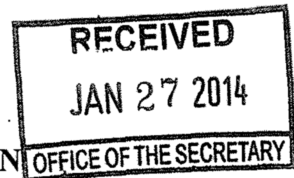

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

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

Respondents.

DIVISION OF ENFORCEMENT'S RESPONSE TO THE APPEAL BRIEFS OF RESPONDENTS OPTIONSXPRESS, INC. AND JONATHAN I. FELDMAN

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INTRODUCTION

The decision by Judge Brenda Murray confirmed that this case, for all its seeming complexity, is simply old-fashioned, deceptive securities trading conducted with the assistance of a broker-dealer that failed to comply with its regulatory obligations. Respondent Jonathan I. Feldman ("Feldman") and a few other retail customers of Respondent optionsXpress, Inc. ("optionsXpress") undertook an options trading strategy to make ***millions*** of dollars by trading ***billions*** of dollars of securities. The strategy included selling "deep-in-the-money" call options on hard-to-borrow securities with no intention of actually delivering stock when those options were inevitably (and expectedly) exercised and assigned. Instead, Feldman and the other optionsXpress customers executed "buy-write" transactions, which involved simultaneously buying stock and selling an equivalent number of deep-in-the-money calls that they knew had a high probability of being exercised and assigned on the same day they were sold—***resulting in no stock actually being delivered***. As Judge Murray rightly concluded, Feldman did not discover some novel "arbitrage" opportunity, but instead "discovered" an illegal options trading strategy that could (and did) succeed only with a derelict broker-dealer (optionsXpress) that willingly neglected its regulatory obligations.

Rules 204 and 204T of Regulation SHO ("Reg. SHO") were designed to reduce failures to deliver by broker-dealers like optionsXpress to a registered clearing agency – in this case, the National Securities Clearing Corporation's ("NSCC") Continuous Net Settlement ("CNS") system – and to curb abusive naked short selling (that is, short selling stock and intentionally failing to deliver stock within the standard three-day settlement cycle). 74 FR 38266 (July 31, 2009); 73 FR 61706 (Oct. 17, 2008). To accomplish these goals, the Rules require broker-dealers like optionsXpress – the gatekeepers of the settlement system – to deliver shares into CNS no later than three days after the shares are sold (*i.e.*, by T+3). 17 C.F.R. § 242.204(a); 17 C.F.R. § 242.204T(a). The Rules are clear – if a broker-dealer like optionsXpress does not

deliver shares to CNS by the end of those three days, then it has a failure to deliver position at CNS, and must "***immediately close out*** its failure to deliver position" by purchasing or borrowing shares in a bona fide transaction "no later than the beginning of regular trading hours" the following day (*i.e.,* T+4). 17 C.F.R. § 242.240(a) (emphasis added).

The CNS records in this case are unequivocal—optionsXpress' and Feldman's buy-writes resulted in no shares being delivered to CNS and thus optionsXpress' failure-to-deliver positions were not closed out as required by Reg. SHO. These buy-writes, "even viewed in the most favorable light" to the Respondents, were "nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." Commission Guidance on Rule 3b-3 and Married Put Transactions, SEC Interpretive Rel. 34-48795, 2003 WL 24028210 (Nov. 21, 2003). In other words, the buy-writes were sham transactions that did nothing more than fraudulently circumvent delivery obligations. Indeed, optionsXpress facilitated what the evidence showed no other brokerage firm would allow – customers, including Feldman, engaging in day-over-day buy-writes that optionsXpress recognized early on created a "vicious cycle" of "perpetual" failures to deliver. Nonetheless, optionsXpress allowed this conduct because it made money on every trade (nearly $2 million over the course of the relevant period). In sum, optionsXpress' persistent and uncured failures to deliver violated the delivery requirements of Reg. SHO and allowed Feldman to profit from his fraudulent scheme.

optionsXpress was aware in 2008 that the trading activity was violating federal securities laws. Indeed, when optionsXpress' head trader emailed the clearing department about "an article in the Wall Street Journal about how short sellers in [Sears] are using options ***to circumvent the SEC cover rule,***" optionsXpress' head of clearing responded, ***"[The Customers are] definitely***

doing this. " DX255-56.[1] Likewise, as early as October 15, 2008, less than one month after the Commission issued its emergency order for Rule 204T, optionsXpress employees recognized the firm's customers had "short positions on hard to borrow stocks where the ***customer has to buy in every day,*** " adding that customers were "buying back the short and writing in the money calls which are ***assigned on a daily basis.*** " DX253. The next month, optionsXpress employees noted that the trading activity was creating perpetual failures to deliver: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, ***we are in a vicious cycle.*** " DX41. Despite early awareness of the securities law implications of the buy-writes, optionsXpress did nothing until March 2010 (after being contacted by the Division of Enforcement) to stop what it recognized as "perpetual," "chronic," or "rolling" failures to deliver. Indeed, as late as August 2009, an optionsXpress employee confirmed that customers like Feldman persisted in remaining "[a]lways short, cover[] [their] buys by buying [sic] short options deep in the money, so they get assigned. More or less, their trade date position stays constant, ***settled position never closes or goes long.*** " DX58.

Tellingly, while optionsXpress knowingly permitted and facilitated this activity for over a year, ***every other brokerage that confronted identical trading by Feldman promptly stopped it.*** optionsXpress does not dispute that its employees understood they were allowing a "vicious cycle" of failures to deliver at CNS to continue. Nor could it, for the evidence demonstrates that optionsXpress knowingly allowed Feldman and its other customers to continue their trading in the face of numerous red flags and scrutiny from regulators. Indeed, after reading about SEC actions involving similar trading, an optionsXpress trader's first reaction was the right one— "I'm not placing any trades today." DX149. optionsXpress was also warned by the SEC that its

[1] "DX" refers to the Division's Exhibits, "RX" refers to the Respondents' Exhibits, and "ID" refers to the Initial Decision.

customers may be engaging in fraud. Accordingly, optionsXpress should be found liable for helping Feldman commit fraud.

Because it cannot claim that it did not know what it was doing, optionsXpress instead seeks to evade liability through what it calls "a literal, 'mechanical' application of strict liability Rule 204," optionsXpress Opening Brief ("OPX Br.") 1, which interprets Rules 204 and 204T to provide that simply executing a purchase "transaction" would satisfy optionsXpress' delivery obligation under the rules. However, optionsXpress' interpretation ignores the plain language of the rules that were designed to cure failure-to-deliver positions—that is, it ignores the requirement that brokers "***close out***" their failure-to-deliver positions. 17 C.F.R. § 242.240(a) (emphasis added). It should be axiomatic that a broker does not "close out" a failure-to-deliver position when that very position remains open for hundreds of days and trading activity results in no actual delivery to CNS. If the Commission were to accept optionsXpress' purported "literal, 'mechanical'" reading of the rule, there would be no rule at all because brokers would never deliver shares to "close out" their failures to deliver at CNS when they could instead place a wash sale that results in no shares actually being delivered to CNS. This illogical proposition must be rejected and the Commission should enforce the law as written (and understood by other market participants).

While optionsXpress claims its customers are responsible for the trading, Feldman in turn offers a "my broker let me do it" defense. Feldman Opening Brief ("Feldman Br.") 2. This defense rings hollow – and was rightly rejected by Judge Murray – because Feldman admitted that his trading strategy was executed deliberately and intentionally. Indeed, he even bragged that he was not going to make (or wanted to avoid making) delivery to settle his trades: "***I don't settle the stock@all***"; "So I could do a buy-write ***and then I wouldn't settle***"; "So how many SHLD do I have to buy-in today (***to avoid settlement***)?" DX25, 27, 94. Moreover, Feldman knew his trading was deceptive, admitting that message board followers of stocks he was trading were

confused by the volume of trading related to his buy-writes and that they placed "***some significance to it***...." Tr.2273:10-2274:3.

Feldman's professed "reliance" on optionsXpress was particularly unreasonable and not credible, as Judge Murray recognized, when Feldman testified unequivocally that he is steadfastly skeptical in all his business dealings and always seeks his own understanding of the true nature of the circumstances he faces. Feldman's supposed reliance on optionsXpress further lacks credibility when ***every other brokerage firm he tried to use promptly shut down his strategy over regulatory concerns***. Moreover, Feldman was personally exposed to numerous red flags about the implications of his trading activity – he was provided a copy of Rule 204 and an SEC case regarding similar trading and he communicated with optionsXpress and another broker about the regulatory implications of his trading. DX58; DX278; RX888. He even wrote an email to a friend about it: "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. ***(Until someone notifies the SEC and they shut down the strategy!!)***. DX29. In short, Feldman found the weak link in the system that would allow him to commit his fraud – optionsXpress – and then exploited it. Indeed, Feldman recognized this: "Millions of $$ inc [sic] comissions[sic],,,,,yet treat me/us like criminals...But, in the big picture...***it's still quite the gig...where can you get such mkt-b[e]ating retu[r]ns consistently***? So, as disgusting as [optionsXpress] are [sic], have to bend over and get raped, and take the punishment[.]" DX249. This is not good faith reliance on a broker—this is securities fraud.

After seventeen days of hearings, Judge Murray did what Feldman rightly predicted – "shut down the strategy!!" – and confirmed what was apparent to optionsXpress six years ago – the buy-write trading violated Rules 204 and 204T. In the process, Judge Murray found Feldman liable for violating Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 10b-5 and 10b-21 thereunder, as well as Section 17(a) of the Securities Act of 1933 ("Securities Act"). Judge Murray also held that optionsXpress caused and willfully aided and

abetted Feldman's and other customers' abusive naked short selling, and in the process violated Reg. SHO. For their violations of the securities laws, Feldman and optionsXpress were ordered to cease and desist, disgorge improper gains, and pay civil penalties. Judge Murray's conclusions were supported by the evidence and the Division of Enforcement ("Division") respectfully suggests that the Commission should reach a similar result on all grounds.

FACTUAL BACKGROUND

During the relevant period, Feldman and a few other optionsXpress customers (hereinafter, collectively, "the Customers") bought ***millions*** of dollars of calls referencing hard-to-borrow securities, giving them the right to buy stock at a certain price on these stocks. *See* DX74-75, 77, 81, 82-83, 84, 87; DX310 (¶52); DX375 (¶18). At the same time, Feldman and the Customers sold an identical quantity of puts in the same hard-to-borrow stock, giving purchasers the right to make the Customers buy stock. The calls and puts had the same strike price and such combined transactions mimic owning stock, a result known as a "synthetic" long position. *See* DX310 (¶101); DX375 (¶24). Because a synthetic long position exposed Feldman and the Customers to potential losses if the stock price went down, they established an offsetting short position to "hedge" their synthetic long. DX310 (¶¶17-18, 111, 142); DX375 (¶¶46, 49). The profit came from the difference between the price they *received* from selling the put on the hard-to-borrow security and the price they *paid* to buy the call, less the price they would have to *pay* for the initial and all subsequent hedges. *See* DX310 (¶¶137-139); DX375 (¶46).

Feldman's and the Customers' short "hedge" positions were established in one of two primary ways: (1) selling stock short; or (2) selling a deep-in-the-money call.[2] The short sale of stock created an immediate delivery obligation, and the sale of the deep-in-the-money call created a delivery obligation after the call was exercised and assigned. Because Feldman and the Customers sold deep-in-the-money calls referencing hard-to-borrow securities, the calls were

[2] A call that is "deep-in-the-money" has a strike price that is far below the market price of the referenced security. *See* DX310 (¶¶18, 68); DX375 (¶19c); RX915 (¶24).

highly likely to be exercised immediately, triggering the obligation to deliver. Tr.4409:16-18 ("it's a fact" that the "deeper the call is in the money, the more likely it is to be assigned"). In fact, the deep-in-the-money calls were regularly and promptly exercised. *See* DX310 (¶¶23, 28, 74, Ex. 32); DX375 (¶¶61-64).

Despite having delivery obligations when the calls were exercised and assigned, 17 C.F.R. § 242.204(a); 17 C.F.R. § 242.204T(a), optionsXpress did not deliver stock by settlement date. DX310 (Ex. 32); DX11-12, 14-18, 21-24, 30-32, 36-37, 39-40, 43, 46-47, 50-53. Instead, optionsXpress facilitated Feldman's and the Customers' execution of "buy-writes" – orders to "buy" the amount of stock that was required to be delivered and simultaneously to sell (*i.e.,* "write") deep-in-the-money calls representing the same quantity of stock. DX310 (¶21); DX375 (¶8). To trade these buy-writes, Feldman and the Customers had to actually ***pay money to*** the counterparty that was purportedly ***purchasing*** the options from them. *See* DX310 (Ex. 21); DX375 (¶9(f)). The deep-in-the-money calls sold as part of the buy-writes were promptly exercised by the counterparty – as one would expect – resulting in the stock that Feldman and the Customers purportedly "bought" promptly being sold. *See* DX310 Ex. 16; DX375 (¶54(a)). For example:

- Start day: Feldman/optionsXpress owe delivery of 100 shares
- 11:00 a.m.: Feldman buys 100 shares and sells 1 deep-in-the-money call (the buy-write)
- 11:00 a.m.-4:30 p.m.: Deep-in-the-money call exercised
- 10:00 p.m.: Feldman assigned on 1 call thus selling 100 shares
- End of Day: Feldman/optionsXpress still owe delivery of 100 shares

This same day purchase-and-sale resulted in no shares being delivered to CNS and thus the same cycle recurring the following day, and so on thereafter, a process which optionsXpress recognized as a "vicious cycle" as early as November 2008. *See* DX 41, DX310 (¶¶29, 193-

195); DX375 (¶62). optionsXpress should have known the "buy" portion of the buy-writes did not satisfy its delivery obligations because the buying (of the stock) and selling (of the deep-in-the-money calls) occurred simultaneously and effectively cancelled each other out, resulting in no shares actually being delivered to CNS. *See* DX310 (¶¶30, 43, 115-16).

Feldman made money from this strategy because the cost to borrow the hard-to-borrow stock was already factored into the price of the options he was trading as part of his synthetic long—this occurred because everyone else was following the rules, *i.e.,* buying or borrowing the stock to make delivery. DX310 (¶¶14-20, 143-45, 165-70, 176); DX375 (¶¶9.d, 34-41, 54-60). Simply put, Feldman profited because he did not follow the rules and others did. RX915 (¶54) ("only the buy-write allows the person following the strategy to continue the economic purpose of the strategy"); Tr. 2125:6-21.

From October 2008 through March 2010, Feldman and the Customers routinely engaged in buy-writes in at least 25 securities. *See* DX310 (¶¶174-78). As a result, optionsXpress had continuous failures to deliver in numerous securities that persisted for months. Feldman personally "purchased" at least $2.9 ***billion*** of securities and sold short at least $1.7 ***billion*** of options through optionsXpress in 2009 alone – making a gross profit of more than $4 million. optionsXpress' other five customer accounts purchased approximately $2.6 ***billion*** worth of securities and sold short approximately $2.3 ***billion*** of options. In the process, optionsXpress avoided paying $7,214,977 in hard-to-borrow fees, *see* DX310 (¶¶41, 188, 199), and earned roughly $2 million in commissions. *Id.* (¶42).

<u>ARGUMENT</u>

I. OPTIONSXPRESS VIOLATED REG. SHO'S CLOSE-OUT REQUIREMENTS

optionsXpress violated the plain language of Rule 204 and its predecessor, Rule 204T, which required optionsXpress to deliver securities to CNS by T+3 or in the event it failed to deliver securities on time, to "immediately close out its fail to deliver position." 17 C.F.R. §

242.240(a). The issue in this case is whether the Customers' deep-in-the-money buy-writes closed out optionsXpress' failures to deliver—and the answer is a clear "no." optionsXpress never made delivery to CNS and its arguments seeking to avoid liability are without merit.

A. optionsXpress Violated the Plain Language of Reg. SHO by Not Closing Out Its Failures to Deliver.

The release for Rule 204 indicates that the rule was designed to reduce failures to deliver at registered clearing agencies—namely CNS. *See, e.g.,* 74 FR 38266, 38268, 38272, 38277. The Commission's goal of reducing such failures to deliver is clearly reflected in Rule 204(a). A broker-dealer, such as optionsXpress, is required to deliver securities to CNS by settlement date or in the event it fails to deliver securities on time, to "immediately ***close out*** its fail to deliver position." 17 C.F.R. § 242.204(a) (emphasis added). The record demonstrates that (1) optionsXpress had failure-to-deliver positions at CNS and (2) as a result of the buy-write activity, optionsXpress did not make delivery to CNS. Without delivery to CNS, ***there is no delivery*** and thus, no Rule 204(a) close-out.

The evidence proved that optionsXpress' employees were aware of the vicious cycle of failures to deliver caused by the buy-writes from the outset. For example, on October 15, 2008, less than one month after the Commission issued its emergency order for Rule 204T, optionsXpress employees recognized that the Customers had "short positions on hard to borrow stocks where the ***customer has to buy in every day***," adding that the Customers were "buying back the short and writing in the money calls which are ***assigned on a daily basis***." DX253. The next month, optionsXpress employees noted that the trading activity was creating perpetual failures to deliver: "Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, ***we are in a vicious cycle***." DX41. This vicious cycle of what optionsXpress employees called "perpetual," DX58, 140, "chronic," Tr. 301:19-302:8, 404:25-405:5, or "rolling," DX127, failures to deliver, continued into and beyond August 2009, when an optionsXpress employee confirmed that the Customers, including

Feldman, persisted in remaining "[a]lways short, cover[] [their] buys by buying [sic] short options deep in the money, so they get assigned. More or less, their trade date position stays constant, ***settled position never closes or goes long***." DX140. Because the buy-write activity kept optionsXpress from closing out its failures to deliver at CNS until it finally stopped the buy-writes in March 2010, the Commission should hold that optionsXpress failed to satisfy its close-out obligations under Rules 204 and 204T and thereby violated the Rules.

1. optionsXpress' interpretation of Rule 204(a) would lead to absurd results.

optionsXpress contends that the "close-out" language of Rule 204 only requires an attempt to "borrow or purchase securities," regardless of whether that activity ultimately results in any shares being delivered to CNS. OPX Br. 22. This reading of the rule ignores a clearing broker's strict requirements to "***close out*** its fail to deliver position" at a "registered clearing agency" (*i.e.*, CNS). Moreover, this reading of the Rule would lead to absurd results and would effectively eliminate the phrase "immediately close out its fail to deliver position" from Rule 204(a). Simply put, optionsXpress' reading of the Rule is wrong and defies generally accepted tenets of statutory construction.

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

If optionsXpress' interpretation was accepted, broker-dealers would never be required to "close out" their failure-to-deliver positions at CNS rendering the Rules' language moot.

Instead, as long as they purchased stock – ***even if they sold it one second later*** – their obligation would be satisfied. For example, a customer could place a limit order to sell and buy the same amount of shares and the broker could cross that trade in the customer's brokerage account – otherwise known as a "wash sale." Or a customer could place market orders to buy and sell the same amount of shares. Inevitably, the trades would be executed and no delivery to CNS would take place because the customer bought and sold the exact same thing.

In short, under optionsXpress' interpretation of Rule 204(a), anyone who wanted to short stock for any reason – good or bad – could do so without ever having to actually deliver stock. All you need, according to optionsXpress, was a "buy" on the firm's books regardless of what other activity optionsXpress allowed that particular customer to engage in that day.[3] Without a need to deliver stock, market participants would not do so and the exact harms that the Commission sought to address in adopting Rule 204 – notably, persistent failures to deliver and naked short selling – would come to fruition. DX310 (¶¶14-15, 86-88).

optionsXpress relies on the testimony of Dr. Erik Sirri ("Sirri") to support its interpretation of Rule 204(a). OPX Br. 23. But Sirri's testimony is irrelevant for the following reasons:

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

Second, the meaning of Rule 204 is an issue for the Commission to decide and paid opinion testimony from Feldman's proffered expert on this issue is irrelevant and improper.

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[3] Under optionsXpress' interpretation of Rule 204(a), the appropriate inquiry to determine compliance is "to look to the broker's books and records," not CNS. OPX Br. 22. *First,* this reading ignores Rule 204(a)'s requirement to "close out" failures to deliver at a registered clearing agency. *Second,* optionsXpress never produced its entire books and records – it only produced the Customers' records – so this argument has no bearing on this matter. *Third,* if optionsXpress' interpretation were correct, a firm could invent transactions on its own books and records and there would be no violation because the firm's books and records show a transaction occurred. In this case, optionsXpress did not invent a transaction on its books and records but instead recorded the buy-writes and argues that the buy portion of those transactions satisfied its closeout requirement. But the buy-writes had the same effect as an invented transaction because there was no delivery to CNS due to the repeated assignment of the deep-in-the-money calls.

Densberger v. United Techs. Corp., 297 F.3d 66, 74 (2d Cir. 2002) ("experts are not permitted to present testimony in the form of legal conclusions"); *Pfizer, Inc. v. Teva Pharm. USA, Inc.*, 2006 WL 3041097, at *2 (D.N.J. Oct. 26, 2006) (excluding expert testimony that either explains the law in general or offers legal conclusions "that follow from the facts presented at trial").

Third, the fact that Sirri used to work at the SEC does not mean that his views are those of the Commission. For example, even if Sirri had made similar statements when he was the Director of the Division of Trading and Markets ("TM") (which he never did), his statements would not bind the Commission. *See Sidell v. Commissioner of Internal Revenue*, 225 F.3d 103, 111 (1st Cir. 2000) ("statements by individual IRS employees cannot bind the Secretary [of Treasury]"); *Connecticut General Life Ins. Co. v. Comm'r of Internal Revenue*, 177 F.3d 136, 145 (3d Cir. 1999) ("reliance upon remembered details from officials who lacked the ultimate authority to issue any proposed regulation has little support in the law"); *SEC v. Nat'l Student Mktg. Corp.*, 68 F.R.D. 157, 160 (D.D.C. 1975) (SEC staff views and "the views of an individual Commissioner will not invariably reflect the position of the agency as a whole").

Fourth, Ms. Josephine Tao, the staff member who helped write the Rule, testified that the use of a deep-in-the-money buy-write to address a close-out is likely unlawful. Tr. 3634:5-19 ("that would not be a bona fide purchase"). In September 2009, Ms. Tao told FINRA the same thing:

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

DX237 (emphasis added).

Finally, Sirri made clear that he was not offering any opinions about whether optionsXpress complied with Rule 204: ***"I'm not offering any opinions about whether optionsXpress complied with SHO****....I don't have the information to do it even if I were to try."* Tr. 3265:25-3266:9 (emphasis added).

Simply put, the Commission should hold that optionsXpress' interpretation of Rule 204(a) is incorrect.

2. optionsXpress' interpretation ignores regulatory guidance.

optionsXpress claims that Judge Murray erroneously interpreted Rule 204(a). But industry guidance issued before Rule 204(a) even went into effect demonstrates that Judge Murray correctly held that optionsXpress' use of buy-writes did not satisfy its "close-out" obligations. Although Rule 204T was enacted in September 2008 and Rule 204 in July 2009, the concept of a bona fide "close-out" has existed in other Commission rules. For years preceding the enactment of Rules 204T and 204, the Commission notified market participants that combined purchase-and-sale transactions (such as buy-writes) cannot be used to avoid timely delivery of securities. For example, in 2003, the SEC issued guidance to "disabuse traders of any notion" that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). As the Commission noted back then, "[e]ven viewed in the most favorable light, these married put transactions appear to be nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." *Id.* n.20.

Prior to the enactment of Rule 204T, other regulatory guidance confirmed the Commission's stated policies. In July 2007, the American Stock Exchange ("AMEX") fined several entities and individuals for violating Reg. SHO Rule 203 based on trading activity similar to what the Customers did here. *Scott H. Arenstein and SBA Trading, LLC*, Case No. 07-71 (AMEX July 20, 2007); *Brian A. Arenstein & ALA Trading, LLC*, Case No. 07-71 (AMEX July 20, 2007). In the *Arenstein* cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligations of Rule 203. *Id.*

In August 2007, AMEX issued guidance about conduct that could violate Reg. SHO. DX384. This guidance provided that "a purchase of stock paired with one or more short term option transactions such as, for example, a one day in-the-money FLEX option, or a married put or ***buy-write transaction whereby the short stock position is only temporarily covered and does not result in actual delivery of the shares*** in question may not satisfy the Regulation SHO close out requirement and will invite regulatory scrutiny of both sides of the transaction...." *Id.* (emphasis added). The guidance further provided that:

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

Id. n.11 (emphasis added). This guidance did not suggest that "an improper arrangement" between parties was the only way to not properly close out a failure to deliver. optionsXpress' compliance personnel reviewed the *Arenstein* case and the AMEX guidance during the relevant time period. Tr. 3314:18-22, 3316:12-17.

Following the release of the *Arenstein* cases, the Chicago Board Options Exchange ("CBOE") sent a regulatory circular to its members, including optionsXpress, "strongly caution[ing]" its members that transactions "pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement." DX124. CBOE proceeded to explain that while its examples involved market-makers, "the same analysis would apply to similar arrangements between any market participants." *Id.* The following year, CBOE reiterated its caution: "When accompanied by certain option transactions, stock purchases that are intended to effect close-outs of fail to deliver positions may bring into question ***whether a bona-fide purchase has occurred***." DX129.

This guidance was again reinforced when the Commission adopted Rule 204T on October 14, 2008, explaining that "the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement." 73 FR at 61715 n.78. In July 2009, Rule 204T became permanent with the adoption of Rule 204 and the Commission commented in footnote 82 on what a close-out under Rule 204(a) means:[4]

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

74 FR at 38272 n.82 (emphasis added).[5]

In short, there has been substantial industry guidance that the use of buy-writes to address failures to deliver is highly questionable and is indicative of attempts to circumvent Reg. SHO's close-out requirements. In fact, the testimony at the hearing confirmed that ***every other broker-***

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[4] Less than a month later, the SEC brought the *Hazan* and *TJM* cases. *Hazan Capital Management, LLC and Steven M. Hazan*, Ex. Act Rel. 34-60441, 2009 WL 2392842 (Aug. 5, 2009); *TJM Proprietary Trading, LLC, et al.*, Ex. Act Rel. 34-60440, 2009 WL 2392840 (Aug. 5, 2009). Respondents in these cases engaged in series of sham reset transactions that employed short-term paired stock/options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203. optionsXpress claims its trading was different than in these cases, OPX Br. 30-31, but the distinctions it tries to draw are unavailing. As one of optionsXpress' own compliance officer recognized, the result of the trading in the *Hazan*, *TJM*, and *Arenstein* cases was the same as at optionsXpress—there was a continuation of a fail to deliver. RX678 ("The end result in all situations is similar: the shares are bought-in, but the subsequent exercise or assignment of the option that night results in a continuation of the fail.").

[5] Importantly, footnote 82 is in the section of the Commission's release describing ***Rule 204(a)'s*** close-out requirement, *see* 74 FR at 38272; there is an entirely separate section relating to Rule 204(f) and "sham close-outs" that pertain to market participants who collude with each other. *See id.* at 38278. Moreover, optionsXpress' chief compliance officer referred to footnote 82 as "a very pertinent section in the final rule [204] release" in response to a question regarding the Customers' use of buy-writes. DX60.

dealer who encountered Feldman's use of buy-writes considered the trading a regulatory risk and decided they would not allow it. ID 79-80.

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

optionsXpress claims that Judge Murray's holding that buy-writes were "sham closeouts" under Rule 204(a) renders Rule 204(f)'s prohibition on improper arrangements between parties "superfluous." OPX Br. 25-26. optionsXpress is wrong.

optionsXpress apparently believes that the only way a clearing firm can violate Rule 204 is by violating Rule 204(f). But this argument ignores the plain language of Rule 204(a) that requires a firm to "close-out its fail to deliver position." optionsXpress never closed out its fail-to-deliver position because the buy-writes simply perpetuated failures to deliver from one day to the next. Judge Murray correctly held 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." ID 79.

In support of its position, optionsXpress distorts the record. For example, optionsXpress claims the Division conceded that "optionsXpress *made delivery* of the stock it purchased." OPX Br. 27. The Division conceded no such thing. optionsXpress cites a portion of the report of the Division's expert, Dr. Larry Harris, that calculated how long it took parties ***to receive*** their shares after optionsXpress failed to deliver them. DX310 (¶196). Dr. Harris never stated that optionsXpress made delivery. The fact that firms received their shares from CNS does not mean that ***optionsXpress*** delivered those shares to CNS because each day the "failures to receive" were allocated by CNS to different clearing firms as those with more aged failures to receive moved up in priority. Tr. 80:17-21, 140:18-141:9. As Dr. Harris explained, other member firms delivered the shares that went to these counterparties – ***not optionsXpress***. Tr. 4890:2-20, 4894:4-4897:9 (explaining that optionsXpress' expert wrongly conflates "purchase" with "delivery"). To be clear, there is no permanent correlation between the firm that fails to deliver

at CNS and the firm that fails to receive, because the firms that have fails to receive are constantly changing due to priority allocations.

Next, optionsXpress claims that it did not engage in "naked short selling" because neither it nor Feldman had control over if and when the calls would be exercised and assigned. OPX Br. 29. Judge Murray explained how this contention is belied by the record:

> [B]ased on the character of the calls, publicly available information on the level of open interest, and past experience, Feldman and optionsXpress knew that his deep-in-the-money calls on Sears and other securities would likely be exercised and assigned to him. ***To say that Feldman and optionsXpress had no control over, and were unaware of, the likely creation of short positions in Feldman's account, is not being candid.***

ID 78 (emphasis added).

Finally, optionsXpress claims that "other firms were engaging in the exact same trading at issue here." OPX Br. 30. But there is no evidence that these other firms were using deep-in-the-money buy-writes ***to address failures to deliver***. Moreover, optionsXpress' only support for this bold contention is testimony from a former junior CBOE employee who testified that CBOE specifically surveilled for deep-in-the-money buy-writes to look for possibly violative conduct. This hardly supports the argument that optionsXpress was engaging in standard industry conduct, particularly when the evidence shows every other firm that confronted Feldman's trading promptly shut it down. ID 79-80.

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

optionsXpress makes multiple assertions that CNS data is irrelevant in determining whether there has been a proper closeout under Rule 204(a). Each of these assertions is without merit.

First, optionsXpress cites statistics from its expert, Dr. Atanu Saha, that "the firm's books and records confirmed that the short stock positions...were timely closed out through the customers' legitimate stock purchases virtually 100% of the time." OPX Br. 23. This analysis, however, only proves that, when faced with a failure to deliver, optionsXpress executed a buy-

write. That has never been in dispute. The dispute is whether that buy-write constitutes a valid closeout under Rule 204. More troubling is the fact that optionsXpress' expert makes this claim when he never reviewed the entirety of optionsXpress' "books and records" for the securities at issue and only looked at the firm's records for the Customer accounts, Tr. 4437:7-24, 4442:7-4443:22, nor could he—optionsXpress never produced them to demonstrate that it was "net flat." There is good reason for this. As was admitted by optionsXpress' former chief financial officer, an assignment would be reflected in optionsXpress' books and records as a sale on the day of the assignment (which would be the same day as the alleged "buy" of the buy-write). Tr. 1664:3-1665:6. Thus, optionsXpress' own books and records would demonstrate that at the end of that calendar day it would once again be short on delivering securities to CNS, which is why optionsXpress continued the vicious cycle of buying the Customers in day after day after day.

Second, optionsXpress' claim that delay in settlement can "cause CNS fails to occur for an extended period even when Rule 204(a) admittedly is satisfied," OPX Br. 24, has nothing to do with this case. This is not a situation where thousands of separate trades from thousands of separate customers constituted a firm's failures to deliver at CNS, where one day's failures may not be related to the previous day's failures. Here, optionsXpress allowed a small number of its customers to repeatedly engage in a buy-write strategy that had a predictable outcome and resulted in no delivery of shares to CNS. Tr. 4904:15-17 ("it's highly predictable that the deep-in-the-money call is going to be exercised resulting in a sale"). Notably, other brokers' CNS failures were dwarfed by those at optionsXpress, negating any claim that the failures to deliver were somehow due to regular market activity or were common in the industry.[6]

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[6] For example, optionsXpress was by itself responsible for 64% of all shares that all 273 clearing brokers failed to settle in the CNS system during the periods and the stocks identified in the Order Instituting Proceedings ("OIP"). DX310 (¶¶43, 193-94). Moreover, during these same periods, optionsXpress ranked first among all 273 clearing brokers for the largest failures in 26 of the 44 periods in the OIP, and it was ranked among the top three clearing brokers in 38 of the periods. In 38 of the periods, it ranked first in the average age of its continuous settlement failures. DX310 (¶¶43, 195, Ex. 31).

Finally, optionsXpress' claims SEC guidance suggests that "the age of fails cannot be determined by looking at [CNS data]." OPX Br. 25. But this is comparing apples to oranges. The reference on the SEC's website relates to ***aggregate*** CNS fails across ***every*** NSCC member. That data is not tied to ***specific*** NSCC members. Unlike the data on the SEC's website, the CNS Account Summaries introduced in this case do tie to ***a specific*** NSCC member firm, optionsXpress, and demonstrate the age of optionsXpress' own failures to deliver.

D. optionsXpress' Due Process Rights Were Not Violated.

optionsXpress' claim that the Initial Decision violates its due process rights has no basis for three main reasons.

First, courts have long held that it is not "unfair to require that one who deliberately goes perilously close to an area of proscribed conduct shall take the risk that he may cross the line." *United States v. Kay*, 513 F.3d 432, 442 (5th Cir. 2007) (quoting *Boyce Motor Lines, Inc. v. United States*, 342 U.S. 337, 340 (1952)). Clearly, optionsXpress has crossed the line and should be held liable. Rules 204T and 204 are straightforward—optionsXpress was required to immediately close out its failures to deliver at CNS. optionsXpress cannot seriously contend it did not realize this was the point of Reg. SHO or that the conduct at issue was causing perpetual failures at CNS.

optionsXpress was aware of the buy-write activity and its effect from the inception of Rule 204T. optionsXpress' own head trader read an article in the *Wall Street Journal* noting that regulators were cracking down on the type of trading at issue in this case. DX255. optionsXpress' compliance personnel told the traders that the firm should "absolutely not" process the buy-writes because regulators may view the trades as "sham transactions as the SEC did with the two fined prop trading institutions [*Hazan* and *TJM*.]" DX105, 104, 60. Employees of the clearing department even warned that allowing the trading might hurt the firm:

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

DX131 (emphasis added); DX41 ("Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle.").

Yet, the illegal trading continued at optionsXpress. By contrast, Feldman could not conduct his trading at any other firm for more than a few months. For instance, within days, Penson Financial Services ("Penson") – which cleared the buy-writes Feldman placed at another broker-dealer, Terra Nova Financial, LLC ("Terra Nova") – knew Feldman's buy-writes were not resulting in the delivery of shares. Tr. 841:7-23, 907:15-908:5, 913:3-8. As a result, Penson immediately began borrowing shares to cover Feldman's trades – satisfying the firm's Rule 204 responsibilities. This demonstrates that other market participants quickly realized that buy-write trading could lead to Rule 204 issues. Because there was plenty of guidance (besides the plain language of the Rule) that the buy-write activity would violate Reg. SHO, there is no due process issues. *Howmet Corp. v. EPA*, 614 F.3d 544, 553-54 (D.C. Cir. 2010) ("If, by reviewing the regulations and other public statements issued by the agency, a regulated party acting in good faith would be able to identify, with 'ascertainable certainty,' the standards with which the agency expects parties to conform, then the agency has fairly notified a petitioner of the agency's interpretation. This court has held published agency guidance may provide fair notice of an agency's interpretation of its own regulations.") (citations omitted).

Second, that the exact facts in this case had not previously been addressed in any litigated case is irrelevant, and certainly does not mean that optionsXpress' due process rights have been violated. Courts have emphasized that due process is not necessarily offended even where "there is no litigated fact pattern precisely in point," as this may "constitute a tribute to the cupidity and ingenuity of the malefactors involved but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved." *SEC v. Wills*, 777 F. Supp. 1165, 1173 (S.D.N.Y.

1991), *reaffirmed*, 787 F. Supp. 58 (S.D.N.Y. 1992) (*quoting United States v. Brown*, 555 F.2d 336, 339–40 (2d Cir. 1977)).

Finally, optionsXpress distorts the record to claim that employees in TM found that the trading did not constitute a violation of Reg. SHO. Ms. Tao testified that she never told anyone at CBOE that optionsXpress had complied with Reg. SHO. Tr. 3609:10-23, 3611:2-3612:1. Moreover, CBOE was focused on an individual customer, not optionsXpress, and the CBOE employees had mistakenly told Ms. Tao that there were no failures to deliver. Tr. 4035:19-4036:15, 3610:4-8. In any event, Ms. Tao told CBOE to refer the case to the Division for potential enforcement action as she thought the conduct may be fraudulent. Tr. 3647:6-3648:4.[7]

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

The issue of the buy-writes' execution times is only relevant if the Commission somehow decides that the buy-writes otherwise constituted a valid closeout under Rule 204(a). Because the Commission should hold that the buy-writes were not a valid closeout under Rule 204(a), the Commission need not reach the issue of whether the buy-writes were executed at market open. In any event, Judge Murray correctly found that optionsXpress did not close out its failure-to-deliver positions in a timely fashion on T+4. ID 77-78. optionsXpress' arguments that the buy-writes were executed before 10:00 a.m. on T+4 are all unavailing.

optionsXpress' claim that the Division "failed to prove that any specific trades were late" is false. ***First***, the Division established that optionsXpress' clearing department frequently could not even calculate its T+4 trades until well after the market opened and even when the data was

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[7] optionsXpress cites an email from Ms. Tao where she mentioned seeking to propose a new rule as alleged evidence that she thought the trading did not violate Reg. SHO. OPX Br. 33 n.127. But optionsXpress fails to mention that Ms. Tao testified that this email related to "customers who are not under Reg. SHO." Tr. 3661:25-3663:13. In that same email, Ms. Tao also stated that a Division attorney "might bring this case if they are going to refer it." RX559. Thus, optionsXpress' claim that the authors of Rule 204 "believed the rule needed to be amended to cover the buy-write trading at issue here" is a gross overstatement. OPX Br. 33. After all, why would Ms. Tao state that the Division may bring an action if she thought the Rule did not cover the conduct at issue?

calculated the trade desk did not execute the trades in a timely fashion. ID 77-78. ***Second***, the trading records, DX1, contain numerous examples of buy-writes executed after 10:00 a.m. on T+4.[8] In short, optionsXpress consistently executed buy-writes well after market open, further evidence that optionsXpress did not take its Reg. SHO obligations seriously.

II. FELDMAN COMMITTED SECURITIES FRAUD

Feldman's scheme to profit by not delivering shares that he sold short is the kind of deceptive conduct that has long been illegal under the federal securities laws. The Division is not attempting, as Feldman claims, to find him liable for fraud based on his broker's violation of Reg. SHO. Instead, it is Feldman's own actions that make him liable for securities fraud. He was not a completely naïve trader. Instead, he was a sophisticated trader[9] who understood the system and profited solely because he manipulated it to his advantage.

A. The General Anti-Fraud Provisions Of The Federal Securities Laws Prohibit Feldman's Conduct.

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit (a) employing "any device, scheme, or artifice to defraud" or (c) engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." Section 10b-5 does not require that there be a specific oral or written statement; "conduct itself can be

[8] Two examples: *First*, on Monday, July 6, 2009, Feldman was assigned 61 calls in UA and was thus short on that day ("T") 6,100 shares. DX310 (Ex. 6 (p. 46)). Because he failed to deliver 5,100 of those shares by Thursday, July 9, 2009 ("T+3"), Feldman placed a buy-write on July 10, 2009 ("T+4") for 5,100 shares (and 51 calls). *Id.* This buy-write was executed on T+4 at 12:09 p.m., more than two-and-a-half hours after market open. DX1 (rows 50617, 50665). *Second*, on Wednesday, January 27, 2010 ("T"), Feldman was assigned 4 calls in LPHI and was thus short on that day 400 shares. DX310 (Ex. 6 (p. 22)). Four trading days later, on Tuesday, February 2, 2010 ("T+4"), Feldman placed a buy-write for 4 calls (and 400 shares) at 2:45 p.m., more than five hours after market open. *Id.*; DX1 (rows 56903 & 56962).

[9] Feldman's trading was large. For example, on December 31, 2009, Feldman entered into a buy-write for 516,600 shares of Sears (SHLD). The value of the stock at issue was $43 million – 32% of the 1,603,300 SHLD shares that were traded in the United States that day. DX310 (¶24, Ex. 6). Trades of this size were not unusual for Feldman. *Id.* The maximum value on any day of any of Feldman's buy-writes for SHLD was $84.6 million. DX310 (¶27). In 2009 alone, Feldman purchased at least ***$2.9 billion*** of securities and sold short at least ***$1.7 billion*** of options through his account at optionsXpress. DX74-75, 89 (p. 4) ("[m]y annual 1099! [for 2009] Will be over $2bb"). Indeed, Feldman was a sophisticated trader who optionsXpress treated as an institutional investor. Tr. 1196:10-18, 4526:3-22.

deceptive." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008). In *Ernst & Ernst v. Hochfelder,* the Supreme Court stated that Section 10(b) reflected "overall congressional intent to prevent 'manipulative and deceptive practices which...fulfill no useful function.'" 425 U.S. 185, 206 (1976). The Supreme Court recognized that Section 10(b) is "'a catch-all clause to prevent manipulative devices'" designed "to enable the Commission 'to deal with new manipulative (or cunning) devices.'" *Id.* at 202-03 (quoting a spokesman for the drafters, during hearings prior to enactment of the Exchange Act). It is for this reason that the securities laws and rules must be read broadly and flexibly and not "technically and restrictively." *SEC v. Zandford,* 535 U.S. 813, 819 (2002). These laws are enacted for the purpose of protecting against fraud and are designed to prevent "all the ingenious variations of security fraud that arise." *United States v. Jensen,* 608 F.2d 1349, 1354 (10th Cir. 1979). Feldman's scheme is simply another variation of securities fraud.

1. Feldman's trading strategy was a manipulative scheme that deceived the market.

Trading is a classic form of conduct that can be deceptive. Feldman's trading scheme – the sale of option contracts with no intention of fulfilling the terms of those contracts – is a type of conduct that courts have already found to be fraudulent. In *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, the Supreme Court held that selling an option while secretly intending not to fulfill one's obligations under the options contract is securities fraud. 532 U.S. 588, 596-97 (2001). "To sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith." *Id.*; *see also Walling v. Beverly Enterprises*, 476 F.2d 393, 396 (9th Cir. 1973) (entering "into a contract of sale with the secret reservation not to fully perform it is fraud cognizable under §10(b)").[10]

[10] Feldman's claim that his due process rights were violated because there was no clear notice of his violation has no merit. As described above, this type of conduct has long been held to be a violation of the securities laws. Further, Feldman's claim that different divisions within the SEC disagreed about the meaning of an unspecified rule, Feldman Br. 17, is inapposite. *First,* Feldman is not

The record is unequivocal that market participants were deceived by Feldman's manipulative conduct. ***First,*** certain investors were deceived about the nature of the trading as it related to the reported volumes. For example, Feldman himself admitted that he was aware that people on the message boards were confused about his trading. Tr. 2271:8-2274:3. Indeed, Feldman bragged about the effect of his trading on the market to a floor broker telling him that the Yahoo! message boards were "shaken up" that upward of 50 to 75 percent of the daily volume in Sears occurred on "one block print." Tr. 1297:19-1298:13. Feldman knew and "had a good laugh" that his buy-writes were "panicking other people on message boards."[11] *Id.*

Second, other market participants were deceived because they did not receive their shares when delivery was due.[12] DX310 (¶¶83-88). The ultimate purchasers and clearing brokers would reasonably have assumed they would receive shares they bought in the open market within the standard three-day settlement period.[13] 73 FR at 61667 ("all buyers of securities have the right to expect prompt delivery of securities purchased"). However, Feldman did not make delivery on

being charged with a violation of Reg. SHO—he is charged with fraud. *Second,* if he is claiming that TM cleared his fraudulent conduct, the evidence is actually to the contrary. The notes of optionsXpress' call with TM note that Feldman may have been engaged in fraudulent sham transactions. RX729 (p. 3); *see also* Tr. 3591:18-3592:7.

[11] Feldman claims that he was open and honest by describing his trading strategy in public forums, Feldman Br. 7, however, Feldman never told the market that he was not delivering stock. For instance, as Judge Murray noted, when questioned on a blog about how he was able to handle the inevitable delivery requirements resulting from his strategy, Feldman never responded. ID 90; *see also* DX383; RX866.

[12] Feldman claims that the marketplace could not been deceived because it had full view of the options' open interest and volume. Feldman Br. 35. This, he claims, would have shown that there was "frequent same-day exercise of written calls." *Id.* It is true that someone such as Feldman, who followed the open interest and volume closely, would have seen that his calls were likely to be assigned. Feldman's Answer ¶¶147, 149; Tr. 2202:16-18; DX218, 375 (¶¶45, 63, Ex. 5); Tr. 1327:1-14. However, not all persons who purchase ***stock*** review, or should be expected to review, ***options*** open interest and volume in order to determine whether or not their stock will be delivered on time.

[13] Equity options are "physical delivery" options which means that "there is physical delivery of the underlying stock" on "third business day following exercise." CBOE, *Equity Options Product Specifications*, www.cboe.com/products/EquityOptionSpecs.aspx; *see also* OCC, *Equity Options Product Specifications*, http://www.optionsclearing.com/clearing/clearing-services/specifications-equity-options.jsp. These terms are part of the basic options contract provisions upon which all exchange-traded equity options purchases and sales are based. Thus, Feldman's claim that he made no "representation or [] promise to the marketplace," Feldman Br. 14, is simply not true.

T+3, instead, he sold a buy-write.[14] DX310 (¶¶83-88). Far from satisfying his delivery obligation, the deep-in-the-money buy-writes that Feldman traded served to only further delay delivery.[15] *Id.* While the use of buy-writes in some circumstances is an entirely appropriate investment tool, Feldman's use of the buy-write here allowed him to avoid delivering stock to other market participants – in other words, they were matched orders set up to avoid delivery obligations. Manipulative and deceptive devices such as this have long been prohibited by the anti-fraud provisions of the securities laws. *Hochfelder*, 425 U.S. at 206 & 205 n.25 (holding matched orders are "orders for the purchase/sale of a security that are entered with the 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/purchase of such security."); *cf. Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) ("[P]ractices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the regulatory agency have been found practically essential.") (internal quotations omitted).[16]

[14] Feldman claims that "unrebutted evidence" showed optionsXpress' books and records demonstrated that the stock was delivered on time. Feldman Br. 42. Indeed, the evidence was to the contrary. *See supra* Section I.C.

[15] Feldman claims that a failure to deliver does not necessarily mean that there is a failure to receive, citing Sirri's report. Feldman Br. 36. This statement is facially ridiculous. As optionsXpress' expert testified, a "fail to receive and fail to deliver, they will net out in CNS. They are exactly equal to each other." Tr. 4461:23-25; *see also* Tr. 64:7-25; SEC, *Division of Market Regulation: Reponses to Frequently Asked Questions Concerning Regulation SHO*, Question and Answer 7.1 (last modified Apr. 10, 2012) http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

[16] Feldman cites *United States v. Finnerty*, 533 F.3d 143 (2d Cir. 2008), for the proposition that "the submission of an order alone cannot serve as a basis for liability under Rule 10b-5." Feldman Br. 15. Feldman's reliance on *Finnerty* is misplaced. *First*, the facts of *Finnerty* are inapposite. In *Finnerty*, the Second Circuit overturned a criminal conviction where Finnerty had surreptitiously interposed his trades between the buyers and sellers of publicly-traded stock to conduct otherwise arms-length stock transactions and profit from both transactions. The court found that the purchasers and sellers of the stock received the benefit of their bargain. *Finnerty*, 533 F.3d at 145. As the court in *SEC v. Simpson Capital Mgmt., Inc.*, 586 F. Supp. 2d 196, 204 (S.D.N.Y 2008) noted in distinguishing *Finnerty:* "[A]ll that Finnerty did was to execute trades at disclosed terms…[he] did not deceive either the buyer or the seller with respect to the terms of their trades. Each side of the trade knew what it got— the shares purchased or sold and at what price." *Id.* at 204. Here, unlike in *Finnerty*, the purchasers of Feldman's sales did not receive the benefit of their bargain – they were deceived as to the terms of their

2. Feldman's argument that there was no harm should be disregarded.

Feldman claims he cannot be held liable because there is "no evidence in the record that anyone in the marketplace suffered any harm." Feldman Br. 35. This argument should be disregarded because it is wrong both as a factual and legal matter.

First, other firms' failure to receive shares in a timely manner did, in fact, harm market participants. For instance, there were numerous notices of intent to buy-in issued by market participants who had failures to receive at CNS on days when optionsXpress and Feldman had failures to deliver.[17] DX54. These notices sought delivery of shares the market participants had not received on a timely basis, indicating they wanted their shares to be delivered. *Id.* (showing optionsXpress received notices of intent to buy-in on at least 161 occasions).[18] A former employee of Penson and an employee of E*Trade both testified that failing to receive shares can cause firms financial and regulatory problems. Tr. 4811:1-4812:22 ("it could run the risk of having possession and control impact"); Tr. 784:25-785:16 (Penson).

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trades. *See, e.g.,* DX310 (¶¶15, 49, 85-86). Simply put, purchasers did not get their shares in a timely fashion as a result of Feldman's trading. Further, there is clear and unequivocal evidence that other market participants were deceived about the nature and purpose of Feldman's trading. *See supra* Section II.A.1. *Second*, the Second Circuit has given *Chevron* deference to the Commission's post-*Finnerty* adjudicatory decision finding Finnerty's conduct to be deceptive, which the Second Circuit has held "'trumps' [the Second Circuit's] prior interpretation in *Finnerty*." *VanCook v. SEC,* 653 F.3d 130, 141 (2d Cir. 2011) (citations omitted).

[17] Where a seller of securities fails to deliver securities on settlement date, the seller in effect unilaterally converts a securities contract (expected to settle within the standard three-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently. 73 FR at 61709; 74 FR at 38267; DX310 (¶¶15, 49, 85-86). Large and persistent failures to deliver may also deprive shareholders of the benefits of ownership, including voting and lending rights, and create a misleading impression of the market for an issuer's stock. 73 FR at 61723; 74 FR at 38267; DX406 (p. 4); DX310 (¶86). As a result of optionsXpress' and Feldman's failures to deliver, the brokers and their clients who bought stock that did not settle on time did not receive the stock they could have lent at very high rates. That lost opportunity was worth $7,214,977. DX310 (¶¶41, 199, Ex. 28). Moreover, market participants recognize the importance of having trades that reliably settle according to the agreements made between traders. If these agreements are not regularly honored, traders would not be willing to allow brokers and exchanges to arrange trades with strangers. Such constraints would greatly increase the costs of trading for everyone and would greatly complicate the search for best price. DX310 (¶87).

[18] In addition, market makers complained to CBOE about the activity. Tr. 3818:2-15, 3913:5-9.

Second, Feldman's argument is wrong as a legal matter because the Division does not have to prove actual harm. *SEC v. Wolfson*, 539 F.3d 1249, 1256 (10th Cir. 2008). In another abusive short selling case, the Supreme Court held that under Section 17(a)(1) there is no requirement that the government prove an impact on an actual investor. *United States v. Naftalin*, 441 U.S. 768, 776 (1979). As the Supreme Court in *Naftalin* recognized:

> [T]he welfare of investors and financial intermediaries are inextricably linked—frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole. ***Fraudulent short sales are no exception. Although investors suffered no immediate financial injury in this case because the brokers covered the sales by borrowing and then "buying in," the indirect impact upon investors may be substantial.*** "Buying in" is in actuality only a form of insurance for investors and, like all forms of insurance, has its own costs. Losses suffered by brokers increase their cost of doing business, and in the long run investors pay at least part of this cost through higher brokerage fees. ***In addition, unchecked short-sale frauds against brokers would create a level of market uncertainty that could only work to the detriment of both investors and the market as a whole. Finally, while the investors here were shielded from direct injury, that may not always be the case. Had the brokers been insolvent or unable to borrow, the investors might well have failed to receive their promised shares.***

Id. at 776-77 (emphasis added) (internal citations omitted). In this case, market participants failed to receive their promised shares in a timely fashion. As recognized in *Naftalin*, when a firm is unable or unwilling to cover its delivery obligations, investors who failed to receive their promised shares are harmed. In addition, all broker-dealers and customers end up paying for unchecked short-sale fraud in the form of "market uncertainty," *i.e.* harm to market integrity. DX310 (¶¶15, 83-88).

3. Feldman's *Janus* argument should be rejected.

Feldman's argument that the decision in *Janus Capital Group, Inc. v. First Derivative Traders,* 131 S.Ct. 2296 (2011), protects him from liability should be summarily rejected. Feldman Br. 36. ***First,*** *Janus* was based on the word "make" in subsection 10b-5(b). Here the applicable subsections, (a) and (c), prohibit (a) employing "any device, scheme, or artifice to defraud" and (c) engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." Neither contains the word "make." Thus, *Janus*

is not applicable. ***Second,*** even if a "statement" were required under these subsections, which it is not, Feldman as the architect of the scheme and the person who made the decision to place the orders, was a maker of those statements. *See SEC v. Pentagon Capital Mgmt. PLC*, 725 F.3d 279, 286-87 (2d Cir. 2013) (rejecting argument that traders were not liable because brokers, not themselves, communicated directly with the mutual funds: "To the extent that late trading requires a 'statement' in the form of a transmission to a clearing broker, we find that in this case, [the defendants] were as much 'makers' of those statements as were the brokers."). ***Third,*** Feldman's argument that he could not have made a misrepresentation because "optionsXpress had control over this account" should be rejected. Feldman was, as optionsXpress stated, "a self-directed customer," OXP Br. 10, and thus was responsible for all of his own trading decisions. For example, it was Feldman who "decided to fulfill this 'forced buy-in' requirement through a buy-write...." OXP Br. 11. As the creator of the scheme, Feldman should be held liable.

4. Feldman acted with the requisite scienter.

The scienter required for a Section 10(b), Rule 10b-5, or Section 17(a)(1) violation is "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 193 n.12. Scienter may be established by showing either (1) knowing conduct or (2) "an extreme departure from the standards of ordinary care...which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Dolphin & Bradbury, Inc. v. SEC*, 512 F.3d 634, 639 (D.C. Cir. 2008) (quoting *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992). With respect to direct violations, a willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). "[K]nowledge of one's actions and their consequences is all the law requires; a demonstration of a subjective belief that those actions are illegal is

unnecessary" for purposes of scienter. *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 79 n.32 (D.C. Cir. 1980).

Feldman does not (and cannot) dispute that his trading strategy was executed deliberately and intentionally. As part of his strategy, Feldman sold deep-in-the-money calls knowing that they were likely to be exercised and assigned (or was recklessly indifferent to that probability). As a result of the assignments, Feldman was required to deliver shares by the standard settlement date. Instead of delivering shares, Feldman entered into buy-writes to give the appearance of delivery but for which no delivery actually occurred. Feldman knew that his sales were not settling and that his trading was deceiving market participants. Indeed, he also encountered numerous red flags that his trading posed regulatory risk.[19]

a. Feldman knew his calls would be assigned and stock would not be delivered.

Contrary to Feldman's argument, the record is clear that Feldman was well aware that the calls he sold would be assigned almost immediately, obliging Feldman to deliver stock, which he sought to avoid. "The buy-writes were, as we all know, repetitious, and did happen frequently." Tr. 2182:8-9; *see also* Tr. 2186:11-14 ("Q: [Y]ou knew you were going to get buy-ins on C quite frequently; correct? A. Yes...."). Indeed, on numerous occasions, Feldman was expressly told that his calls were being assigned on a regular (if not daily) basis. For example, one broker told Feldman "***market-makers are always going to assign what you're short***," and that the counterparties to the buy-writes were exercising (or "dropping") "on almost every one" of Feldman's deep-in-the-money calls. DX218. Feldman had a similar discussion with an

[19] At a minimum, Feldman should be held liable for negligence under Section 17(a)(3) of the Securities Act which prohibits any person from engaging in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a)(3); *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999).

optionsXpress trader, who explained: "***the market maker is usually always going to assign*** whatever call [it purchases]...***normally you'll always going to get assigned.***" DX221.[20]

Feldman expressed in writing his understanding that he was going to get assigned on a daily basis.[21] For example, Feldman sent an instant message to a friend, who was engaged in the same trading at optionsXpress: "it [a]lmost doesn't matter, JUL or SEP, ***as u get assigned that night anyway, so what's the diff?,***" DX246 (emphasis added), and even told one floor broker in an instant message, "***See how it happens? Same trade every day. Get assigned stock [sic] + sell options.***" DX89 (emphasis added). Feldman also emailed optionsXpress: "***Can do the same today re shld as yest re buy writes. Same applies tomorrow (Fri) too.***" DX303 (emphasis added). Feldman again emailed optionsXpress, "a buy-write of 2500 SHLD, incurs a commission of $1,250 ***each and every day,***" DX72, and emailed optionsXpress' risk department: "***it's part of my daily routine.*** Brush teeth, get coffee, rest [sic] C [Citigroup, Inc.], cover buyin on C." DX247. Feldman also told a floor broker that he would be placing his buy-writes on a ***daily recurring basis.*** Tr. 1293:19-1294:7.[22]

Moreover, expert analyses confirm that Feldman's deep-in-the-money calls were in fact frequently exercised and assigned on a daily basis. DX310 (¶¶23, 115-19, 130, 141, Ex. 17) (91.9% of Feldman's buy-write call volume that was ultimately closed by assignment was assigned on the same day that Feldman sold the calls; 96.9% was assigned on the day of trade or the first trading afterward); DX375 (¶¶61-64, Exs. 7a-7b) (between 87.9% and 94.5% of Feldman's Sears

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[20] Feldman's claim that his buy-writes had a legitimate purpose, Feldman Br. 33, should be rejected. Circumventing a law is never a legitimate economic purpose. *See, e.g.,* 73 FR at 61715 n.78; 74 FR at 38272 n.82; *Hazan*; *TJM*; DX124, 129, 384.

[21] Feldman's claim that he cannot be liable because the Division did not include in the OIP every security he traded, Feldman Br. 29-31, is a red herring. The evidence clearly shows that Feldman knew he was highly likely to be assigned and was in fact assigned regularly.

[22] Even after the pattern of daily assignment had been established, Feldman continued to increase the size of his position in Sears. In addition, Feldman continued to sell deep-in-the-money calls rather than closer to the money calls, further ensuring that the calls would be exercised. These actions are inconsistent with any claim that Feldman did not expect to be assigned. DX375 (¶66, Ex. 3).

calls were assigned overnight); DX382 (Ex. A3); RX915 (Ex. 13) (percentage of days when at least some calls were assigned on the day of issue: AIG (97%), AMED (98%), APWR (77%), CSKI (91%), C (98%), LPHI (91%), MJN (100%), MNKD (75%), OSIR (100%), SHLD (97%), SEED (100%), TLB (100%), TXI (95%), and UA (83%)); Tr. 4505:24-25 ("[I]f it's deep-in-the-money, there is [a] fair amount of assignment risk."). There should be no doubt that at the time he was trading Feldman knew (or was reckless in not knowing) that there was a very high likelihood that his calls would be exercised and assigned.

Further, Feldman knew that his trading resulted in failures to deliver. optionsXpress told Feldman, "[b]y shorting options deep in the money, to get assigned, your trade date position stays constant, and ***the settled position never closes or goes long.***" DX58 (emphasis added). optionsXpress also told Feldman that it was "experiencing persistent fails" relating to Feldman's trading. DX28. Feldman told his broker at Terra Nova, "***I don't settle the stock@all.***" DX25 (p. 20) (emphasis added). Feldman also wrote: "So how many SHLD do I have to buy-in today ***(to avoid settlement)?***" DX27 (emphasis added). And in a phone conversation with his Terra Nova broker, Feldman stated: "So I could do a buy-write and ***then I wouldn't settle,***" to which the broker replied, "Exactly. You do a buy-write so you don't...." DX94 (emphasis added).[23]

b. Feldman knew his trading created regulatory concerns.

Feldman was well aware that his trading was raising regulatory concern. Indeed, he was told by optionsXpress that the SEC was investigating his trading. Tr. 2262:12-2264:13. In addition, optionsXpress sent Feldman copies of Reg. SHO on several occasions and a copy of the

[23] Feldman's claim that it is impossible to map a delivery failure to an individual customer emphasizes theory over reality. Feldman Br. 8. The record shows that optionsXpress, Penson, E*Trade, and TD Ameritrade were all able to determine who – Feldman – was responsible for failures or potential failures to deliver. *See, e.g.,* DX28, DX98; DX416, Tr. 4804:18-4805:7. Moreover, Feldman's trading frequently dwarfed all other trading. For example, on 5% of the 385 days on which Feldman traded buy-writes, his buy-write trades were more than all the other trading volume combined. DX310 (¶182, Ex. 24). It is not credible that Feldman thought optionsXpress had this much stock in inventory to lend for free or that optionsXpress was unable to determine that Feldman's outsized trading was responsible for their outsized failure to deliver.

Hazan case.[24] DX58; DX278; RX888; Tr. 2264:12-13. Then, a compliance officer explained to Feldman that "when an assignment results in a short sale in a security we are already failing to deliver, we have to take action to clean up the entire fail immediately." DX28. Feldman responded by asking if there were other ways he could "***restart the clock,***" knowing full well the illegal nature of "restarting the clock" found in *Hazan*. *Id.* (emphasis added).

Another broker-dealer, Terra Nova, also told Feldman that there were regulatory issues with his trading. In fact, within two weeks of Feldman transferring part of his positions to Terra Nova, Feldman was told that Terra Nova's clearing broker, Penson, was requiring him to pay hard-to-borrow fees if he wanted to continue trading. Tr. 2315:15-23. The broker further advised that regulators were concerned about this type of activity and were getting "heavy" or "skittish." Tr. 2299:25-2300:7, 2306:24-2307:24, 2309:1-2309:6; 2310:25-2311:8.

Instead of paying the hard-to-borrow fees at Penson, Feldman headed back to optionsXpress, the only broker that would let him do what he wanted. However, upon his return, optionsXpress increased Feldman's commission rate citing as one of the reasons for the increase the fact that optionsXpress was having to interact with regulators about the trading. Tr. 2317:9-2318:22. Nonetheless, Feldman knew that he had to stay at optionsXpress. DX249 (Feldman telling his friend: "Millions of $$ inc [sic] comissions[sic],,,,yet treat me/us like criminal...But, in the big picture...***it's still quite the gig...where can you get such mkt-bating [sic] retu[r]ns consistently***? so, as disgusting as [optionsXpress are], have to bend over and get raped, and take the punishment[.]") (emphasis added). By this time, Feldman was well aware that there could be regulatory problems, telling a friend: "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. ***(Until someone notifies the SEC< and they shut down the strategy!!).***" DX29 (emphasis added). Even after the SEC sent Feldman a subpoena regarding his trading, he

[24] Feldman claims that *Hazan* is distinguishable because respondents in that case used FLEX options instead of standard, exchange-traded options; however, the respondents in *Hazan* used both FLEX options and standard, exchange-traded options such as those used by Feldman.

continued to trade until he was forced to stop by optionsXpress, which had also received a subpoena.[25] Tr. 2322:20-2323:21.

c. ***Other brokers prohibited Feldman's trading.***

Feldman knew from the outset that his strategy would only work if he did not pay hard-to-borrow fees. Thus, Feldman had to trade at optionsXpress because it was the only broker who would allow him to conduct his strategy for any significant period of time. When Feldman tried his strategy elsewhere, he was shut down.

In late 2009, Feldman decided to try his strategy at Terra Nova, which cleared his trades through Penson. Penson had never seen a strategy like Feldman's before, and thought it was strange to have calls so deep-in-the-money. Tr. 816:22-25. According to Penson, Feldman's deep-in-the-money calls had a high probability of assignment and, in fact, his trading did result in recurring assignments – the high frequency of which was "out of the ordinary" for Penson. Tr. 800:2-5, 820:11-15; 838:5-8. This in turn led to fails to deliver at CNS for Penson. Tr. 911:22-913:6. According to Penson, Feldman's buy-writes never satisfied the original delivery obligation; Tr. 907:21-909:8; 913:3-6, leaving Penson with a failure-to-deliver position at CNS that would never (and did not) change unless Penson borrowed stock to make delivery (which it began doing immediately, and accordingly charged Feldman the borrowing fees). Tr. 778:19-780:7, 781:8-14, 790:3-791:6, 796:17-21. After less than a month, Penson made it clear that they no longer wanted Feldman's business because the failures to deliver caused by Feldman's trading were affecting the clearing broker's ongoing operations and the firm recognized the trading was creating Reg. SHO problems.[26] Tr. 77:21-775:21; 820:16-821:5, 821:24-827:14, 848:6-849:20, 2297:12-19. Indeed, a Penson employee did research into fails to deliver and found a memorandum discussing the violative activity in the *Hazan* and *TJM* cases and believed that Feldman's trading was the same. DX374; Tr. 821:24-827:14.

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[25] Most of these red flags regarding the legality of his trading occurred after the conversation with optionsXpress that Feldman alleges gave him the green light.

[26] In just less than a month, Feldman's account incurred over $336,000 in hard-to-borrow fees. DX347; Tr. 813:19-814:7.

Even after Feldman had been told to leave Penson and had been informed he could no longer do buy-writes at optionsXpress, Feldman tried his strategy in hard-to-borrow securities at TD Ameritrade in late 2011 and early 2012. Tr. 2283:1-2285:5, 2651:14-18. On January 20, 2012, however, TD Ameritrade told Feldman that his "strategy that continues to be executed creates operational risk, market risk, ***and potential regulatory risk*** for the clearing firm....***As a result of these frequent sizable and aged fails to deliver, the firm has absorbed significant*** market, economic, and ***regulatory risk*** to allow this activity to continue." DX416.

Feldman also tried his trading strategy at yet another firm, E*Trade, in 2011. Tr. 2286:20-2287:10; 2650:21-23. Like Terra Nova and TD Ameritrade, he was able to conduct his strategy there only for a very short period of time. *Id.* At E*Trade, Feldman continued to use deep-in-the-money buy-writes and was once again assigned on his calls day-after-day, creating delivery issues and Rule 204 concerns for E*Trade. Tr. 4805:24-4807:23, 4808:11-21. Like Penson, E*Trade did not believe Feldman's use of buy-writes satisfied its delivery obligations to CNS and proceeded to shut down Feldman's trading. Tr. 4847:12-25.

Simply put, Feldman is not the kind of person who takes no for an answer. Feldman went searching for a broker who would allow him to do buy-writes. And, he found only one—optionsXpress. Feldman should be found liable for fraud.[27]

B. Feldman Cannot Escape Liability by Blaming His Broker.

Throughout the hearing, Feldman tried to portray himself as someone who completely relied on his broker. Feldman disclaimed any knowledge of the settlement system and what his responsibilities were as it related to delivery – an argument belied by his contemporaneous communications. In essence, he argues "my broker let me do it so I should not be found liable." Yet, during the hearing, Feldman made clear that he is someone who pushes to get what he wants

[27] Feldman claims that if he had done due diligence and asked his hired expert, Sirri, for advice, he would have been told that his trading was not improper. Feldman Br. 21. However, Sirri testified that he was not offering any opinions about the legality of Feldman's conduct. Tr. 3265:19-3266:4.

and is not the type of person who trusts what others – including his brokers – tell him. Tr. 2250:7-12, 2365:2-2381:25, 2633:6-2640:11 ("Q: Now, is it fair to say when they would tell you various changes and procedures, you – you didn't take it easily, you didn't just sit down and be like, oh, okay, ***you questioned things; right***? A: ***Absolutely.***") (emphasis added). Yet, despite this and the numerous red flags described above, he did not do any due diligence to determine if his trading was legal—nor did he stop trading. Tr. 2654:7-11.

Furthermore, it was Feldman, not optionsXpress, who decided to place the buy-write orders, OXP Br. 2 ("Feldman often wrote a replacement deep in-the-money call option"). In doing so, it was Feldman who took on the ultimate obligation to ensure that purchasers received stock when his options were assigned. DX403; DX405; RX248 (p. 7); Tr. 727:16-728:5; OCC, *Equity Options Product Specifications*; CBOE, *Equity Options Product Specifications*. Indeed, Feldman explicitly agreed in his customer agreement with optionsXpress that he was ultimately responsible for his trades: "[I]t is your intention and obligation, in every case, to deliver certificates to cover any and all sales or to pay for transactions upon our demand" and "optionsXpress acts as your agent to complete all such transactions." DX98 at ¶19.

In addition, Feldman's claim that there was no way he could know if his broker was failing to deliver and that he was "reasonably" relying on his broker are refuted by the evidence which shows that Feldman knew his trading was resulting in failures to deliver. *See supra* Section II.A.4.a. Similarly, Feldman's argument that he cannot be liable because optionsXpress did not charge him hard-to-borrow fees is a red herring. optionsXpress did not borrow the securities—which Feldman knew. Indeed, if it had borrowed the securities, there is absolutely no reason to believe that the firm would have allowed Feldman's trading to continue as long as it did—they certainly would not have eaten over $7 million in hard-to-borrow fees, in order to obtain less than $2 million in commissions. DX310 (¶¶41-42, 190, 199, Exs. 28, 30). optionsXpress would have done what all the other broker-dealers did—charged hard-to-borrow fees or shut down the trading.

Feldman's luck in finding the one broker willing to participate in his scheme does not excuse his conduct. *See Pentagon*, 725 F.3d at 286-87.

Finally, courts have rejected similar "my broker let me do it" defenses. The Second Circuit in *Pentagon* found that traders who were architects of a trading scheme, like Feldman, carried out by brokers they specifically sought out because they would engage in the scheme, like optionsXpress, can be primarily liable under the federal securities laws. *Pentagon*, 725 F.3d at 286-87; *see also Simpson*, 586 F. Supp. 2d at 208 (finding defendants liable where they orchestrated the fraudulent scheme, made investment decisions, and "carefully identified" brokers who agreed to participate).

C. Feldman Violated Rule 10b-21.

Under Rule 10b-21, it is a manipulative or deceptive device or contrivance for "any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date." 17 C.F.R. § 240.10b-21. Rule 10b-21 is aimed at sellers of securities who are required to promptly deliver, or arrange for delivery of, securities to respective buyers who have the right to expect prompt delivery. 73 FR at 61667. "Thus, Rule 10b-21 takes direct aim at an activity that may create fails to deliver." *Id.*

To prove a violation of Rule 10b-21, the Division must show (1) scienter; (2) that an order was submitted to sell an equity security; (3) the seller deceived a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security; and (4) the seller failed to deliver the security. The scienter required for a violation of 10b-21 is the same as for a violation of 10b-5: "a mental state embracing intent to deceive, manipulate, or defraud." 73 FR at 61671 n.55. When determining whether a failure to deliver has occurred under Rule 10b-21, the question is not whether there is a failure to deliver in the

CNS system as it is for violations of Reg. SHO, but rather whether there is a failure to deliver ***by the seller***. 73 FR at 61672. "[S]ellers should promptly deliver the securities they have sold and purchasers have the right to the timely receipt of securities that they have purchased." *Id.* Rule 10b-21 targets the misconduct of sellers, specifically, individual sellers who fail to deliver securities that they sold. *Id.* at 61674.

Here, the record is clear that Feldman submitted orders to sell deep-in-the-money calls on hard-to-borrow securities knowing that they would be promptly exercised and assigned.[28] Moreover, Feldman did not intend to make delivery when those deep-in-the-money calls were exercised and assigned. Instead, he executed buy-writes that did nothing more than give the appearance of purchasing stock for the purposes of delivery but that would not (and, in fact, did not) result in any delivery, which Feldman admittedly understood.[29] In doing so, Feldman deceived purchasers of stock and their clearing brokers.[30] *See supra* Section II.A.1.

The foregoing makes clear that Feldman undertook a trading strategy – *i.e.,* using buy-writes in response to exercised and assigned calls – that resulted in failing to deliver the securities that he was obligated to deliver. In other words, Feldman failed to "promptly deliver the securities [he had] sold and [denied] purchasers [] the right to the timely receipt of securities that they [had] purchased." 73 FR at 61672. As explained above, Feldman undertook this trading strategy with "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 193 n.12. Feldman's manipulative and deceptive trading is precisely what Rule 10b-21 was designed to prevent.

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[28] Options are equity securities. 15 U.S.C. § 78c(a)(11); 17 C.F.R. § 240.3a11-1.

[29] Options are settled by delivering the securities when the options are exercised and assigned. *See supra* note 13.

[30] Feldman's claim that Rule 10b-21 applies only when "a seller provides affirmative assurances to the broker-dealer and thus 'elects to provide its own locate source to a broker-dealer'" is a complete misreading of the Rule. Feldman Br. 34-35. The Rule specifies that it applies not only to broker-dealers, but also to purchasers and to participants of registered clearing agencies. *See also* 73 FR at 61667-69.

III. OPTIONSXPRESS CAUSED AND WILLFULLY AIDED AND ABETTED FELDMAN'S FRAUD.

To establish aiding and abetting liability, it is necessary to show (1) a securities law violation by a primary wrongdoer; (2) "substantial assistance" to the primary violator; and (3) that the accused provided the requisite assistance with knowledge of the securities law violation. *See Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (extreme recklessness is sufficient for knowledge).[31] All of these elements have been established in this case.

A. Feldman Violated the Securities Laws.

Feldman's trading violated Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21, thereunder. *See supra* Section II.

B. optionsXpress Provided Substantial Assistance.

Feldman's fraudulent trading would not have been possible without the substantial assistance of optionsXpress. Indeed, optionsXpress was the only broker that allowed his trading to continue for any length of time. All the other brokers that Feldman tried to use stopped his trading within several weeks and had concerns about the regulatory impact of his trading. *See supra* Section II.A.2. In fact, not only did optionsXpress allow Feldman's trading, they gave him preferential treatment in order to facilitate those trades. They treated Feldman as an institutional client and had dedicated traders tasked specifically with handling his buy-ins and executing his buy-writes. These traders notified Feldman of a Reg. SHO buy-in *prior* to any order execution to afford him the opportunity to place a buy-write in response, DX61; DX79, unlike optionsXpress' other retail customers who were notified of their buy-ins only after a stock purchase had been executed and charged to their accounts. DX61; Tr. 1992:25-1993:5, 1994:2-9, 2026:10-14, 2029:7-2030:23. In other words, other customers never got a chance to respond to a buy-in with a buy-write, like Feldman did. DX107; Tr. 2013:18-2015:7, 2016:5-20. Indeed,

[31] To establish causing liability, the Division must show that optionsXpress knew, or should have known, that its conduct would contribute to the primary violation. *See Robert M. Fuller*, 2003 WL 22016309 (Aug. 25, 2003).

in some instances, these dedicated traders, who worked exclusively with a particular floor broker to execute Feldman's buy-writes, Tr. 1141:24-1142:7, would go ahead and place buy-writes for Feldman—*without* receiving any instructions from him. DX400; Tr. 628:13-19. The buy-writes were crucial to Feldman's fraud—without them the trading would not have been profitable. Tr. 2279:11-2280:14.

C. optionsXpress Acted with Scienter.

optionsXpress was fully aware of the contours of Rules 204 and 204T of Reg. SHO as it applied to deep-in-the-money buy-writes and encountered numerous red flags – including specific warnings by regulators – that Feldman's trading was potentially unlawful. Nonetheless, optionsXpress deliberately ignored those red flags, misled its regulators, and took every opportunity to knowingly avoid its regulatory obligations so that Feldman's trading (and the firm's resulting commissions) could continue. In short, optionsXpress' conduct is the epitome of aiding and abetting fraudulent behavior.

1. Regulatory guidance is clear that buy-writes used to satisfy close out obligations are problematic.

optionsXpress' claims that Rules 204T and 204 have "never been clear" and are "silent on the subject" of using deep-in-the-money buy-writes to close out failures to deliver is wrong. OXP Br. 39-41. As described in detail above, *see supra* Section I.A.2, the regulatory guidance was clear that the use of buy-writes in this way is highly problematic and indicative of attempts to circumvent Reg. SHO's close-out requirements. Any reasonable market participant would have realized that Feldman's pattern of buy-writes would lead to CNS failures if his positions were not shut down. Indeed, that is exactly why ***every other broker-dealer*** Feldman tried quickly stopped his trading. By contrast, optionsXpress is the ***only firm*** that did not act in the manner expected of regulated entities. Instead, it chose to ignore the regulatory guidance issued

by the SEC, CBOE, and AMEX.[32] These included (1) the SEC's 2003 release regarding the use of married stock-option transactions to give the appearance of a long position; (2) the initial Reg. SHO adopting release in 2004;[33] (3) AMEX's *Arenstein* cases and companion guidance in 2007;[34] (4) the CBOE circulars issued in 2007 and 2008;[35] (5) the SEC's Rules 204T and 204 releases issued in 2008 and 2009, respectively; and (6) the *Hazan* and *TJM* cases.

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[32] optionsXpress cites a GAO Report to support its claim that Reg. SHO lacks clarity. OPX Br. 40-41. The report provides no such support. *First*, the report says nothing regarding the use of buy-writes to close out failures to deliver; if anything, it reinforced that such trades could violate Reg. SHO. RX646 (p. 55) (discussing the *Arenstein* cases). *Second*, as explained above, by the time the Report was issued in May 2009, industry guidance had been well-established that married stock-option transactions, like buy-writes, were highly questionable (as further confirmed with the *Hazan* and *TJM* cases three months later). *Third*, the Report, contrary to "condemn[ing]" TM for some industry officials' claims that its responses for requests for interpretative guidance on Reg. SHO was "varied and, at times, untimely," OPX Br. 40, found that TM did not believe issuing formal guidance was appropriate for some requests "because they felt the regulation was *clear*," the requests were more for a change of the rule (requiring Commission approval) than an interpretation, or the requests were attempts to find loopholes in Reg. SHO, rather than attempts at compliance. RX646 (p. 11, 64) (emphasis added); *see also* Tr. 3746:12-3747:18. *Fourth*, there was no uncertainty or confusion on the part of the three other broker-dealers Feldman tried – *none of whom requested guidance from TM* – who recognized within weeks that Feldman's deep-in-the-money buy-writes posed regulatory risk and promptly stopped the trading. *Fifth*, there was no uncertainty or confusion on the part of two SROs – FINRA and CBOE – who, by the time of the Report, independently recognized that the buy-writes warranted investigation for possible violations of Reg. SHO.

[33] Here, the SEC reiterated guidance that a transaction that lacks legitimate economic purpose cannot be used to circumvent regulatory requirements. The release discussed a non-bona fide, "sham transaction" – *not involving pre-arrangement with another party* – in which the covering transaction "is structured such that there is no legitimate economic purpose or substance to the contemporaneous purchase and sale, no genuine change in beneficial ownership, and/or little or no market risk...." 69 FR 48008, 48021 (Aug. 6, 2004). In giving an example of such a transaction, the release described essentially what occurred with Feldman's buy-writes; that is, an individual trader "plac[ing] ***limit orders to sell and buy the same amount of shares***, and the transaction is crossed in the individual's brokerage account. There is no change in beneficial ownership and no market risk associated with the transaction; i.e., these are 'wash sales.'" *Id.* n.126 (emphasis added).

[34] Nonsensically, optionsXpress refers to its review of the *Arenstein* cases as evidence that it "proactively sought" guidance from regulators, OPX Br. 41, when in fact optionsXpress never reached out to the contact persons listed on AMEX's circular for guidance. Tr. 2910:3-12; 3503:18-3504:9; ID 83.

[35] Unsurprisingly, optionsXpress never "proactively sought regulatory guidance," OPX Br. 41, from CBOE when the circulars were issued or reached out at any time to the contact persons listed on these circulars. *See* ID 81, 83-84; Tr. 3502:2-13. CBOE was only in contact with optionsXpress because it was investigating one of the Customers' trading.

2. optionsXpress encountered numerous red flags.

In addition to clear regulatory guidance, optionsXpress encountered numerous other red flags that Feldman's deep-in-the-money buy-writes were highly unusual and posed regulatory risk:

- ***Daily Assignments***: optionsXpress knew that the trading pattern – and assignment of calls – was to repeat day after day after day. optionsXpress employees referenced the "daily," "chronic," "perpetual," and "rolling" buy-ins on numerous occasions, and expressed the near-certain expectation that the calls would be immediately assigned, *see, e.g.,* DX41 ("Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle"); DX33 ("It's cheaper...to do the deep in the money buy write and get assigned the next day than to put on a married put."); DX133 ("Each day the [Feldman] account sells deep in the money calls, and he gets assigned the following day."); DX221 ("the market maker is usually always going to assign whatever call [it purchases]...normally you'll always going to get assigned"); *see also* DX253; Tr. 1273:6-21.[36]

- ***Resulting CNS Failures***: optionsXpress knew (or was extremely reckless in not knowing) that the "vicious cycle" of buy-writes resulted in no delivery of shares to CNS, as epitomized in an optionsXpress trader's explanation to Feldman that his positions were "***always short***. By shorting deep in the money calls, to get assigned, your trade date position stays constant, and the ***settled position never closes or goes long.***" DX58 (emphasis added); *see also* DX28 ("we are experiencing persistent fails"). Indeed, optionsXpress' own Reg. SHO buy-in procedures specifically reference perpetually recurring fails that are "continuously open due to customers being assigned in the money short calls" that were associated with the buy-writes. DX128.

[36] Indeed, optionsXpress knew that market makers had "resting orders" in place to take the other side of these buy-writes – meaning that the counterparties to the buy-writes were anticipating that the trades would occur each day. DX146; Tr. 1163:4-1164:20.

- ***"Definitely Doing This"***: In November 2008, optionsXpress' head trader emailed the head of the firm's clearing department about a *Wall Street Journal* article, DX256, describing the trading activity in the *Arenstein* cases and noting that FINRA had several cases involving similar activity: "There is an article in the WSJ about how short sellers in SHLD are using options to circumvent the SEC cover rule. I think we need to review this." The immediate response was: "[The Customers are] definitely doing this." DX255. Despite recognizing that the Customers were using options to circumvent Reg. SHO, optionsXpress continued the buy-writes.

- ***"Troublesome" Similarities***: On August 6, 2009, after reading the *Hazan* and *TJM* cases, an optionsXpress compliance officer circulated an email identifying "troublesome" similarities between those cases and the Customers' trading activity. RX678. He also noted that the "end result" of the trading in those cases and the Customers' was essentially the same: "the shares are bought-in, but the subsequent exercise or assignment of the option that night results in ***a continuation of the fail.***" *Id.* (emphasis added).[37] Despite recognizing that the Customers' fails were continuing, optionsXpress continued the buy-writes.

- ***"Absolutely Not"***: the same optionsXpress compliance officer emphatically instructed optionsXpress traders in early 2009, in August 2009, and again in September 2009 that the firm could not and should not execute buy-writes in response to Reg. SHO buy-ins. Tr. 3511:3-3512:3; DX109. Indeed, when asked by traders on August 20, 2009, if optionsXpress could continue executing the Customers' buy-writes, he responded "absolutely not," adding that optionsXpress "do[es] not want to be an active party in the call transactions" and if it "process[ed] the buy-write, regulators could consider the buy-ins as sham transactions," as the

[37] optionsXpress trumpets the fact that he also distinguished the trading from these cases in his email, OPX Br. 42, but that is of no moment. Just two weeks after his email, he (again) told the firm's traders that the buy-writes had to stop. DX104.

SEC did in *Hazan* and *TJM.* DX104.[38] Despite these unequivocal admonitions, the buy-writes were allowed to continue.

- ***"I am not placing any orders"***: On the morning of September 23, 2009, one of the traders designated to process Feldman's buy-writes read *Hazan* and sent an email to his supervisor and another trader with a summary of the case to alert them to *Hazan*'s similarity to the Customers' trading. DX149; Tr. 1150:1-1151:2. Immediately after receiving the email, the other trader emailed his supervisor and stated "I am not placing any orders today." DX35. Nonetheless, the traders were told to continue the buy-writes.[39]

- ***"This is going to bite us"***: Later on September 23, 2009, an officer in the clearing department emailed a compliance officer, reiterating that compliance had earlier warned to stop the buy-writes: "Phil [Hoeh] basically said the same thing. Cannot cover a short as a buy write. The orders must be placed separate. ***Don't want to get anyone in trouble, but somewhere down the road this is going to bite us....***" DX131 (emphasis added). Despite sensing trouble with the buy-writes, optionsXpress allowed them to continue.

In analogous cases where brokers have encountered similar red flags, courts have found those brokers liable for aiding and abetting a fraud. For example, in *Graham v. SEC*, 222 F.3d 994 (D.C. Cir. 2000), the court held a broker liable for aiding and abetting a customer's fraud by executing trades that were a part of a manipulative scheme despite noticing "numerous suspicious circumstances" with the trading. *Id.* at 1004-05. Here, as in *Graham*, there were numerous suspicious circumstances: optionsXpress knew (or was extremely reckless in not knowing) that: (1) the pattern would repeat day after day after day in a "vicious cycle"; (2)

[38] The officer forwarded his email to his supervisor stating "we do not want to be an active participant in the call trade. They will need to do that trade on their own. I believe that if we do the buy-write for them, auditors [like FINRA or SEC] will consider them sham transactions as the SEC did with the two fined prop trading firms [Hazan and TJM]." DX105.

[39] Tellingly, after the traders were told by their supervisor to continue with the trades, the traders immediately forwarded the supervisor's go-ahead to their personal email accounts to document that they had raised the issue with their boss. DX35; DX149; Tr. 1151:11-23.

delivery was not taking place as the Customers' positions were "always short" with "perpetually" open fails; and (3) the buy-writes posed regulatory risk, could be considered as "sham transactions" by regulators, and could ultimately "bite" the firm.

3. optionsXpress never received "comfort" from any regulator.

In the face of regulatory guidance and numerous red flags, optionsXpress can only resort to claiming that it received "green flags" from regulators that the buy-writes were permissible. The firm received no such clearance or comfort.

- ***CBOE***: optionsXpress claims that CBOE's letter of caution resulting from the investigation means that CBOE "notified" optionsXpress that it found no Rule 204 violation. OPX Br. 15, 37. That is incorrect. CBOE never informed optionsXpress that the trading did not violate Reg. SHO or that it did not have concerns with the buy-writes. Tr. 3959:5-3960:4, 4063:23-4064:14.[40] To be clear, the letter never mentioned that deep-in-the-money buy-writes were proper close-outs under Reg. SHO.

- ***FINRA and SEC***: In May 2009, FINRA initiated its first investigation of the Customers' trading at optionsXpress related to compliance with Rule 204T.

  - *September 24, 2009 call with FINRA*: optionsXpress called FINRA to discuss the Customers' trading and the status of FINRA's open Reg. SHO investigations. DX233; RX665; Tr. 2688:3-10. FINRA told optionsXpress that it would not comment on the trading because its investigations were still ongoing, RX665; Tr. 2725:25-2726:23, and that it

[40] optionsXpress points to two letters from December 2010 claiming that CBOE found no violations of Rule 204 in connection with the trading activity. OPX Br. 18. The Commission should give these letters no weight. *First*, optionsXpress could not have relied on these letters to justify its conduct as they were received well after the trading had ceased in March 2010. *Second*, as well established at the hearing, the single CBOE employee responsible for the letters did only a cursory review of the information provided by optionsXpress and lacked a basic understanding of Reg. SHO. Tr. 4658:8-16, 4680:16-4681:22.

could not provide any guidance, Tr. 2690:2-11, 2695:14-18. FINRA continued to investigate optionsXpress for Reg. SHO violations after the call. Tr. 2695:19-2696:8.[41]

➢ *September 24, 2009 call with TM*: optionsXpress officials called TM. On the call, Ms. Tao told optionsXpress that their customers may be engaging in a fraud. Tr. 3591:25-3592:8. The notes of this call from optionsXpress' in-house counsel state "we do not fall into the sham transaction → the customer may." RX729. optionsXpress claims that TM told the firm to "keep doing what you're doing, keep closing out." OPX Br. 16. But anything conveyed to optionsXpress on the call was based on a misleading fact pattern provided by the firm, DX168 at 324:10-327:15, Tr. 1738:18-1739:6, 1746:2-14, and on the assumption that optionsXpress was actually "closing out" its Customers' fails, *see* Tr. 3591:6-17, 3592:9-14, which it was not.

➢ *October 2, 2009 call between FINRA and TM*: TM learned that FINRA had an open investigation into the trading, that the pattern of trading involved deep-in-the-money calls, and that the calls were being sold at virtually the same time the buy-in was executed, DX237; Tr. 2838:5-2839:2; ***facts which were not disclosed by optionsXpress on the September 24 call with TM***. DX208, 237, 241, 243; Tr. 3592:9-23, 3595:1-14, 3598:24-3600:4. Based on FINRA's description of the trading, TM stated that it would not consider optionsXpress to be in compliance with Reg. SHO, DX237; Tr. 2815:20-2816:5, and told FINRA that "it would contact [optionsXpress] and tell the firm that it's [sic] understanding is that there may be a difference in the facts as they were presented so the SEC is not going to get involved or provide an opinion on the issue." DX237.

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[41] Puzzlingly, optionsXpress points to this call as evidence that it "proactively sought regulatory guidance" from FINRA. OPX Br. 41-42. On the contrary, optionsXpress and FINRA had been in communication because of FINRA was *already investigating* the buy-write activity. Far from being "proactive," optionsXpress went so far as to inform FINRA that they did not know the Customers' motivation for entering into the buy-writes, Tr. 3526:17-3528:17, ***despite evidence that they did in fact know***, *see* DX33; RX678.

➢ *October 2, 2009 call with TM*: TM called optionsXpress and told the firm that the SEC declined to get involved and it could provide "no comfort." *See* DX208, 241, 243; Tr. 3595:1-14. After the call, Ms. Tao emailed FINRA a summary of her discussion with optionsXpress: "We just told [optionsXpress' in-house counsel] that we have spoken to you and that ***we now understand there are additional facts and different facts from what they told us***, and as a result, we can provide no comfort and decline to get involved....She started to ask about the different facts and we said she has to talk to you. She was a bit flustered." DX241 (emphasis added).

➢ *October 2, 2009 call with FINRA*: After the SEC refused to provide any comfort to optionsXpress, optionsXpress reverted back to FINRA. RX668; DX238. FINRA told optionsXpress that if it wanted guidance about the trading, it should submit a request in writing to FINRA's General Counsel or the SEC.[42] DX238; RX668; Tr. 2809:7-23. optionsXpress never submitted a written request for guidance and continued executing the deep-in-the-money buy-writes. *See* ID 83-84.

In this regard, optionsXpress' claim that "no regulator ever told optionsXpress that it was violating Rule 204 despite the firm's repeated requests for guidance on the issue," OPX Br. 39, lacks any credibility. According to optionsXpress, unless it was told specifically by a regulator to stop the trading, they had the green light.[43] OPX Br. 17, 39, 42. Yet, at the same time,

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[42] On January 14, 2010, FINRA's Options Regulatory Team also had a call with optionsXpress regarding their concerns about the buy-write activity. Tr. 2912:2-2914:12; DX231. At no time on this call did FINRA staff tell optionsXpress that the trading was lawful. Tr. 2918:16-2919:4.

[43] optionsXpress would have the Commission believe that if it received any red light from a regulator, it would have stopped the activity. But the firm's response to CBOE's letter of caution demonstrates that when it came to the Customers' buy-writes, it would not take "no" for an answer. The letter found that the firm called one customer, and not other customers, prior to the execution of buy-ins in his accounts, which was a deviation from optionsXpress' procedures, thus violating CBOE rules. This deviation allowed the Customers to buy themselves in with a buy-write, an opportunity not afforded to optionsXpress' other customers. Tr. 3956:19-3957:16; *supra* Section III.B. Nonetheless, after receiving the letter of caution, optionsXpress continued to notify the Customers *prior* to any buy-ins and continued placing the Customers' buy-writes. *See* DX1, 359-362. The firm simply ignored CBOE's red light and "kept doing what it was doing" with the Customers' buy-writes. As Judge Murray found: "CBOE and

optionsXpress knows full well that regulators "rarely" do that unless formal guidance is sought. *Id.* 41. optionsXpress cannot ignore the fact that regulated entities are always responsible for ensuring compliance with the law and "cannot blame [regulators] for their failure to carry out their responsibilities." *Stephen J. Horning*, Ex. Act Rel. 318, 2006 WL 2682464, *22 (ALJ Sept. 19, 2006), *aff'd*, *Horning v. SEC*, 570 F.3d 337 (D.C. Cir. 2009); *Certain Broker-Dealers Who Failed to File All or Part of Form BD-Y2K*, Ex. Act Rel. 146, 1999 WL 557616, *12 (ALJ Aug. 2, 1999) ("It is established that a broker-dealer cannot shift its responsibilities for compliance with applicable requirements to the...Commission.").

The *Graham* case is instructive on this issue as well. In *Graham*, the defendants claimed they should not be held liable because the NASD reviewed the trading and the SEC had allegedly blessed the NASD's view that there was no violation. 222 F.3d at 1006-07. The court, however, disagreed noting that the NASD, like CBOE here, did not give the trading a "clean bill of health," but instead had, like CBOE here, reviewed the trading, found that it was "fishy" and "didn't smell right," and concluded in an internal memo that it did not violate a NASD rule. *Id.*; *see also* Tr. 3913:5-3915:9. The defendants also claimed that the SEC blessed the trading as the NASD examiner testified that someone at the SEC "basically agreed" with his interpretation that there was no violation. *Id.* The court in *Graham* held that:

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

Id. at 1008 (emphasis added); *see also SEC v. Culpepper*, 270 F.2d 241, 248 (2d Cir. 1959) ("the Commission would not now be estopped even if it had acquiesced in the...transaction" at issue);

FINRA personnel made clear at the hearing that those regulatory bodies would ***not*** have approved optionsXpress's conduct, if optionsXpress had been candid and made a good faith effort to secure an opinion." ID 84 (emphasis added).

W.N. Whelan & Co., 50 S.E.C. 282, 284, 1990 WL 312067, at *2 (Aug. 28, 1990) ("A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation."). Put simply, optionsXpress never received any blessing from any regulator that the trading complied with Reg. SHO. *See* ID 80 ("the evidence is that regulators did not give the guidance that optionsXpress claims it relied upon"). On the contrary, optionsXpress, far from making "efforts to ensure compliance," OPX Br. 43, made a deliberate business decision to ignore glaring red flags and clear industry guidance to allow the buy-writes to continue.

4. *Howard* provides no recourse for optionsXpress.

optionsXpress relies heavily on *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004) in claiming that it lacked scienter to aid and abet Feldman's fraud. That reliance is misplaced. As explained above, (1) Reg. SHO, and its adopting releases, were not "silent on the subject" of the use of buy-writes to close out failures to deliver, unlike the transactions at issue in *Howard*, 376 F.3d at 1146; (2) industry guidance – in the form of Commission releases, regulatory circulars, and settled cases – was consistently clear that the use of buy-writes in this manner was questionable at best; (3) the firm was alerted by numerous "'red flags' signifying obvious problems," *id.* at 1147, with the buy-writes; and (4) far from encountering "green" flags from its regulators, no regulator – unlike the lawyers in *Howard*[44] – ever approved the buy-writes.

While optionsXpress points to CBOE's letter of caution as one green flag, it was not. As explained above, the letter never cleared the buy-writes. Moreover, the day after the firm received the letter, FINRA told optionsXpress that its investigation was still ongoing and it would not provide any clearance of the trading. Later that same day, TM told the firm that its customers may be engaged in fraud and a week later, told optionsXpress it would provide "no

[44] Moreover, unlike in *Howard*, optionsXpress never consulted or relied upon competent and experienced counsel in choosing to allow the buy-writes. In fact, as discussed above, the one lawyer from optionsXpress' compliance department instructed traders on multiple occasions that the firm should not execute buy-writes in response to Reg. SHO buy-ins and warned his supervisor that in doing so, regulators could consider them to be sham transactions as in *Hazan* and *TJM*. *See supra* Section III.C.2.

comfort" because it learned from FINRA the actual nature of the trading – completely rendering optionsXpress' claimed "keep doing what you're doing, keep closing out" guidance null and void. Having no regulatory cover for its conduct, optionsXpress rushed back to FINRA who instructed the flustered firm to submit a written request for guidance to the SEC or FINRA, ***which optionsXpress never did***. In *Howard*, there was no such evidence that a green flag encountered by the defendant was ever neutralized or cast into doubt or based on misleading facts, unlike the case here. Under these circumstances, by continuing with the buy-writes in the face of numerous red flags – ***and no green ones*** – optionsXpress' reliance on *Howard* is misguided. The facts here are more akin to those in *Graham*: "In *Graham*, what made the defendant's actions reckless, and not merely negligent, was an 'abundance' of 'red flags and suggestions of irregularities [that] demand[ed] inquiry as well as adequate follow-up and review." *Howard*, 376 F.3d at 1149 (quoting *Graham*, 222 F.3d at 1006)).

5. The CBOE Settlement is irrelevant and not inconsistent with the Initial Decision.

The Commission's June 11, 2013 settlement with the CBOE (the "CBOE Settlement") – issued ***thirty-nine months*** after Feldman's trading at optionsXpress ceased – is not a defense. Contrary to the Respondents' arguments, nothing in the CBOE Settlement is inconsistent with the Initial Decision.

optionsXpress claims that Judge Murray's finding that optionsXpress "was not fully forthcoming" with regulators, ID 81, "conflicts" with the CBOE Settlement's finding that optionsXpress "'provided documents to CBOE' sufficient for CBOE to determine that the firm 'was potentially not in compliance with Reg. SHO.'" OPX Br. 43 (quoting CBOE Settlement at ¶10). optionsXpress is overreaching. ***First***, the documents optionsXpress provided to CBOE were in response to the CBOE's *request* for additional information. ***Second***, the CBOE Settlement simply states that optionsXpress provided CBOE with failure-to-deliver data that should have alerted CBOE employees that the firm could be violating Reg. SHO. It ***does not*** say

optionsXpress provided information "sufficient" for CBOE to determine the firm's compliance with Reg. SHO. ***Third***, the CBOE Settlement's findings about that *failure-to-deliver* information in no way contradict the Court's findings that optionsXpress failed to describe its use of deep-in-the-money *buy-writes* to meet its Reg. SHO close-out obligations to CBOE and that optionsXpress failed to ask CBOE (or any other regulator) for an opinion on using such *buy-writes* in this manner. ID 81, 83-84.

optionsXpress also points to the CBOE Settlement's findings that certain CBOE employees lacked a fundamental understanding of, and formal training on, Reg. SHO, as supporting its position that Reg. SHO "has never been clear." OPX Br. 19-20, 40. Again, optionsXpress overreaches. In the CBOE Settlement, the Commission found that certain CBOE investigators did not even know what a "failure to deliver" was, were completely unaware of the relationship between failures to deliver and CNS, and were somehow confused as to whether Reg. SHO applied to *retail customers*.[45] The fact that the Commission found several individuals at CBOE, ***which is not a party to these proceedings***, lacked a basic understanding of Reg. SHO has no bearing on Judge Murray's conclusion that the purpose of Reg. SHO – to address persistent failures to deliver and abusive naked short selling – "has been clear since day one." ID 84. What is certainly relevant is that it was clear to optionsXpress that the trading was so "troublesome" that, on multiple occasions, its own compliance department consistently said "absolutely no[]" to the buy-writes.

Lastly, optionsXpress argues that the CBOE Settlement's finding that CBOE took no action against optionsXpress was an "indisputable green flag." OPX Br. 19. As explained above, CBOE's investigation and resulting letter of caution was no green light. Thus, rather than CBOE clearing optionsXpress of any wrongdoing, the CBOE Settlement found that because certain CBOE employees lacked a basic understanding of Reg. SHO, it failed to detect

[45] These findings of CBOE's basic ignorance of Reg. SHO are consistent with the evidentiary record in these proceedings. *See, e.g.,* Tr. 3929:1-9; 4658:8-16, 4680:16-4681:22.

optionsXpress' wrongdoing in the first place. As the Court found, in no way can this be seen as a "green flag," especially when optionsXpress never "requested an opinion from CBOE on whether it was to legal to [use deep-in-the-money buy-writes]" to cover fails to deliver in hard-to-borrow stock. ID 81.

D. optionsXpress Misunderstands Rule 10b-21.

As explained above, Feldman violated Rule 10b-21. optionsXpress contends that the Court erred as it failed to limit Rule 10b-21's scope to a customer's delivery to his broker (as opposed to a broker's delivery to CNS). OPX Br. 44. Thus, because Feldman's delivery to optionsXpress is not at issue, there can be no violation of Rule 10b-21. *Id.* This is wrong. ***First,*** Feldman's failure – as a *seller* – to deliver the securities he sold directly implicates Rule 10b-21. ***Second,*** Rule 10b-21 does not only implicate a seller's delivery obligations to brokers, but also, *by its very language*, to a participant of a registered clearing agency or a purchaser. As reiterated by the adopting release to the rule: "*sellers* should promptly deliver the securities they have sold and *purchasers* have the right to the timely receipt of securities that they have purchased." 73 FR at 61672 (emphasis added).

While optionsXpress also argues that it could not aid and abet Feldman's violation of Rule 10b-21 because the firm knew what he was doing, OPX Br. 44, this argument has no merit. Again, the text of Rule 10b-21 prohibits deception not only of one's own broker, but a participant of a registered clearing agency or a purchaser. As discussed above, other participants of a registered clearing agency and purchasers were deceived by Feldman's trading. Indeed, under optionsXpress' interpretation of Rule 10b-21, a customer who sells something with no intention of ever delivering what he sold could not be liable if that customer's broker knew the customer's fraudulent plan. This contradicts not only the explicit language of Rule 10b-21, but its adopting release, which specifically contemplated that broker-dealers could aid and abet their customers' violations of the rule. 73 FR at 61673.

IV. THE COMMISSION SHOULD ORDER DISGORGEMENT, PENALTIES, AND OTHER EQUITABLE RELIEF AGAINST OPTIONSXPRESS AND FELDMAN

As Courts have long recognized, wrongdoers should not be allowed to profit from their misconduct. *SEC v. First Jersey Sec., Inc.*,101 F.3d 1450, 1474 (2d Cir. 1996) ("The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws."). This principal is incorporated into the federal securities laws which provide that those who violate the federal securities laws, including the anti-fraud provisions, should disgorge their ill-gotten gain. 15 U.S.C. § 77h-1(e); 15 U.S.C. § 78u-3(e). Disgorgement is an equitable remedy, and it is well-established that there is "broad discretion not only in determining whether or not to order disgorgement but also in calculating the amount to be disgorged." *SEC v. Svoboda*, 409 F.Supp.2d 331, 344 (S.D.N.Y. 2006) (citing *First Jersey*, 101 F.3d at 1474-75). The Division may quantify the amount of the defendants' disgorgement liability by "producing a reasonable approximation of [the defendants'] ill-gotten gains." *SEC v. Calvo*, 378 F.3d 1211, 1217 (11th Cir. 2004). The burden then shifts to the defendants to clearly demonstrate, if appropriate, that the disgorgement figure is not a reasonable approximation. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1232 (D.C. Cir. 1989). In determining the amount of disgorgement, all doubts should be resolved against the defrauding party. *Id.* (citations omitted).

A. optionsXpress Should Disgorge $7,214,977 Plus Pre-Judgment Interest.

By willfully and repeatedly failing to comply with its obligations under Reg. SHO, optionsXpress avoided paying $7,214,977 of hard-to-borrow fees. DX310 (¶¶41, 188, 199). In addition, optionsXpress directly earned $1,908,744 in commissions related to its violations of Reg. SHO. DX310 (¶42). Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to require an accounting and disgorgement, including reasonable interest. 15 U.S.C. § 77h-1(e); 15 U.S.C. § 78u-3(e). It is well-established that disgorgement of losses avoided is an appropriate means of disgorgement. *SEC v. Patel*, 61 F.3d 137 (2d Cir.

1995). While Judge Murray accepted optionsXpress' argument that its illicit profits could not exceed $1,574,999, ID 97-98, given its willful misconduct, disregard of its responsibilities as a broker-dealer, and aiding and abetting of Feldman's fraud, the Commission should order optionsXpress to disgorge $7,214,977 (the amount it avoided paying in hard-to-borrow fees) plus pre-judgment interest.

B. Feldman Should Disgorge $4,000,000 Plus Pre-Judgment Interest.

Through perpetrating his fraud, Feldman earned illicit gross "profits" of more than $4 million. DX310 (¶151). Judge Murray imposed disgorgement of $2,656,377, representing Feldman's "net" profits, but the Division's request for disgorgement of the $4,000,000 plus prejudgment interest is a more appropriate measure of Feldman's ill-gotten gains. Thus, Feldman should disgorge the entire proceeds of his illicit scheme – $4 million – plus any prejudgment interest.

C. The Respondents Should Be Ordered To Pay Civil Money Penalties.

Exchange Act Section 21B(a) authorizes the Commission to assess a civil money penalty where a respondent has willfully violated the Exchange Act or rules and regulations thereunder.[46] A willful violation of the securities laws means the intentional commission of an act that constitutes the violation. Put another way, there is no requirement that the actor "must also be aware that he is violating one of the Rules or Acts." *Wonsover*, 205 F.3d at 414 (internal quotations marks and citation omitted).

optionsXpress' and Feldman's conduct harmed market participants and undermined market integrity. DX310 (¶¶83-88). Further, optionsXpress and Feldman greatly profited from

[46] The Exchange Act has a three-tier system identifying the maximum amount of penalty. For each "act or omission" by a natural person, the maximum amount of a penalty is $7,500 in the first tier, $75,000 in the second tier, and $150,000 in the third tier. *See* 17 C.F.R. § 201.1003, Subpt. E, Table IV. For an entity like optionsXpress, the tiers are $75,000, $375,000 and $725,000 per violation. *Id.* To determine whether to issue a penalty, courts consider the following six statutory factors: (1) fraud; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) need for deterrence; and (6) such other matters as justice requires. *See* Exchange Act Section 21B(c) ("Determination of Public Interest").

the scheme. A third-tier penalty is warranted against both optionsXpress and Feldman for each of their multiple violations, in order to deter other market participants from engaging in similar conduct.[47] optionsXpress violated Reg. SHO in 25 securities on at least 1,200 occasions and Feldman committed fraud in connection with 13 securities over 20 different periods with 390 buy-write trades from June 2009 to March 2010. ID 101. The Division urges the Commission to follow the decision of Judge Murray and impose at least $2 million in civil penalties on both optionsXpress and Feldman, which would be $1,667 and $5,128 per violation respectively. *Id.*

D. The Respondents Should Be Ordered To Cease-And-Desist.

Exchange Act Section 21C authorizes the Commission to enter a cease-and-desist order against any person who is "is violating, has violated, or is about to violate" any provision of the Exchange Act or rule or regulation thereunder. 15 U.S.C. § 78u-3. In considering whether a cease-and-desist order is appropriate, the Commission looks to see whether there is some risk of future violations. *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1185 (2001). The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction. *Id.* at 1191. In fact, a single violation can be sufficient to indicate some risk of future violation. *Ofirfan Mohammed Amanat*, Ex. Act Rel. 54708, 2006 WL 3199181, at *12 n.64 (Nov. 3, 2006). The Commission has indicated that other factors may demonstrate the need for a cease-and-desist order such as the seriousness of the violation, the degree of harm to investors or the marketplace resulting from the violation, the sincerity of assurances against future violations, the opportunity to commit future violations and the remedial function to be served by the cease-and-desist order in the context of other sanctions sought in the proceeding. *Id.* at *12. In this case, optionsXpress and Feldman both should be ordered to cease-and-desist from violating the relevant sections of the federal securities laws.

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[47] The penalties in Section 21B are based on "each act or omission." 15 U.S.C. § 78u-2.

1. optionsXpress violated multiple provisions of the securities laws.

optionsXpress should be ordered to cease-and-desist from violating Rules 204 and 204T of Reg. SHO and from aiding and abetting violations of Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder as well as Section 17(a) of the Securities Act. As Judge Murray rightly concluded, optionsXpress engaged in multiple acts that caused it to fail to deliver thousands of securities in a timely fashion. By doing this, optionsXpress avoided paying over $7 million of hard-to-borrow fees that should have been paid to other market participants. If optionsXpress had followed the mandates of Rules 204T and 204, Feldman would not have been able to carry out his fraud. optionsXpress is still a registered broker-dealer and thus has the opportunity to commit future violations. optionsXpress claims that because it was purchased by Schwab in March 2011 there is no need for a cease and desist order. OPX Br. 49. But Schwab itself has been investigated by and reached substantial settlements with the SEC and other regulators. *See, e.g.*, SEC, *SEC Charges Schwab Entities and Two Executives With Making Misleading Statements* (Jan. 11, 2011), http://www.sec.gov/news/press/2011/2011-7.htm (discussing January 2011 settlement and payment in excess of $118 million); FINRA, *FINRA Orders Schwab to Pay $18 Million to Investors for Improper Marketing of YieldPlus Bond Fund* (Jan. 11, 2011), http://www.finra.org/Newsroom/NewsReleases/2011/P122755; CBOE, *Charles Schwab & Co., Inc., Decision Accepting Offer of Settlement* (May 29, 2013), http://www.cboe.com/publish/DisDecision/13-0021%20%28Schwab%29.pdf. Accordingly, the now Schwab-owned optionsXpress continues to pose a substantial risk of harm to investors and the marketplace, and a cease-and-desist order is necessary to protect the public interest.

2. Feldman poses a future risk to investors and the marketplace.

Feldman traded billions of dollars of options and placed numerous trades with no intention of delivering shares. This conduct greatly undermines market integrity. DX310 (¶¶83-88). Feldman encountered numerous red flags that put him on notice that his trading was

problematic yet he continued to trade. As Judge Murray found, Feldman's conduct was not simply negligent, it was intentional and fraudulent. Feldman's activities demonstrate that he will continue trading, indeed, he already tried to find other broker-dealers who would allow his use of buy-writes. In short, he poses a substantial, continuing risk of harm to investors and the marketplace and a cease-and-desist order should issue.

V. THESE PROCEEDINGS DO NOT VIOLATE THE DODD-FRANK ACT

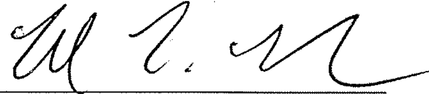
In his appeal, Feldman claims that these proceedings violate Section 929U of the Dodd-Frank Act. Feldman Br. 46. Feldman is wrong for two main reasons. ***First***, Feldman's argument has been rejected by every court that has considered it. Courts have consistently held that the "expiration of the 180-day deadline [in] Section 929U does not create a jurisdictional bar to SEC enforcement actions." *SEC v. NIR Group, LLC*, 2013 WL 5288962, at *5 (E.D.N.Y. Mar. 24, 2013); *SEC v. Levin*, 2013 WL 594736, at *13 (S.D. Fla. Feb. 14, 2013) ("This Court agrees that Section 4E imposes only an internal deadline on the SEC, not a private right to be free from agency action occurring beyond the internal deadline."). ***Second***, even if Section 929U could act as a bar against enforcement actions, Judge Murray correctly found the requirements of Section 929U were followed as extensions to the 180-day deadline were given by both the Division Director and then the Commission. ID 74-75.

CONCLUSION

For the foregoing reasons, the Commission should rule in favor of the Division and against the Respondents.

Dated: January 27, 2014

Respectfully submitted,



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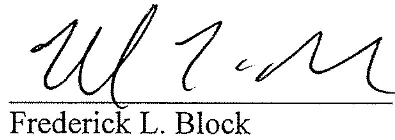
CERTIFICATE OF COMPLIANCE WITH RULE 450(d)

I, Frederick L. Block, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 450(c), as it contains 20,792 words, excluding the table of contents and table of authorities as they are exempted by the Rule. 17 C.F.R. § 201.450(c).

Dated: January 27, 2014



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