) (replacing NASD Rule 2320, effective May 1, 1968, through May 31, 2012 (same)); *see also* OPX679 at 122; Tr. 3404:4-25; *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 270 (3d Cir. 1998).

[40] OPX250 ¶ 27; Tr. 3397:9-17; 3404:9-16; 4341:20-25.

[41] OPX250 ¶ 27; Tr. 4341:20-25.

[42] OPX248 at 12-13; Tr. 2519:16-2520:15, 2627:3-5; 636:15-19; 3326:6-12.

[43] Tr. 2519:16-2520:15, 2627:3-5; 636:15-19; 3326:6-12.

[44] Tr. 1348:11-21; Tr. 4193:7-17, 4195:11-17 (Division counsel); 2520:10-15; 3892:10-3893:6; 2851:5-22; 3704:14-3705:8.

undisputed that optionsXpress never advised Feldman on whether to pursue his buy-write strategy.[45]

CBOE's 2009 investigation into trading at issue: In February 2009, CBOE initiated an investigation into potential Rule 204 violations at optionsXpress.[46] The CBOE investigation focused on the account of one of the other customers at issue in this investigation, Mark Zelezny, who used a buy-write trading strategy virtually identical to the one used by Feldman.[47] Daniel Overmyer, a senior investigator with significant experience and knowledge of Rule 204, led the CBOE investigation.[48]

On April 30, 2009, Overmyer and his boss Timothy MacDonald, CBOE's Director of Market Regulation, met with Phillip Hoeh (optionsXpress' Chief Compliance Officer), Kevin Strine (Vice President of Compliance), and others to learn more about the customers' buy-write trading strategy and the firm's procedures for handling it.[49] Overmyer drafted a memo summarizing the meeting, which confirms that optionsXpress disclosed the use of "buy-writes" and daily CNS fails, and further notified CBOE that other accounts were engaging in the same trading activity.[50]

The only regulatory guidance at the time focused on situations where floor brokers entered into arrangements with one and another to avoid Reg. SHO closeout obligations by

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[45] Tr. 2625:1-20.

[46] Tr. 3331:12-18; 3987:18-3988:1.

[47] Tr. 3333:14-3334:8; 3337:24-3338:21.

[48] Tr. 3906:16-20; 3988:5-19, 4088:6-15.

[49] Tr. 3331:22-3332:1; 3830:15-3831:20.

[50] OPX124; Tr. 3828:24-3830:7.

offsetting stock purchases with customized (or FLEX) options that had to be exercised immediately. Such guidance did not apply here, where retail customers engaged in open-market options trading that involved normal expiration dates. Thus, in May 2009, CBOE reached out to Josephine Tao and Victoria Crane at the SEC's Division of Trading and Markets for guidance on whether the use of buy-writes at optionsXpress to satisfy Rule 204 violated the rule.[51] (Tao, who testified at the hearing, and Crane were responsible for drafting Rule 204 and were identified by the Commission in the Rule's accompanying release as the appropriate persons to answer questions about that rule.[52]) During his call with Tao and Crane, Overmyer explained the trading in detail, including the fact that optionsXpress was bundling the firm's "buy-in" and the customers' new deep in-the-money call together as a "buy-write."[53]

When memorializing his call with Tao and Crane, Overmyer wrote that, after he disclosed the trading strategies, "*the SEC felt that the Zelezny's were conducting and maintaining a hedge to their position* ***appropriately***."[54] Indeed, multiple CBOE witnesses testified that, according to Trading and Markets, "no [Rule 204] violation had occurred" at optionsXpress.[55] Because there was no regulatory violation, Trading and Markets "suggest[ed] that [CBOE] look into potential fraud charges with regard to the customers."[56] But when CBOE did so, it found no fraud—i.e., "*a possible 10b-5 charge just wasn't lining up with the facts*."[57]

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[51] OPX651 Tr. 3844:7-15; 3989:7-22; 3624:19-3625:4.

[52] DX141 at 2; Tr. 3851:7-23; 3989:23-3984:1.

[53] Tr. 3852:12-3853:3; 3994:11-23.

[54] OPX129 at 3 (emphasis added).

[55] Tr. 3901:10-18; 3907:18-21; 3846:7-11; 3997:3-22.

[56] Tr. 4000:18-20.

[57] Tr. 4000:18-4001:15 (emphasis added).

On or about June 10, 2009, CBOE had a second call with Trading and Markets to discuss the trading at issue.[58] On this call, CBOE asked Trading and Markets "point blank" if "the trading appear[ed] to be a sham closeout"—and, in response, Trading and Markets confirmed "*it doesn't appear to be*."[59] Trading and Markets explained that "when they wrote the rule they couldn't cover everything" and that "they may need [to] go [...] back and reevaluate the rule if they want to cover this type of trading."[60]

On June 16, 2009, CBOE sent Trading and Markets a memo detailing the buy-write trades and its investigatory findings.[61] The memo explained that the trading "consist[ed] of a *deep call buy-write strategy*."[62] That is, CBOE clearly explained to the SEC that the trading involved the use of buy-writes with deep in-the-money calls to satisfy Rule 204. Yet, Trading and Markets never told CBOE that this trading violated the rule.[63] On the contrary, Tao and Crane left undisturbed their advice to CBOE that the trading "doesn't appear to be" a "sham closeout."[64]

Thus, on June 19, 2009, CBOE issued a report recommending a "Filed without Action" resolution of its Rule 204 investigation, stating that "the Zelezny's were *appropriately*

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[58] OPX650; Tr. 3631:13-15.

[59] Tr. 4003:10-4004:9 (emphases added).

[60] Tr. 4004:10-17.

[61] OPX565; Tr. 3860:15-3861:3; 3644:23-3645:3.

[62] OPX565 at 3 (emphasis added); Tr. 3651:5-16.

[63] Tr. 4004:18-21.

[64] Tr. 4003:10-4004:9, 3863:24-3864:4 (Overmyer).

maintain[ing] hedged position in multiple securities."[65] According to CBOE's activity log for the optionsXpress investigation, optionsXpress' primary regulator "decided that [the firm] *did not violate the rule [204T].*"[66]

CBOE's Overmyer testified that CBOE closed its investigation on September 23, 2009, because it was "crystal clear from [his] conversation with the SEC" that "no violation has occurred"—that is, "*there wasn't a violation of Reg SHO.*"[67] It then notified optionsXpress that the investigation did not find a Rule 204 violation. Instead, CBOE sent the firm a "Letter of Caution" that cited the firm for a mere technical violation unrelated to Rule 204; Overmyer himself referred to this violation as "ticky-tacky."[68]

Throughout CBOE's investigation, optionsXpress diligently provided all requested information and even brought additional relevant information to CBOE's attention, even when that information was not requested.[69] Thus, as the record confirms, CBOE had full and complete information, including guidance from the Trading and Markets Division, when it found the trading at issue did not violate Rule 204.

optionsXpress voluntarily solicits further guidance from FINRA: Immediately after optionsXpress received CBOE's "Letter of Caution" (which, again, did not find any Rule 204 violation), the firm called FINRA to confirm that this regulator also was comfortable with the

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[65] OPX129 at 1, 5 (emphasis added).

[66] OPX127 at 6 (emphasis added); Tr. 4061:1-25.

[67] Tr. 3901:10-18, 3907:18-21 (emphasis added); 4005:12-23.

[68] OPX138, OPX141, OPX573 at 21; Tr. 4087:11-4089:1; 3904:12-3905:4.

[69] Tr. 3826:10-14, 3843:23-3844:6; 3333:15-3334:8; 4708:8-14, 4721:13-4731:21.

customers' trading strategies from a Rule 204 perspective.[70] At the time, FINRA had related, pending inquiries and already had been given detailed information about the trading by optionsXpress—including information showing that the trading involved buy-writes with deep in-the-money calls.[71]

In a call on September 24, 2009, FINRA did not tell optionsXpress to stop the trading.[72] Instead, this regulator declined to provide optionsXpress guidance due to the pending inquiries and referred the firm to the SEC's Division of Trading and Markets.[73]

optionsXpress voluntarily solicits further guidance from Trading and Markets: Immediately after the FINRA call, optionsXpress called Tao and Crane at Trading and Markets (the same SEC lawyers who spoke several times with CBOE about the trading at issue).[74] Crane's handwritten notes from that call, as well as testimony from call participants, confirm that optionsXpress specifically asked Trading and Markets whether its "execution desk" could "bundle" the stock purchase used to "close out [the] customer" with the "deep in money calls" sold by the customer—i.e., whether the firm could use buy-writes "to achieve best ex[ecution]" for the customer.[75] After optionsXpress explained the trading strategy, Trading and Markets told optionsXpress to "keep doing what you're doing, keep closing out."[76]

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[70] OPX665; Tr. 3411:2-17; 2706:7-13; 2712:17-24.

[71] Tr. 3418:22-3412:9.

[72] Tr. 2749:7-12; 3414:24-3415:8.

[73] Tr. 2725:10-15, 2730:8-25, 3417:2-5.

[74] OPX579.

[75] OPX579; Tr. 3429:13-3430:3; 3676:25-3677:6.

[76] Tr. 3437:8-23; 3439:10-13; 3618:21-24, OPX729; OPX246.

Trading and Markets then called FINRA to summarize its earlier conversation with optionsXpress. As FINRA's notes confirm: *"The SEC stated [to FINRA] that based on the facts [optionsXpress] presented, it [the SEC] told the firm that activity would not be considered a violation of 204."*[77] During this call with FINRA, however, Tao and Crane purportedly represented they were not aware that the trading involved a "buy-in" and "a deep-in-the-money call option" that were executed "at virtually the same time."[78] But that is precisely what the firm previously told them. Trading and Market's ***own*** notes confirm that optionsXpress disclosed its customers were using "deep in money calls" and wished to "bundle" them with stock purchases to "close out customer[s]."[79] Indeed, CBOE's Overmyer (whose name came up on the call with optionsXpress) had previously sent both Tao and Crane a detailed memo discussing this precise trading strategy at optionsXpress, explaining that it involved a "deep call buy-write strategy."[80]

On October 2, 2009, after first clearing optionsXpress of a potential Rule 204 violation but then learning FINRA had related inquiries pending, Tao and Crane called optionsXpress back. During that call, Tao and Crane notified the firm that the SEC could give "no comfort" on whether the trading violated the rule given the pending FINRA inquiries.[81] But neither Tao nor Crane in that call (or ever) suggested to optionsXpress that it stop Feldman's trading.[82]

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[77] DX237 (emphasis added); OPX667.

[78] DX237.

[79] OPX579.

[80] OPX565.

[81] Tr. 3741:5-12.

[82] Tr. 3439:14-20; 3613:10-17.

Pertinent regulatory activity in 2010: On January 20 and 28, 2010, CBOE notified optionsXpress that it was the subject of two new, routine Rule 204 inquiries for trading activity during the third and fourth quarters of 2009, a six-month period covered by the Division of Enforcement's allegations in this case.[83]

In the meantime, in March 2010, the SEC Division of Enforcement told optionsXpress for the first time that it had concerns the trading could violate Rule 204.[84] In response, optionsXpress immediately stopped the trading and instituted policies to prevent the trading from resuming.[85]

In December 2010, after receiving detailed trading information from optionsXpress,[86] CBOE informed optionsXpress that "*no violations of the Securities and Exchange Commission or [CBOE] rules were apparent*" in connection with its 2010 Rule 204 inquiries—again, inquiries that overlap with the time period at issue in the OIP.[87] In other words, CBOE reviewed the very same trading at issue here three separate times (one detailed investigation and two routine inquiries) and, each time, found no violation of Rule 204.

The enforcement action: On April 16, 2012, the Division issued its OIP alleging Rule 204 and fraud violations against optionsXpress, the firm's former CFO Thomas E. Stern (who has withdrawn his petition for review), and Feldman for trading from October 2008 until March 2010.[88]

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[83] OPX101 at 3, 5.

[84] Tr. 3441:11-18; 1700:9-1701:1.

[85] Tr. 3441:11-18; 1700:9-1701:1; OPX484; OPX485.

[86] *See, e.g.,* OPX164; OPX371; OPX734.

[87] OPX151; OPX152.

[88] *See* OIP ¶¶ 1-2, 162-65.

In September and October 2012, Chief Administrative Law Judge Murray held a seventeen-day hearing. The Court's June 7, 2013 Initial Decision read Rule 204(a) as barring any use of buy-writes in response to an option assignment. According to the Court, this expansive reading of Rule 204 was justified "on at least two levels." (Decision 75.) First, the Court concluded that buy-writes do not count as stock purchases "of like kind and quantity" sufficient to satisfy Rule 204(a) because "[u]se of a buy-write transaction comes within the Commission's definition of a naked short sale." (*Id.* at 79.) Second, the Court found that optionsXpress violated Rule 204(a)—but not 204(f)—by engaging in sham transactions, finding the trading akin to a "trick" and a "hoax." (*Id.* at 86.)

The Court also found Feldman liable for fraud, and it found optionsXpress and Stern liable for willfully aiding and abetting that fraud. (*See id.* at 93-95.) To support that finding, the Court noted that optionsXpress was not "fully forthcoming" with the regulators and "did not operate in good faith." (Decision 81.)

The CBOE settlement: Four days after the Initial Decision was released, the Commission issued a settlement order in its case against CBOE, which included findings that directly undermine the fraud finding in the Initial Decision. First, the Commission found that optionsXpress was forthcoming to regulators, "provid[ing] documents to CBOE" sufficient for CBOE to determine that the firm "was potentially not in compliance with Reg. SHO." *In re CBOE, Inc.*, SEC Release No. 69726, 2013 WL 2540903, at *4 (June 11, 2013); *see also* SEC Release No. 33-9466 (Oct. 16, 2013). Second, the Commission found that "CBOE took no action against the member firm" despite its Rule 204 investigation—an indisputable "green flag" to optionsXpress from its primary regulator, regardless of whether the Commission thinks CBOE should have taken action. *Id.* at 5. Third, the Commission found that CBOE's staff, who focus

on options trading, "lacked a fundamental understanding" of that rule—thus confirming that the rule was not clear. *Id.* at 4.

ARGUMENT

As demonstrated below, the Initial Decision should be vacated and this action dismissed. *See* 17 C.F.R. § 201.411(a). The Commission is permitted to make its own findings of fact and conclusions of law based on a *de novo* review of the record. *See id.*[89]

I. The Court erred in concluding that optionsXpress violated Rule 204.

A. Rule 204 is a strict liability regulation that must be limited to its literal language.

The fundamental problem with the Initial Decision is that it outlaws behavior based on the Court's view of what the law *should be*, while ignoring what the rule *actually says or does not say*.

Rule 204 is a strict liability provision that must be construed narrowly based on its plain language and without regard to information outside its four corners. The Supreme Court in *Gollust v. Mendell* requires "*a literal, 'mechanical' application of the statutory text*" when interpreting Rule 16(b) of the Exchange Act, another strict liability provision. 501 U.S. 115, 122 (1991) (internal and quotations omitted) (emphasis added). As the Court explained, this guiding principle remains true "even though in some cases a broader view of statutory liability could work to eliminate an evil that Congress sought to correct through [the rule itself]." *Id.*[90] The rationale for this principle is simple: liability without regard to intent is a severe sanction that

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[89] The Initial Decision rejected, or did not adopt, a number of the Division's alternative arguments, and thus we do not address them in this brief. (*See, e.g.*, Decision 93 n.133.)

[90] *See C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co.*, 705 F. Supp. 972, 976 (S.D.N.Y. 1989) ("[T]he [Supreme] Court emphasized that a narrow construction is appropriate because § 16(b) is a rule of strict liability . . . .") (citing *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972)); *see also Ho v. Duoyuan Global Water, Inc.*, 887 F. Supp. 2d 547, 577 (S.D.N.Y. 2012); *In re Royal Ahold N.V.*, 351 F. Supp. 2d 334, 400 (D. Md. 2004).

should be imposed only where the terms of the rule are clear and unambiguous. *Jammies Int'l Inc. v. Nowinski*, 700 F. Supp. 189, 192 (S.D.N.Y. 1988). Thus, the inquiry must begin and end with the literal language of Rule 204.

The Court ignored this precedent and adopted a theory of liability that expands the rule's scope far beyond its literal language, thus plainly violating Supreme Court precedent. According to the Court, Rule 204(a) *implicitly* prohibits all buy-writes executed in response to an option assignment. (*See* Decision 79.) But the text of Rule 204(a) does not say this. While another subpart, Rule 204(f), addresses sham transactions, it requires "an *arrangement* with another person" to avoid delivery—an element the Division conceded it did not satisfy. (*See* Decision 84.)

Thus, instead of finding a violation of Rule 204(a) based on "a literal, mechanical application" of the regulatory text as required by the Supreme Court, the Court merely found that the Division's proof came close enough: "If something looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck." (Decision 86.) Such loose analysis confirms what is made clear in the following sections—optionsXpress fully complied with a literal application of Rule 204(a).

B. optionsXpress' buy-ins satisfied a literal, mechanical application of Rule 204(a)'s plain language.

A plain reading of Rule 204(a) shows that the trading at issue here could not have violated that rule as a matter of law. As discussed, Rule 204(a) imposed a duty on optionsXpress to deliver shares when faced with a fail to deliver position according to CNS data resulting from a "short sale transaction" in an equity security. 17 C.F.R. § 242.204(a). The rule does not reference options, much less exercises or assignments of options, and it has not been established

that this rule even applies in the options context. But assuming the rule applies to options trading, each assignment ultimately triggered a Rule 204(a) duty for optionsXpress.

The pertinent portion of the rule required optionsXpress, "by no later than the beginning of regular trading hours on the settlement day following the settlement date [T+4], [to] immediately close out its [CNS] fail to deliver position by borrowing or *purchasing securities of like kind and quantity*." 17 C.F.R. § 242.204(a) (emphasis added).

As explained during the Division's cross-examination of Dr. Sirri, the Director of Trading and Markets at the time Rule 204T was enacted, this part of the rule requires only a borrow or purchase "transaction."[91] That is, "if you find yourself on the morning of T plus 4, what you must do is transact. You have to buy [or borrow] securities. That's what it says." *Id.*

When determining whether such a "transaction" occurred, the appropriate inquiry under Rule 204(a) is to look to the broker's books and records. Specifically, the broker's records must show that it "borrow[ed] or purchas[ed] securities of like kind and quantity" in reference to the CNS fail to deliver position for the particular close-out date. 17 C.F.R. § 242.204(a). This reading is clear not only from the Rule's language, but also from its adopting release: "[T]o meet its close-out obligation a participant . . . 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."[92]

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[91] Tr. 3179:20-3180:2.

[92] Rule 204 Adopting Release, 74 Fed. Reg. 38266, 38272 (July 31, 2009) (emphasis added); *see also* Rule 204T Adopting Release, 73 Fed. Reg. 61706, 61711 (Oct. 17, 2008); *see also* FINRA, CBOE, C2, SEC No-Action Letter, 2013 WL 4782336, at *1 (Sept. 6, 2013).

Under the plain language of the rule, optionsXpress complied with its Rule 204(a) obligation by buying-in its customers no later than market open on T+4 in response to option assignments. During the hearing, optionsXpress' expert Dr. Atanu Saha presented evidence that the firm's books and records confirmed that the short stock positions (resulting from assignments) were timely closed out through the customers' legitimate stock purchases virtually 100% of the time.[93] Significantly, the Initial Decision did not challenge this fact. (*See* Decision 77.) The record thus confirms that optionsXpress complied with a plain reading of what Rule 204(a) requires.

The Court appears to have implicitly adopted the Division's theory that optionsXpress violated Rule 204(a) by maintaining a prolonged fail to deliver position at CNS (*See, e.g.*, Decision at 30, 86), but CNS records have nothing to do with whether Rule 204(a) has been satisfied. Rather, as discussed above, compliance is determined by the firm's "books and records." 74 Fed. Reg. at 38272. As Dr. Sirri testified, "[t]he requirement of SHO isn't that it change[s] your CNS delivery position. The requirement is that you buy shares of like kind and quantity. And those shares of like kind and quantity were bought when a buy-write is executed."[94] Nothing in the Rule supports reliance on CNS records to prove a Rule 204 violation.

To the extent the Court looked for a change in CNS position to determine Rule 204 compliance, doing so misconstrued two fundamental aspects of how the CNS system works. First, a stock purchase that complies with Rule 204(a) will take three days (i.e., until settlement)

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[93] OPX248 at 32.

[94] Tr. 3186:19-23.

to resolve a CNS fail.[95] This delay in settlement can cause CNS fails to occur for an extended period even when Rule 204(a) admittedly is satisfied.[96]

Second, as noted above and confirmed by a witness from the Depository Trust and Clearing Corporation, the firm's end-of-day CNS position is an amalgamation of all trading that settled that day—including transactions completely unrelated to the trading that triggered a Rule 204 close-out obligation.[97] Because CNS shows only the firm's net trading activity, it cannot be used to determine whether a party is "net short from trading activity on that day only or net short because of [a] prior day's trading activity."[98] Here, the "data demonstrates that optionsXpress owed stock to different contra-parties on a daily basis, indicating that deliveries were being made and new fails created."[99] Thus, when CNS showed failures to deliver in a security for multiple days, "[i]t wasn't the same fail over an extended period of time. It was different fails, different share amounts owed during this period."[100]

In short, CNS data is irrelevant to Rule 204(a) compliance—and this is precisely why no regulatory guidance even suggests looking to CNS records to determine whether a firm has complied with the rule. On the contrary, SEC guidance recognizes that CNS data "reflect

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[95] Tr. 325:7-13; 446:7-10.

[96] Tr. 4397:6-12.

[97] Tr. 85:25-86:7.

[98] Tr. 89:25-5; 325:7-13; 446:7-10.

[99] OPX250 ¶ 36.

[100] Tr. 4352:13-18.

aggregate fails as of a specific point in time, and may have *little or no relationship to yesterday's aggregate fails*," and "the age of fails cannot be determined by looking at [CNS data]."[101]

As Dr. Sirri aptly put it: "you buy securities of the like, kind and quantity, you execute the buy-write, you purchase the shares, *therefore you've satisfied your obligation under SHO*."[102] This plain reading of the rule controls, and any broader reading (like that found by the Court) would violate the tenet that strict liability rules must be narrowly construed.

C. The Initial Decision improperly rendered Rule 204(f)'s express prohibition of sham close-outs superfluous.

Once Rule 204(a) is satisfied—e.g., once stock of "like kind and quantity" has been purchased—Rule 204 could conceivably still be violated through a buy-write, but only if it satisfies the strict definition of a sham close-out. Rule 204(f) expressly sets forth that definition and prohibits otherwise compliant transactions *only* "where the participant enters into an *arrangement with another person* to purchase or borrow securities as required by this section, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow." 17 C.F.R. § 242.204(f) (emphasis added).

As the Commission made clear during its rulemaking, it had "determined to include rule text in subparagraph (f) of Rule 204"—and nowhere else—to address "sham close-outs." Release No. 34-60388, 2009 WL 2223009, at *20 (July 27, 2009). And, as Rule 204(f) itself confirms, there is no sham close-out absent an "arrangement with another person" to circumvent Rule 204(a). In fact, during the notice and comment process, every iteration of Rule 204

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[101] Frequently Requested FOIA Document: Fails-to-Deliver Data, "What You Should Know About the Data, *available at* http://www.sec.gov/foia/docs/failsdata.htm (emphasis added).

[102] Tr. 3217:20-24 (emphasis added).

required such an "arrangement" to constitute a "sham closeout."[103] And all guidance discussing sham closeouts through buy-writes required such an "arrangement" as well.[104]

Yet, as the Court pointed out, "*[t]he Division is not claiming that optionsXpress violated Rule 204(f).*" (Decision 84 (emphasis added).) This is because, as the Division itself conceded, "[n]either of [its] experts ever said that there was an arrangement with the other parties."[105]

The Court rendered superfluous Rule 204(f) by holding that use of *any* buy-write in response to an option assignment violates Rule 204(a) regardless of an arrangement to circumvent that rule. Doing so violated another Supreme Court holding—i.e., the well-established prohibition on rendering regulatory language superfluous, a canon that "is strongest when an interpretation would render superfluous another part of the same [regulatory] scheme." *Marx v. Gen. Revenue Corp.*, 133 S. Ct. 1166, 1178 (2013).

D. The Court had no legal or logical basis to depart from a literal, mechanical application of Rules 204(a) and 204(f).

Instead of applying a plain reading of Rule 204, the Court read Rule 204(a) as *implicitly* barring all buy-write transactions in response to option assignments as sham closeouts. According to the Initial Decision, such a broad reading of Rule 204(a) is justified "on at least two levels." (Decision 75.) But the Court got it wrong—twice.

1. The Court improperly declined to count buy-writes as stock purchases "of like kind and quantity" sufficient to satisfy Rule 204(a) on the ground that "[u]se of a buy-write transaction comes within the Commission's definition of a naked short sale." (Decision 79.)

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[103] *See* 69 Fed. Reg. 48008, 48031 (Aug. 6, 2004); *see also id.* at 48018; 71 Fed. Reg. 41710, 41711 n.13 (July 21, 2006); 72 Fed. Reg. 45544, 45546 n.31 (Aug. 14, 2007); 73 Fed. Reg. 61690, 61692 n.26 (Oct. 17, 2008); 73 Fed. Reg. 61706, 61714-15 n.78 (Oct. 17, 2008); 74 Fed. Reg. 38266, 38278 (July 31, 2009).

[104] *See, e.g.*, DX124; DX129; DX384.

[105] Tr. 4195:11-17, 4193:7-17.

The Court found that "by not performing its responsibility and closing out fail to deliver positions, optionsXpress allowed Feldman and others to continue what, *in effect*, was naked short selling" through sham closeouts. *Id.* (emphasis added).

But the Court was not charged with enforcing its view of the *spirit* of the rule—only its letter. While a goal of Rule 204 may be to curtail naked short selling, the Supreme Court requires "a literal, 'mechanical' application" of the text approved by the Commission to further that goal. *Gollust*, 501 U.S. at 122. The Commission itself has never characterized the use of any buy-write in response to an option assignment as constituting naked short selling, and Rule 204 certainly does not do so. Thus, instead of mechanically applying the rule's literal text as required, the Court unilaterally found Rule 204(f) insufficient to satisfy the purported policy underlying the rule and thus essentially rewrote Rule 204(a) to capture new, purported "shams" that do not involve arrangements with counterparties.

Even putting aside this obvious violation of Supreme Court precedent, the Court's purported policy justification for broadly construing the strict-liability Rule 204(a) is based on a false premise. The trading at issue was not, "in effect," naked short selling because (1) optionsXpress *did* close out its fail to deliver positions by purchasing stock[106]; (2) optionsXpress *made delivery* of the stock it purchased (as even the Division's conceded)[107]; and (3) as the Division's own expert also conceded, the trading at issue *did not depress stock prices.*[108]

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[106] OPX248 at 32; Tr. 4389:1-4391:4; 4442:23-4444:1.

[107] Tr. 1426:8-23; DX310 at ¶ 196; *see also* 230:11-16; OPX250 ¶ 36; OPX248 at 32.

[108] DX310 ¶ 39; Tr. at 1557:19-25.

2. The Court also erred when concluding (without any legal analysis) that optionsXpress engaged in sham transactions "independent of Rule 204(f)" based on "[t]he common meaning of a sham," which "is 'a trick that deludes: hoax.'" (Decision 86 (quoting *Merriam-Webster's Collegiate Dictionary* 1073 (10th ed. 2001).) But courts cannot rely on dictionary definitions to redefine a key term—i.e., "sham"—expressly defined in the rule itself as requiring the existence of an "arrangement."

First, the Court's ruling (once again) violates Supreme Court precedent. The Justices "have stated time and again that courts must presume that a legislature [or, as here, a regulator] says in a statute what it means and means in a statute what it says there. When the words of a statute [or, here, a rule] are unambiguous, then, this first canon is also the last: judicial inquiry is complete." *Barnhart v. Sigmon Coal Co.*, 534 U.S. 438, 461-62 (2002) (quotations and citations omitted). This same principle applies to Rule 204.

Second, the trading here was neither a "trick" nor a "hoax." In fact, a few months before the trading at issue began, CBOE issued guidance stating, "we recognize that most transactions pairing options with stock" i.e. a buy-write, "may be used as part of a general trading/hedging strategy, and *we do not want to discourage their use for that purpose*."[109]

Despite this clear guidance, the Court found that optionsXpress engaged in sham close-outs because it purportedly knew that the deep in-the-money calls "would be exercised and assigned so that no shares [purchased as part of the buy-write] were delivered to CNS." (Decision 86). The theory is that, in essence, the customer simultaneously sold stock to cancel the stock purchase used to close out the customer's short position. But Feldman *did not actually sell stock* in the trading at issue; rather he sold an option, which created a short position only if

[109] DX129 at 5 (emphasis added); *see also* DX124 at 5.

and when a call was exercised and assigned to him. And neither Feldman nor optionsXpress had any control over if and when his calls would be exercised and assigned to him.

Indeed, the record established that: (1) Feldman wrote his deep in-the-money calls for the legitimate economic purpose of reestablishing his hedged position[110]; (2) he had no control over whether and when the anonymous counterparties would exercise the deep in-the-money calls[111]; (3) he also had no control of whether and, if so, when the calls he wrote would even be assigned back to him, because the entire assignment process is random on both the broker-dealer and customer levels[112]; (4) he could have no expectation of immediate assignment as the trade data showed that fewer than one-third of the deep in-the-money calls at issue were fully assigned on the same day they were written[113]; (5) the shares purchased as part of the buy-writes at issue were actually delivered[114]; and (6) Feldman did not want to be assigned, because it increased his transaction costs and thus threatened to cause him to lose money from his strategy.[115]

Third, the Initial Decision improperly imposed strict liability based on purported industry practice—i.e., "[t]here is no evidence that any clearing broker except optionsXpress used buy-writes to satisfy its CNS fail to deliver positions." (Decision 80). This finding is legally irrelevant, because industry practice cannot change the language of the rule, much less one that must be narrowly construed. Regardless, the Court misconstrued the record: (1) as a CBOE

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[110] OPX248 at 17-21, 40; Tr. 2466:15-18; 2247:24-2248:4.

[111] Tr. 636:15-19; 2520:3-6; 2627:3-5; 3326:6-12; 3969:15-25; OPX915 Ex. 13.

[112] OPX915 ¶¶ 101-103; Tr. 3321:11-3322:4; 3323:9-11; Tr. 258:15-21.

[113] OPX248 at 25.

[114] Tr. 230:11-16; Tr. 1426:8-23; OPX250 ¶ 36; DX310 ¶ 196; OPX248 at 32.

[115] Tr. 3368:24-3369:7; 4994:1-4995:1; OPX248 at 5.

witness testified, other firms were engaging in the exact same trading at issue here[116]; (2) there is no evidence that any other broker shut down Feldman's trading based on Rule 204 or fraud concerns[117]; (3) two of the three firms mentioned by the Court stopped Feldman's trading *after* optionsXpress, at the SEC's request, had already stopped the trading[118]; and (4) the third firm never notified optionsXpress of a potential violation.[119]

E. The Court erroneously attempted to justify its flawed reading of Rule 204(a) by pointing to mere SEC settlements that addressed materially different situations.

The only "authority" the Court cited to support its strained interpretation of Rule 204(a) consisted of three SEC settlements—i.e., *Hazan*, *Arenstein*, and *TJM*. According to the Court, these settlements should have put optionsXpress on notice that the transactions here were unlawful. (*See* Decision 82-84.) Once again, the Court got it wrong.

First, "[i]t goes without saying, and the Commission has stressed many times, that settlements are not precedent." *In re Del Mar Fin. Servs., Inc.*, SEC Rel. No. 188, 2001 WL 919968, at *29 n.61 (Aug. 14, 2001) (citations omitted); *see also In re F.X.C. Investors Corp.*, SEC Rel. No. 218, 2002 WL 31741561, at *10 (Dec. 9, 2002) ("The Division's reliance on settlement orders is misplaced. In the absence of an *opinion* stating the Commission's views on the issues raised, settlements are of dubious value as precedent.") (citation omitted) (emphasis in original)). Yet, the Court repeatedly relied on these settlements—inaccurately referring to them as "decisions" (Decision 22 n.37, 81-82)—to support its legal conclusion that Rule 204(a) prohibits buy-writes in response to option assignments.

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[116] Tr. 4769:14-4770:20.

[117] Tr. 2286:10-14; 907:1-8.

[118] Tr. 2286:10-14; 4802:8-10.

[119] Tr. 907:1-8; 898:22-899:2.

Second, each settlement is easily distinguished from the retail trading at issue here. Each involved an actual *arrangement* between a market maker that traded customized FLEX options in its own proprietary accounts for the sole purpose of avoiding stock delivery and engaging in naked short selling.[120] The situation here could not be more different: optionsXpress was not placing trades for its own account,[121] did not trade any customized options,[122] did not even know Feldman's counterparties,[123] and had no economic incentive to circumvent its delivery obligations.[124]

Until the Initial Decision, there was no authority—decision, settlement, or guidance—construing Rule 204 as prohibiting the bundling of buys from a broker with deep in-the-money calls from a self-directed retail customer. On the contrary, all of the settlements and guidance relied on by the Court and the Division involved "arrangements" to avoid delivery, which the Division concedes was not present here. To be sure, the Initial Decision stands alone, unsupported by any case law or precedent.

II. The Initial Decision also violates optionsXpress' due process rights.

The Initial Decision, if enforced, would violate optionsXpress' due process rights because the Commission 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). Though optionsXpress raised this issue in its post-

[120] *See* DX121; DX130; DX135.

[121] Tr. 3278:13-15.

[122] Tr. 2626:14-17; OPX250 at 35, 37-38; OPX248 at 12-13.

[123] Tr. 636:15-19; 3326:6-12; 2520:3-6; 2627:3-5.

[124] Tr. 3363:20-3364:2.

hearing briefing, the Initial Decision inexplicably failed to address this challenge to the Division's enforcement action.

Liability has been imposed here based on significant departures from the literal text of Rule 204 and despite unclear and contradictory interpretations, guidance, and findings by optionsXpress' regulators. In this respect, the Initial Decision (and the enforcement action from the start) is a textbook due process violation that the Commission should not allow to stand.

For example, the Initial Decision's interpretation imposes civil liability without any notice that *all* buy-write transactions, even those without an arrangement as proscribed by Rule 204(f), violate Rule 204 when executed in response to an option assignment. The Initial Decision also improperly construes Rule 204(a) to implicitly include a new sham provision (*Compare* Decision 84-85 *with* 17 C.F.R. § 242.204(a).) Where notice is insufficient—"for example, *where the regulation is not sufficiently clear to warn a party about what is expected of it*—an agency may not deprive a party of property by imposing civil or criminal liability." *United States v. Approximately 64,695 Pounds of Shark Fins*, 520 F.3d 976, 980 (9th Cir. 2008) (emphasis added) (quoting *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1328-29 (D.C. Cir. 1995)); *see also Affum v. United States*, 566 F.3d 1150, 1163 (D.C. Cir. 2009) ("Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.") (internal quotations omitted).

Due process also is not satisfied where, as here, "different divisions of the enforcing agency disagree about [a regulation's] meaning." *Gen. Elec.*, 53 F.3d at 1332; *see also PMD Produce Brokerage Corp. v. U.S.D.A.*, 234 F.3d 48, 52 (D.C. Cir. 2000); *United States v. Chrysler Corp.*, 158 F.3d 1350, 1354-56 (D.C. Cir. 1998). The Court ignored critical testimony

from CBOE witnesses who stated that when they brought the trading to the attention of Trading and Markets in May and June 2009—including a memorandum that explained, in detail, the trading at issue—Trading and Markets responded that the trading did *not* constitute a violation:

> Q: Then did you ask Ms. Crane and Ms. Tao [of Trading and Markets] a point blank question?
>
> A: I did.
>
> Q: Does the trading appear to be a sham closeout?
>
> A: I did.
>
> Q: And they told you it's not a sham closeout, right?
>
> A: Well, they – I don't know their exact words but I somehow recall something, it doesn't appear to be – it appears to be something else.
>
> Q: Something other than a sham closeout?
>
> A: Correct.[125]

And as this CBOE witness further testified in the context of seeking advice from Trading and Markets regarding the scope of Rule 204: "[W]e weren't sure what the rule was trying to express."[126]

Even the authors of Rule 204 themselves believed the rule needed to be amended to cover the buy-write trading at issue here. The evidence reflected that Trading and Markets thought it would need a new provision to broaden Rule 204(f) by focusing on the economic purpose of the transaction in order to bar the type of trading at issue in the case.[127] Trading and Markets also told CBOE that "when they wrote the rule they couldn't cover everything" and that "they may need [to] go [...] back and reevaluate the rule if they want to cover this type of trading."[128]

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[125] Tr. 4003:10-4004:9.

[126] Tr. 3989:5-6.

[127] *See* OPX559 ("*Should we propose a rule* that would add a circumvention with no economic purpose rule?") (emphasis added).

[128] Tr. 4004:10-17.

To the extent the Commission wishes to ban the trades at issue in this case, there is a process for that—amend the rule to restrict some or all buy-write transactions. Thus, the Commission should vacate the Initial Decision for the additional reason that the Division is empowered only to enforce regulations, *not* to create them.

III. The Court erred by finding that optionsXpress aided and abetted or caused Feldman's alleged securities fraud.

The Court had no basis to find that optionsXpress aided and abetted a purported securities fraud by Feldman. To affirm, the Commission must find that Feldman committed a primary violation, and that optionsXpress substantially assisted that primary violation with the requisite scienter for aiding and abetting or causing liability. *See, e.g.*, *Howard v. S.E.C.*, 376 F.3d 1136, 1151 (D.C. Cir. 2004). Neither element has been satisfied in this case.

A. The Court erred in finding a primary violation.

There is no record support for a finding that Feldman committed securities fraud, thus the finding against optionsXpress for derivative fraud liability must be vacated. There are two types of fraud actionable under the federal securities laws: manipulation and deception. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977).

i. There is no underlying Rule 204 violation, thus negating any fraud finding based on either manipulation or deception.

The Division's fraud theory depends on the alleged Rule 204 violations; the OIP alleges no other fraudulent activity.[129] As explained above, optionsXpress satisfied Rule 204(a) when it purchased stock within the T+4 period in response to option assignments, even though those purchases were bundled with calls as buy-writes. The fraud theory must be dismissed for this reason alone.

[129] *See* OIP ¶ 2; Decision 2-3.

ii. The Court erred in finding market manipulation.

Even if there were a Rule 204(a) violation, there was no market manipulation. "'Manipulation . . . refers generally to practices, such as wash sales, matched orders, or rigged prices, *that are intended to mislead investors by artificially affecting market activity*." *Santa Fe Indus.*, 430 U.S. at 476 (emphasis added) (citation omitted). None of this occurred here, particularly because the record established that Feldman acted with the legitimate economic purpose of reestablishing his hedged position [130]

Indeed, the CBOE Director overseeing the Rule 204 investigation of optionsXpress, Timothy MacDonald, directly addressed this very allegation:

> Q: Did you find any intent to manipulate the market?
> A: *No.*
> Q: Any intent to manipulate . . . the market as to optionsXpress or the customer?
> A: *No.*
> Q: No as in you didn't find any such intent?
> A: *Did not find anything.*[131]

The Initial Decision ignored this testimony and found, contrary to the firm's primary regulator, that the "buy-writes were *essentially* wash trades or matched orders to avoid delivering shares." (Decision 101) (emphasis added).

The Court defined "wash trades" as "transactions involving no change in beneficial ownership." (*Id.* at 92.) But here, securities were purchased[132] and delivered[133]—requiring

[130] *See, e.g.*, OPX248 at 17-21, 40; Tr. 2466:15-18; 2247:24-2248:4

[131] Tr. 4001:5-12 (emphasis added).

[132] OPX248 at 32; Tr. 4384:18-4385:3.

[133] OPX250 ¶ 36; DX310 ¶ 196; Tr. 230:11-16; 4354:16-24; 1426:8-26.

ownership to change. Thus, the trading cannot constitute a "wash trade" under the Court's own definition.

The Court defined "matched" trades as "orders for the purchase or sale of a security that are entered with knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale or purchase of such security." (Decision 92.) But the trading does not fit this definition either. optionsXpress did not know (and could not have known) that "orders of substantially the same size, at substantially the same time and price" would be entered by another party because (1) Feldman did not buy and sell the *same security* but, instead, he bought *stock* and sold *options*; and (2) there was no arrangement with counterparties to exercise the calls.[134] Again, the decision whether and when to exercise a call rested in the sole discretion of an anonymous counterparty.[135] And, as discussed above, the assignment of the call was random at both the broker-dealer and customer level, meaning that neither Feldman nor optionsXpress could know who would be assigned and when. Notably, the actual trade data shows that of all the deep in-the-money calls written on the stocks at issue, fewer than one-third were fully assigned on the same day they were written.[136]

There also was no manipulation according to the Division's own expert, who admitted that "the buy-write trades had little effect on prices in the underlying stock markets."[137] Dr.

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[134] Tr. 1348:11-21; 4193:7-17; 4195:11-17; 2520:3-15 *see also* Decision at 84-85.

[135] Tr. 636:15-19; 2520:3-6; 2627:3-5; 3326:6-12.

[136] *See* OPX248 at 25.

[137] DX310 ¶ 39.

Saha, optionsXpress' expert, concurred—finding that "stock prices did not fall as a result of the buy-write transactions."[138]

iii. The Court erred in finding a misrepresentation or omission.

The Court also found that Feldman deceived the "market as a whole" by purportedly misrepresenting through his open trading that he was going to make delivery of securities with no intention to do so. (*See* Decision 89.) But, earlier in the Initial Decision, the Court found that "Feldman was candid about what he was doing[.]" (*Id.* at 44 (emphasis added).) As the Court further noted, the Division's own expert "admitted . . . his analysis showed that *delivery occurred* within a few days of T+3[.]" (*Id.* at 54 (emphasis added).)[139] The record thus belies any finding of an actual misrepresentation or omission here.

B. The Court erred in finding that optionsXpress acted with the requisite scienter to aid and abet or cause a primary fraud violation.

The Court found that optionsXpress aided and abetted Feldman's fraud, but that finding is legally baseless for several reasons discussed below. Under the controlling authority in *Howard v. SEC*, the requisite scienter for this charge is "extreme recklessness." 376 F.3d 1136, 1143 (D.C. Cir. 2004).

Green flags: There can be no extreme recklessness where, as here, "rather than red flags, [the respondent] encountered green ones." *Id.* at 1147. As discussed, optionsXpress encountered numerous such green flags. Most notably, CBOE conducted a detailed investigated of the trading at issue and, in September 2009, closed that investigation without finding a single Rule 204 violation—and notified optionsXpress of this fact.[140] The CBOE's action alone was a

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[138] OPX248 at 39.

[139] Tr. 1426:8-23; DX310 at ¶ 196.

[140] OPX138; OPX141.

"green flag" that bars a finding of fraud as a matter of law under *Howard*'s extreme recklessness standard—or, for that matter, a negligence standard.

At the hearing, CBOE's MacDonald confirmed that optionsXpress' primary regulator exonerated optionsXpress of fraudulent conduct:

> Q: Did you find fraud?
> A: No.
> Q: Did you find any intent to manipulate the market?
> A: No.
> Q: Any intent to manipulate . . . the market as to optionsXpress or the customer?
> A: No.
> Q: No as in you didn't find any such intent?
> A: Did not find anything.
> *Q*: *Did you find that a possible 10b-5 charge just wasn't lining up with the facts?*
> *A*: *Correct.*[141]

This same regulator confirmed for the Court that optionsXpress could have reasonably said "[o]ur regulator looked at this [trading] and told us we were okay."[142] After all, CBOE guidance expressly recognized that "matching options with stock"—e.g., a buy-write—is "a legitimate hedged strategy" and that CBOE did "*not want to discourage their use for that purpose*."[143]

To the extent the Commission believes that CBOE misunderstood or misapplied the rule, this belief is irrelevant to the fraud finding—which depends on *optionsXpress'* scienter. Even assuming, for the sake of argument, that CBOE misconstrued the rule, this does not negate the

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[141] Tr. 4001:3-15 (emphasis added).

[142] Tr. 4019:13-21.

[143] DX124 at 5 (emphases added); DX129 at 5.

fact that CBOE informed optionsXpress that the trading did not violate Rule 204, which nullifies any argument that optionsXpress acted with the requisite scienter.

In fact, the green flags did not stop with CBOE. The SEC's Division of Trading and Markets told optionsXpress (as confirmed by contemporaneous notes taken during the discussions) that the "*activity would not be considered a violation of 204*"[144] and the firm should "*keep doing what you're doing.*"[145] Although Trading and Markets later told the firm that it could provide "no comfort" due to pending FINRA inquiries,[146] no regulator ever told optionsXpress that it was violating Rule 204 despite the firm's repeated requests for guidance on the issue.[147]

Regulation is "silent on the subject": The *Howard* Court also found that the "extreme recklessness" standard is not satisfied where the underlying rule "was silent on the subject." *Id.* at 1147. As discussed above, the language of Rule 204 does not prohibit a broker from using a buy-write to close out a short position resulting from an option assignment when, as here, there is no arrangement to circumvent the delivery requirements.

Law has never been "clear": Further, under *Howard*, aiding and abetting liability cannot rest where the "law applicable to [the case] has never been clear, and has been based on a partly unwritten body of interpretation regarding what constitutes a 'bona fide' purchase of securities for purposes of the rules . . . ." *Id.* at 1145. That is the situation here. The record establishes that optionsXpress did not even act negligently, much less with extreme recklessness, because the violation found by the Court was far from "clear." After all, CBOE conducted a

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[144] DX237 (emphasis added).

[145] Tr. 3437:8-23; 3439:10-13; 3617:14-17, 3619:5-6; OPX729 at 3; OPX246.

[146] Tr. 3741:5-12.

[147] Tr. 3613:10-17; 3439:14-20; 2749:7-12; 3414:24-3415:8.

detailed investigation of the trading at issue and—during the relevant period —found that "*no [Rule 204] violation has occurred*" and "*a possible 10b-5 charge just wasn't lining up with the facts*[.]"[148]

While the Commission has faulted CBOE for inaction with regard to optionsXpress, the findings and testimony by CBOE confirm that the plain language of the Rule did not clearly prohibit the trading at issue. Indeed, the findings by the Commission in its CBOE settlement order—in particular, the finding that regulators who merely "read the rules themselves" would not appreciate its purportedly broad scope without "formal training," and they "were confused" as to its meaning—confirm that Rule 204(a) "has never been clear" as to whether it prohibits buy-writes in response to option assignments. *In re CBOE, Inc.*, SEC Release No. 69726, 2013 WL 2540903, at *5 (June 11, 2013); *Howard*, 376 F.3d at 1145. The Commission cannot possibly find Rule 204 to be "clear" in this appeal given its own contrary findings in the CBOE Settlement.

In fact, the rule's lack of clarity was underscored by a General Accounting Office report, which found that Rule 204T generated "a lot of *uncertainty* and *confusion* related to the scope and application of the new requirements."[149] The same report condemned "Trading and Markets' varied and, at times, untimely responsiveness to . . . requests for interpretive guidance on Regulation SHO."[150] It then warned that "[w]ithout timely and *clear* interpretive guidance from SEC, SROs [self-regulatory organizations such as CBOE] may be unable to effectively enforce SEC rules and regulations, and SEC cannot ensure the consistent implementation of the

[148] Tr. 3901:10-14; 4001:3-15.

[149] OPX646 at 64 (emphasis added).

[150] OPX646 at 64.

rules and regulations."[151] The Initial Decision inexplicably ignores this important observation from another agency of the U.S. Government—an observation that, in and of itself, defeats the aiding and abetting charge under *Howard.*

Given the profound confusion surrounding the implementation of Rule 204, it is not surprising that optionsXpress engaged in internal discussions and debates concerning the rule's meaning. The Initial Decision relies on some of these emails in its findings (*see, e.g*., Decision 17-18), but these emails confirm how optionsXpress acted in good faith to determine what the rule actually required—and, in particular, whether it should take the extraordinary step of shutting down trading by a self-directed retail customer.

Faced with abundant evidence in the record that Rule 204 was so unclear that the regulators themselves could not agree on what it means, the Court turned *Howard* on its head by holding that optionsXpress acted at least recklessly because it failed to "get[] a *definitive determination* on whether optionsXpress' use of buy-writes was lawful." (Decision 94 (emphasis added).) But this is not—and should not be—the law. The Division carries the heavy burden of proving "extreme recklessness." And it cannot satisfy this burden based on a mere presumption that conduct is fraudulent absent a "definitive determination" of lawfulness by a respondent's regulator, a determination regulators rarely provide. If the law were otherwise, regulators would be flooded with requests for such "definitive determinations" on all types of market activity and, pending those determinations, even routine market activity would be chilled for fear of a fraud prosecution.

optionsXpress was proactive: The record also is replete with evidence that compliance officers at optionsXpress proactively sought regulatory guidance from the SEC and FINRA on

[151] OPX646 at 65 (emphasis added).

the topic of whether the trading at issue violated Rule 204. This evidence—which belies any finding of extreme recklessness or, for that matter, negligence—includes:

- Fall 2008: The firm's Legal, Compliance, Operations, Clearing, and Execution Departments discussed the *Arenstein* settlements and found the trading to be materially different.[152]

- Spring and summer of 2009: The firm fully complied with CBOE's investigation of the trading at issue and even provided information that was not requested by CBOE.[153]

- August 6, 2009: The firm analyzed the *Hazan* and *TJM* settlements, and the firm's Vice President of Compliance authored a detailed e-mail distinguishing the trading.[154]

- September 24, 2009: The firm asked FINRA for guidance on the trading at issue.[155] FINRA suggested the firm contact the SEC.[156]

- September 24, 2009: The firm called the SEC seeking guidance on whether it could bundle buys and writes for best execution.[157] In response, the SEC told the firm to "keep doing what you're doing."[158] While SEC later told the firm it could give "no comfort" on that issue due to pending FINRA inquiries, the SEC at that time did not ask the firm to stop the trading.[159]

- March 2010: The firm shut down the trading after, for the first time, the Division expressed its discomfort with the trading.[160]

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[152] Tr. 216:9-217:10; 3300:17-3308:10.

[153] *See, e.g.*, OPX339; Tr. 3826:10-14, 3333:15-3334:8; 4708:8-11.

[154] OPX678; *see also* Tr. 3342:21-3370:1.

[155] OPX665; Tr. 2706:7-13; 2712:17-24

[156] Tr. 2725:10-15, 3417:2-7.

[157] Tr. OPX579; Tr. 3429:13-3430:3.

[158] Tr. 3437:8-23; 3439:10-13; 3618:21-24, OPX729; OPX246.

[159] Tr. 3741:5-12; 3613:10-17; 3439:14-20.

[160] Tr. 3441:11-18; 1700:9-1701:1 .

These efforts to ensure compliance are further evidence of reasonableness and good faith, "a relevant consideration in evaluating [a respondent's] scienter." *Howard*, 376 F.3d at 1147-48; *see also In re John P. Flannery & James D. Hopkins*, SEC Rel. No. 438, 2011 WL 5130058, at *48 (Oct. 28, 2011) (Murray, Chief ALJ) (finding no negligence where "Flannery reasonably relied on . . . other knowledgeable persons").

The Court ignored the evidence of optionsXpress' good faith, and instead found that optionsXpress "was not fully forthcoming" with the regulators (Decision 81; *see also id.* 84). But, again, this finding in the Initial Decision conflicts with the Commission's findings in the CBOE Settlement that optionsXpress was forthcoming to its regulators, "provid[ing] documents to CBOE" sufficient for CBOE to determine that the firm "was potentially not in compliance with Reg. SHO." *See In re CBOE, Inc.*, SEC Release No. 69726, 2013 WL 2540903, at *4 (June 11, 2013).

The Court's finding also overlooks key record evidence on this point. CBOE witnesses testified that optionsXpress was "fully cooperative" and "straightforward" in response to CBOE's investigation and inquiries.[161] Indeed, CBOE used information from optionsXpress to prepare a detailed memo in June 2009 to Trading and Markets, which the Division has never asserted was inaccurate or contained misleading information from the firm.[162] The FINRA witnesses testified similarly, agreeing that optionsXpress "g[ave] [FINRA] the information [it] requested," including CNS and trade blotter data regarding the trading at issue, in response to various FINRA requests.[163]

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[161] Tr. 3844:3-6; 3826:10-14; *see also* Tr. 3333:14-3335:2.

[162] OPX124.

[163] Tr. 2701:6-16, 2707:18-2708:1.

C. The court misconstrued Rule 10b-21.

The Court's finding of fraud liability under Rule 10b-21 independently fails. In fact, the Court failed even to analyze the elements of Rule 10b-21—which require, among other things, *deceiving a broker-dealer*, participant of a registered clearing agency, or purchaser regarding his intention, or ability, to deliver the security by settlement date. *See* 17 C.F.R. § 240.10b-21 (emphasis added).

The Division failed to demonstrate a primary violation of this rule. The Court apparently missed the key distinction between (1) a customer's delivery to his or her broker—which implicates Rule 10b-21 and (2) the broker's delivery to CNS—which does not.[164] "Rule 10b-21's focus is on whether or not there is a fail to deliver *by the seller [to the broker]*, rather than on whether or not there is a fail to deliver in the CNS system." Rule 10b-21 Adopting Release, 73 Fed. Reg. 61666, 61672 (Oct. 17, 2008) (emphasis added). The allegations in this case focus on optionsXpress' delivery to CNS, not on Feldman's delivery to optionsXpress. Indeed, there is no evidence that Feldman ever represented that he intended to deliver shares to optionsXpress, much less misrepresented that fact.

The case for aiding and abetting liability under this rule is even more tenuous. By the Commission's own admission, aiding and abetting would require a finding "close to a contradiction in terms that the broker/dealer would have both been deceived and know about the potential violation."[165] Due to this contradiction, the Commission has recognized that "the realm

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[164] OPX915 ¶ 125 ("Delivery 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").

[165] DX401 at 9.

of aiding and abetting liability [with regards to Rule 10b-21] is modest."[166] And it certainly does not stretch to the situation here.

D. The Court failed to identify any victim or any harm caused by the trading.

The Initial Decision concluded that Feldman's transactions harmed the market (*see* Decision 100-01), but there is no support for these findings. In fact, the Division never identified a single "victim" of the trading.

The Division's own expert (Dr. Harris) failed to identify any harm.[167] He admitted that he had no evidentiary support for the Division's allegation that market participants were deprived of voting rights, dividends, or stock loan fees.[168] And Dr. Saha (optionsXpress' expert) provided unrebutted testimony that flatly contradicted that allegation: "regardless of what happens at the CNS level, at the customer level they are credited" and, therefore, market participants can exercise their voting rights and receive dividends to which they are entitled.[169] Indeed, it strains credulity that if the Division's theory (and it is nothing more than a theory) were correct, there would not be a single letter of complaint from a counterparty or some other document to prove the alleged harm.

The weakness of the allegations regarding investor harm is highlighted by the Initial Decision's heavy reliance on hearsay excerpts of Internet chats to show market harm. (*See, e.g.,* Decision 46, 92, 101.) This is a stretch, to say the least—particularly with no evidence that optionsXpress was privy to those discussions. Nor can the Division rely on after-the-fact

[166] DX401 at 9.

[167] Tr. 1580:9-21; *see also* Tr. 1432:9-1435:17; 4403:16-4407:2.

[168] Tr. 1432:9-1435:17.

[169] Tr. 4402:7-23.

speculative testimony from CBOE's Overmyer that "these transactions disadvantaged market participants" (Decision 101), when his boss (MacDonald) specifically investigated the fraud charge at the time and rejected it.[170]

IV. The Court erred when finding late buy-ins on T+4.

The Initial Decision found that optionsXpress violated Rule 204(a) through late buy-ins—i.e., "optionsXpress' efforts to close out its fail to deliver positions frequently occurred after 10:00 a.m. ET on T+4 during the relevant period." (Decision 77; *see also id.* at 78.) The Commission should vacate this finding as well for the following reasons:

First, the data contradict this finding. As Dr. Saha explained, the data show that at least 99.3% of the fails to deliver were cured by T+3, and at least 99.8% were cured by T+4.[171] The Court itself recognized that, based on Dr. Saha's analysis, the fails to deliver were timely cured somewhere between 99.3% and 99.8% of the time.[172]

The Court tried to turn this evidence of regulatory compliance into a concession of liability, but that effort fails. According to the Initial Decision, "Saha's assertion that his data show that 99.3 percent of trades occurred before the end of T+3 is an acknowledgement that there were many fails to deliver because seven-tenths of an enormous number of trades is a very large number." (Decision 77.) This finding, however, misconstrues the relevant data and Dr. Saha's testimony. Dr. Saha expressly testified that he was making no such concession; rather he

[170] OPX141; OPX151; OPX152; Tr. 4000:18-4001:15, 4019:13-21.

[171] OPX248 at 32; Tr. 4389:1-4391:4.

[172] Tr. 4390:24-4391:3 ("Judge Murray: Right. And also, the difference between 99.3 and 99.8, it's plausible that some part of that .8 occurred before. The Witness: Absolutely, Your Honor. That's very astute.")).

simply did not have enough data to draw a conclusion as to the final .7%.[173] Thus, the Division could not rely on Dr. Saha to meet *its burden of proof.* Regardless, seven-tenths of one percent of the trades is not "a very large number"—any such trades clearly would represent mere anomalies, not a widespread problem warranting the type of enforcement action brought here.

Second, while the Court also found that, "[a]fter August 20, 2009, [optionsXpress] executed fifty-one percent of 1,105 buy-writes after 10:00 a.m. ET" (Decision 57), this finding is meaningless, because only trades after 10:00 a.m. *on T+4* violate Rule 204(a). The Division's expert, Dr. Harris, admitted on the stand that he did not analyze the day (T+1, T+2, etc.) on which these trades occurred after 10:00 a.m. ET.[174] This evidence thus falls far short of showing late buy-ins *on T+4*, especially considering that optionsXpress changed its policy during the period at issue to require buy-ins on T+1.[175]

Third, the Court relied on purported circumstantial evidence that there *could have been* late trades, but this evidence is insufficient to meet the Division's burden of proving that stock purchases to close-out short positions were actually made late on T+4 in violation of Rule 204(a). According to the Court: "Some examples [of evidence showing late buy-ins] are Risley's acknowledgement that Clearing had trouble getting buy-in information to the Trading Desk; Tortorella's acknowledgement that before August 2009, he occasionally could not get the list of who had to be bought in to the Trading Desk before the opening of the market, and evidence that after August 2009, Tortorella sent two lists, one after the market opened." (Decision 77.) The Court further found that: "Payne, Coronado, and Stella were playing fast and

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[173] Tr. 4389:1-4391:3.

[174] Tr. 1566:25-1567:8.

[175] Tr. 3374:20-3375:2; 312:22-313:12; DX128.

loose with the rules and allowed Feldman, Zelezney, and certain other customers to decide how to cover the shorts in their accounts, which took time." (Decision 77.)

Putting aside the Court's mischaracterization of the facts, this is not evidence of stock purchases to close out short positions after 10:00 a.m. on T+4. The Division had access to the trade data and, therefore, if it had proof of such late trades it should have presented it. The truth is, no such evidence existed – even though the Division spent over two years trying to find it. The Division's failed attempt to show just one late buy-in reveals the weakness of its primary theory of liability.

In sum, the Division failed to prove that any specific trades were late, and thus did not meet its burden. But even if one were to assume that a handful of trades were executed late on T+4, the Court itself found that such late buy-ins would have caused no harm or deception: "CNS participants waiting to receive shares would not notice any difference in buy-ins occurring late in the day because all trades that occurred during the business hours of the exchange get the same trade date." (Decision 13 n.27.) Thus, assuming for the sake of argument—in spite of a total lack of evidence—that the Initial Decision's finding of late buy-ins on T+4 was accurate, it certainly could not support a finding of fraud. Nor could such a finding support the fine imposed here.

V. Even if liability were affirmed, the imposed remedy should be vacated.

A. The Commission should vacate the cease and desist order.

The Court issued a cease and desist order against optionsXpress based on a finding that "there is nothing in this record that provides any assurance that these Respondents will not commit future violations." (Decision 96.) This finding ignores undisputed evidence that optionsXpress: (1) immediately stopped the buy-write trading at issue when the Division

suggested it do so in the spring of 2010[176]; (2) implemented changes to its operating procedures accordingly[177]; (3) has not permitted the trading at issue for over three years[178]; and (4) the Division presented no evidence of investor harm.[179]

The Court also imposed a cease and desist order based on a finding that "[t]he evidence and the demeanor and testimony of Respondents establishes a high likelihood that they will commit future violations if they have an opportunity to do so." (Decision 96.) This finding, too, is contradicted by the record. This finding ignores that optionsXpress was acquired in August 2011, and there has been an almost complete change in its management since the trading occurred. As the Court itself noted, the firm's "new corporate ownership [under Schwab]" provides added protection to the public against future violations. (Decision 101.)

B. The Commission should vacate the disgorgement order.

The Court's order against optionsXpress for disgorgement totaling $1,574,599 plus prejudgment interest is based on the following clearly erroneous finding:

> Harris's calculation that the six customer accounts that engaged in the trading strategies described in this Initial Decision paid optionsXpress a total of $1,908,744 during the relevant period, and that $1,574,599 of that amount was for buy-writes, makes the latter the most reasonable approximation of optionsXpress' ill-gotten gains, plus prejudgment interest.

(Decision 98.) This finding should be vacated not only because disgorgement is unwarranted, but because disgorgement against optionsXpress should reflect only net profits from the trading

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[176] Tr. 3441:11-18.

[177] Tr. 3441:21-3442:4; OPX485.

[178] Tr. 3441:21-23.

[179] Tr. 1580:9-21; *see also* Tr. 1432:9-1435:17; 4403:16-4407:2.

at issue, rather than gross revenues.[180] The disgorgement amount ordered by the Court, as provided by Harris, is thus grossly inflated.

C. The Court should vacate the civil penalty amount ordered against optionsXpress.

The Court's $2 million civil penalty also is based on clearly erroneous findings. For example, the Court found that: "It is in the public interest to assess civil monetary penalties against: optionsXpress and Feldman at the *third tier* because they committed willful violations involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement, which resulted in substantial pecuniary gain to each of them." (Decision 99-100 (emphasis added).) As discussed above, optionsXpress did not willfully violate Rule 204, or otherwise possess the scienter necessary for aiding and abetting (or causing) fraud. Thus, a third-tier classification is not appropriate here.

The Court also found that optionsXpress ignored "numerous red flags that warned of possible violations" and "willfully ignored regulatory mandates." (*Id.* at 100.) But the evidence showed the precise opposite. As discussed, optionsXpress' staff sought guidance on Rule 204, interacted with regulators in good faith, and received "green flags" regarding the trading activity.[181]

There certainly is no evidence that optionsXpress "willfully ignored regulatory mandates"—in fact, the opposite is true. The record is undisputed that optionsXpress recognized that the trading presented questions of Rule 204 compliance, took steps internally to ensure compliance with the Rule, and voluntarily solicited guidance from three regulatory bodies. And when the firm was told to stop the trading, it stopped.

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[180] *See* optionsXpress Holdings, Inc.'s 2010 10-K's Consolidated Statement of Operations (attached as Exhibit A to optionsXpress' Post-Hearing Finding of Fact).

[181] *See* discussion, *supra*, at I.B.

CONCLUSION

For the foregoing reasons, the Commission should vacate the judgment and order this enforcement action against optionsXpress dismissed with prejudice.

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 450(d)

I, Charles B. Klein, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 450(c), as it contains 13,971 words, excluding the parts of the brief exempted by the Rule. 17 C.F.R. § 201.450(c).

Dated: December 16, 2013

Charles B. Klein