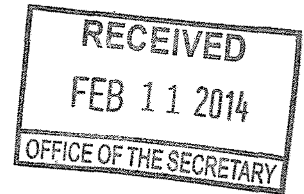

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

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

RESPONDENT JONATHAN I. FELDMAN'S REPLY IN SUPPORT OF HIS OPENING BRIEF TO THE COMMISSION

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INTRODUCTION

The Division's Opposition, like the Initial Decision, runs roughshod over the clear and material distinctions between a customer's and a broker's delivery obligations and misstates and misconstrues how delivery actually occurs under Reg SHO. The consequence of this convoluted advocacy is that the Division would render Reg SHO meaningless and replace it with a T+3 fraud standard.

Equally troubling, the Division consistently fails to address Mr. Feldman's arguments and instead simply repeats significant mischaracterizations of law and evidence adopted in the Initial Decision. In summary, the following major arguments in Mr. Feldman's Opening Brief (the "Brief") were completely ignored by the Division:

Mr. Feldman's Argument	**Division's Response**
The Initial Decision is materially inconsistent—it found that Mr. Feldman covered all short positions, but also found that Mr. Feldman committed fraud because he did not cover. Brief at 12-13.	None.
Mr. Feldman was told by optionsXpress that the SEC had reviewed his trading and concluded "it's fine, it's okay, we're good to go." *Id.* at 11, 16.	None.
Mr. Feldman received daily reports showing him to be net flat with no delivery obligation. *Id.* at 9-10.	None.
Mr. Feldman could not have confirmed that optionsXpress was complying with Reg SHO with regulators, because the regulators would have refused to give him guidance on the issue if he had called them. *Id.* at 20.	None.
Mr. Feldman could not have confirmed that optionsXpress was delivering at CNS because he had no access to optionsXpress's books and records or CNS reports. *Id.* at 13.	None.
Mr. Feldman was expected to rely on optionsXpress for delivery (as set forth in the Rule 10b-21 Adopting Release) and he could	None.

not deliver to CNS and had no obligation to deliver to CNS. *Id.* at 2, 13-14.	
Delivery for customers is different than delivery for broker-dealers. Delivery for a customer is delivery to the broker-dealer, and no one is alleging that Mr. Feldman failed to deliver to his broker. *Id.* at 13.	None.
Mr. Feldman is a lay person and cannot be expected to understand a byzantine set of rules that even regulators, like the CBOE, were confused by. *Id.* at 20.	None.

For Mr. Feldman's arguments that the Division chose to address, it overwhelmingly mischaracterized Mr. Feldman's positions and attacked straw men. The Commission should closely scrutinize these mischaracterizations and the non-responsiveness and treat it for what it is: a failure to have a legitimate and persuasive response to serious and fatal flaws in the Division's case and the Initial Decision.

At base, this case represents an unjust expansion of liability and obligations of retail customers concerning complex delivery obligations of clearing firm participants. The Commission should reject this attempt at setting radical new standards through litigation. Moreover, rejecting the case against Mr. Feldman is particularly appropriate because not only was he completely transparent and non-deceptive, he was told by optionsXpress during his trading that the SEC had reviewed his trades and concluded "it's fine, it's okay, we're good to go."

ARGUMENT

I. Division Ignores Fundamental Flaw: No Fraud in Absence of Reg SHO Violation

The Division entirely ignores Mr. Feldman's lead argument: That the Initial Decision is irreconcilably inconsistent because it found that Mr. Feldman always covered his short positions by purchasing shares when bought in, ID at 44, but that he committed fraud by "not cover[ing]

his short position." ID at 89. The Division fails to address these obviously inconsistent findings because it cannot rebut either (1) that Mr. Feldman always bought-in, or covered, when optionsXpress required; and (2) that buying-in was Mr. Feldman's only "delivery" obligation. Tr. 638:22-639:18 (Coronado); Tr. 2074:15-20 (Payne); Sirri Report, ¶¶68, 124-125, 127. Throughout the Opposition, the Division simply ignores the distinction between a broker's delivery obligations and a customer's obligation to cover by buying securities. *See, e.g.*, Opposition at 26. The Rule 10b-21 Adopting Release confirms that "delivery" for customers is not delivery in the CNS System. Rule 10b-21 Adopting Release, 73 FR 61666, 61672.

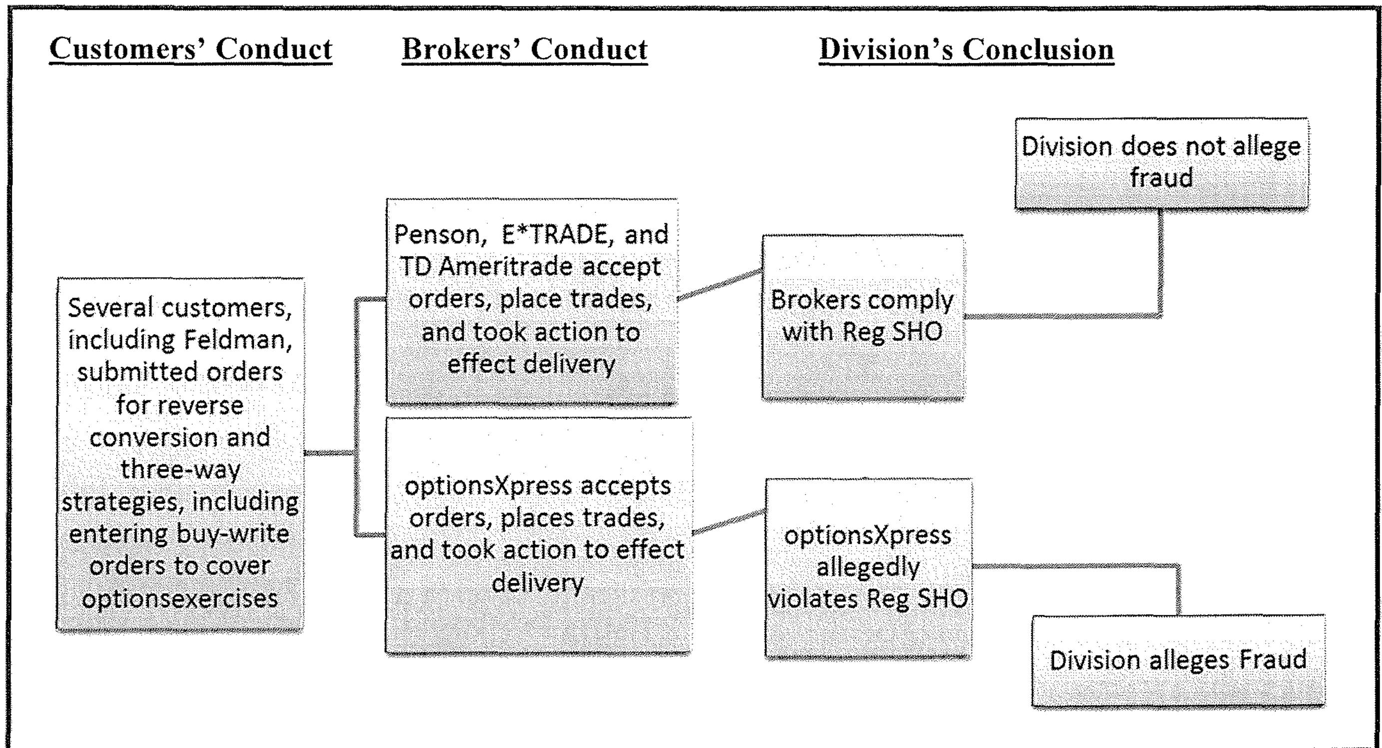
The Division goes so far as to deny that the fraud case against Mr. Feldman is based on a violation of Reg SHO. Opposition at 22 ("The Division is not attempting ...to find [Mr. Feldman] liable for fraud based on his broker's violation of Reg. SHO."). This is pure sophistry. If there was no Reg SHO violation, there could be no fraud in this case. This is because Reg SHO is the only measure of delivery for the trades at issue, and if delivery occurred, no one was defrauded. Thus, as has been demonstrated over and over on the record and in briefing, delivery under Reg SHO entirely is determined by how a broker addresses its obligation. Thus, even under the Division's theory and the Initial Decision, Mr. Feldman's trading could result in Reg SHO-compliant delivery to counterparties. This was exactly what the undisputed evidence showed for every broker other than optionsXpress that executed Mr. Feldman's trades: Penson, E*TRADE, and TD Ameritrade. This was succinctly explained by the E*TRADE corporate designee:

> Q: And specifically E*TRADE did not violate Reg SHO?
>
> A: That is correct.
>
> Q: So Mr. Feldman engaged in his reverse conversion strategy with hard-to-borrow stock using deep-in-the-money calls with buy-writes and it did not violate

Reg SHO. Is that your testimony?

A: It did not violate Reg SHO.

Tr. 4831:22-4832:8 (Mikus). The corresponding illogic of the charges against Mr. Feldman is exemplified by the following chart:



As is clear, the only variable between what the Division concludes is fraudulent or not fraudulent is how the brokers satisfied their Reg SHO obligation. This is plainly not legally or factually sound.

II. Division Advocates for Radical T+3 Fraud Standard to Replace Reg SHO

The Division and Initial Decision's fraud theory against Mr. Feldman amounts to a new T+3 fraud standard that would supplant Reg SHO. The Division maintains that purchasers have an expectation that they will receive shares on T+3, and if they do not receive them on time, they are defrauded and harmed. Opposition at 29.

This radical interpretation would impose a new delivery regime significantly more

stringent than Reg SHO. Under this interpretation, a non-broker customer could be deemed to have committed fraud simply by selling short knowing his or her clearing broker will close out a fail-to-deliver by purchasing shares of like kind and quantity on T+3 (which is explicitly permitted under Rule 204). Purchasing on T+3 prevents the buyers from receiving shares on T+3 as they purportedly expected , causing delivery no sooner than T+6. Likewise, under the Division's interpretation, a customer could be charged with fraud for selling short on Monday and covering on Wednesday, while knowing that his or her broker will fail to deliver on T+3 and claim pre-fail credit as explicitly permitted by Rule 204. To avoid aiding and abetting charges, brokers would have to adopt a strict "no fail" policy much stricter than Rule 204, undermining the Commission's deliberate regulatory approach of allowing clearing firms flexibility in the delivery process. Interpreting a short sale or written call transaction as an implicit representation of an intent to deliver shares on T+3 is thus an untenable position.

III. Division Mischaracterizes Feldman's Knowledge

A. Division Ignores SEC Approval and Futility of Feldman's Contacting SEC

The most glaring omission in the Division's Opposition is that it wholly fails to rebut, or even address, that Mr. Feldman was told by optionsXpress in the fall of 2009 that the SEC had reviewed his trading and concluded "it's fine, it's okay, we're good to go." *See* Brief at 11, 16. Instead, the Division attacks a straw man, claiming Mr. Feldman is "blaming" his broker. Opposition at 34. To the contrary, Mr. Feldman is relying on a truthful representation from his broker that the regulators said the activity was permissible. The Division claims that Mr. Feldman could not rely on his broker's representations of compliance (though never addressing SEC approval) because he knew "his trading was resulting in failures to deliver." Opposition at 35. In addition to being false, such knowledge would be irrelevant because CNS fails-to-deliver

do not violate Reg SHO, and Mr. Feldman had no reason to further inquire in the face of an explicit representation that the SEC had approved the trading. *See* Sirri Report at ¶78. Indeed, the Division wholly ignores that the Commission itself expected Mr. Feldman to rely on his broker:

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

Rule 10b-21 Adopting Release, 73 FR at 61672 (emphasis added).

The Division likewise does not address the testimony from SEC, CBOE, and FINRA representatives that confirmed that they would have refused to comment and would not have given Mr. Feldman guidance. Brief at 20. Further, the Division does not dispute or even address that the Division's own counsel not only did not tell Mr. Feldman he was violating the rule, she misstated the status of the investigation. Tr. 2347:14-2348:4, 2667:10-2670:4 (Feldman).

Dr. Sirri repeatedly confirmed that Mr. Feldman played no role in delivery, which is exclusively a broker's obligation, and thus reasonably relied on his broker and was not expected to seek further guidance from regulators. Tr. 3234:7-3235:5; 3262:20-22 (Sirri). The Division asserts that Dr. Sirri was not offering an opinion on the legality of Mr. Feldman's conduct. Opposition at 34, n.27. This argument lacks substance—Dr. Sirri testified that Mr. Feldman's trading did not "cause" a Reg SHO violation and that none of the Division's allegations concerning Mr. Feldman's conduct would violate Rule 10b-21. Tr. 3217:8-3218:20; 3231:19-23 (Sirri); Sirri Report, ¶¶75, 80-81. The Division offered no Reg SHO expert to counter Dr. Sirri's testimony and made no objection to his testimony on the grounds that it offered a "legal" opinion. The Division's efforts to discount Dr. Sirri now, by arguing that his view does not represent that of the Commission, Opposition at 12, is a weak rebuttal given that Dr. Sirri is

wholly qualified to given opinions on Rule 204 and Rule 10b-21, which were drafted and implemented under his leadership. *See* Tr. 3007:19-3008:2, 3226:16-3227:1 (Sirri).

The Division does not point to any credible "red flags" that Mr. Feldman allegedly saw subsequent to his learning that the SEC had reviewed and approved his trading. Because he was told the SEC had looked into it and found it not to be problematic, any supposed red flags he learned of before the approval would be negated. In this regard, Mr. Feldman received the *Hazan* settlement (which for reasons described in the Brief involved trading that was not analogous to Mr. Feldman's) days before he learned that the SEC gave the green light.

The Division presents no evidence whatsoever to contradict that Mr. Feldman had no insight into optionsXpress's books and records, back room compliance discussions, discussions with regulators, or CNS delivery data. Mr. Feldman's reputable broker told him that regulators approved; there were no further steps that Mr. Feldman was required to take—or could have taken—to continue trading.

B. Division Falsely Implies That Feldman Was Told Trading Violated a Rule

The true crux of the Division's argument for, and the Initial Decision's finding of, scienter—that Mr. Feldman knew that optionsXpress violated Reg SHO when submitting his order—is not supported by a single e-mail, witness, or other piece of evidence in the entirety of the massive record in this case. No broker or broker's representative ever told Mr. Feldman that his trading was illegal or improper. In all the telephone calls and e-mails between Mr. Feldman and his brokers, there is not a single instance in which the brokers or Mr. Feldman indicated that optionsXpress was not complying with Reg SHO.

The Division and Initial Decision take e-mails and phone calls completely out of context to support a finding of scienter. For example, the Division claims that Mr. Feldman knew that

optionsXpress was failing to deliver as a result of Mr. Feldman's trading. Opposition at 31. But the e-mail the Division cited provides no such accusation, and the Division omitted explicit confirmation in that same e-mail that optionsXpress was complying with the rules: "We want to continue working your orders, but we have to follow the rules." Div. 58 (emphasis added). Similarly, the e-mail that the Division alleges alerted Mr. Feldman to "persistent fails" in fact outlines specifically how optionsXpress was complying with Rule 204:

> In the past, we didn't even have to issue buy-ins that early, but in this new era, with the implementation of the SEC's Reg SHO Rule 204, we have to be much more proactive. The MJN situation involved a new position, and new fail. That triggered our Reg SHO Rule 204 response on T+4. With the SHLD and the additional MJN shorts, however, we are experiencing persistent fails. Because of that, we must take action every day.

Div. 28 (emphasis added). Mr. Feldman responded to this e-mail:

> This gives me some other food for thought. I am wondering if there might not be some different strategies I could use to avoid buyins, or "restart the clock" sometimes.

Id. It is plain from Mr. Feldman's response (selectively truncated by the Division in the Opposition) that Mr. Feldman wanted to know if there were legitimate ways to prevent assignment, not whether optionsXpress could avoid delivering shares to CNS.

Similarly, when Mr. Feldman faced increased commissions after returning from Terra Nova, no one at optionsXpress told him the increase was because anyone was violating Reg SHO. optionsXpress told him his trading took up a great deal of time for optionsXpress traders and that optionsXpress had to interact with regulators—a fact Mr. Feldman was aware of because optionsXpress had previously told Mr. Feldman that the SEC had reviewed his trading and approved of it. Tr. 2317:9-2318:22 (Feldman).

The Division alleges that Mr. Feldman was the type to "push back" and question his broker, Opposition at 34, but Mr. Feldman had no reason to question the explicit confirmations

of compliance from his reputable broker, because he also received daily confirmations of delivery via the buy-in notices and Daily Position Recap. The Division cannot credibly dispute the reasonableness of Mr. Feldman's belief that these confirmations showed he had covered as required, because this fact was acknowledged by the Division's own expert:

> [I]f I was short the shares, and I got bought in by my clearing company, they actually went on the marketplace and purchased or whatever, and they bought me in, I would think that that is producing the short share I guess. I am covering – it's covering my short, yes.

Tr. 953:17-22 (Sheehy).

The fact that Mr. Feldman did not pay hard-to-borrow fees (HTBs) at optionsXpress is no "red herring" as the Division claims—it is material because it demonstrates that whether or not optionsXpress was borrowing, Mr. Feldman would not have been charged HTBs. Thus the fact that he was not charged HTBs does not indicate he knew optionsXpress was supposed to borrow to comply with a rule and did not. Mr. Feldman had absolutely no insight into optionsXpress's back-office or compliance measures (other than the express confirmations of compliance), nor did he know the various costs to borrow so as to know whether optionsXpress was still making a profit off of his commissions. There are many reasons why a broker might not have to borrow to comply with Rule 204. For example, because of netting with other customer trades that day or the firm had a previous fail-to-receive in CNS, had shares in inventory, or had purchased the shares itself. Tr. 2976:13-2977:6 (Sirri). The Division's assertion that Mr. Feldman should have known that optionsXpress did not have enough stock in inventory to lend, Opposition at 31 n.23, is patently ridiculous given that optionsXpress has thousands of customers and could have had all or a portion of the necessary stock to lend. The Division does not present any evidence showing that Mr. Feldman had knowledge of optionsXpress's compliance measures, nor does it dispute that optionsXpress could have taken alternative steps to comply with Reg SHO that Mr.

Feldman would never have been aware of. Tr. 3456:4-3457:11 (Strine).

The Division's reliance on Mr. Feldman's communications with Terra Nova to prove he knew delivery was not occurring is grossly misleading. It is undisputed that Penson (which Terra Nova cleared through) did not have CNS delivery failures as a result of Mr. Feldman's trading. Thus, none of Mr. Feldman's communications with Terra Nova (he never interacted directly with Penson) could possibly demonstrate that he knew his trading caused fails-to-deliver or Reg SHO violations. Further, as was exhaustively explained in the Brief (and completely ignored by the Division), Mr. Feldman's references to not "settling" in these communications with Terra Nova were not referring to avoiding delivery, but rather to the fact that he never "settled" on T+3 because he bought in on T+1. *See* Tr. 2480:22-2481:18 (Feldman); Tr. 893:13-23 (Crain).

The Division's reliance on internal Penson communications is likewise grossly misleading because these communications were never relayed to Mr. Feldman and because the internal research and analysis Penson did concerning Reg SHO post-dated Mr. Feldman's trading at Terra Nova. Tr. 895:8-9 (Crain). The simple evidence unequivocally shows that Penson stopped Mr. Feldman's trading because of business reasons—it did not have sufficient capital to support it. Tr. 900:23-901:23(Crain); *see also* Tr. 2309:12-18 (Feldman). Indeed, contemporaneous internal correspondence shows that Mr. Feldman satisfied all cover requirements for all trades placed through Penson. Div. 212 (internal Penson e-mail stating that "[t]hey [Terra Nova] are covering this the day that they get their assignment report so they are processing these as we agreed."); Div. 296 at 3 ("he has already covered the short that we say that we are buying him in on is what they are saying which is correct."). The undisclosed regulatory concerns surfaced later and appear to be a post hoc justification. Tr. 900:23-902:6

(Crain) (memorandum discussing fails-to-deliver and the determination that Mr. Feldman's trading was similar was not made until <u>after</u> Penson had requested that Mr. Feldman stop trading).

Similarly, neither TD Ameritrade nor E*TRADE told Mr. Feldman that his trading at those firms in 2011 and 2012 caused a violation of Reg SHO. But even if they had, this would not show anything about Mr. Feldman's state of mind in 2009 and 2010. *See* Div. 416 (TD Ameritrade e-mail listing only "potential regulatory risk" among a several reasons TD Ameritrade asked Mr. Feldman to stop his strategy); Tr. 4831:22-4832:8 (Mikus). Nor would TD Ameritrade's and E*TRADE's termination of the trading in 2011 and 2012 prove Mr. Feldman's scienter in 2009-2010. From Mr. Feldman's perspective in 2009 and 2010, at least two brokers allowed the strategy, and one broker (Terra Nova) later decided it could not accommodate it for business reasons.

C. <u>Division's *Howard* Analysis Does Not Apply to a Layperson Like Feldman</u>

The Division makes no effort to distinguish *Howard v. S.E.C.*, 376 F.3d 1136 (D.C. Cir. 2004) as it applies to Mr. Feldman. The Division contends that *Howard* provides no recourse for optionsXpress because no regulators approved the conduct, the firm encountered many red flags, and there was substantial "industry guidance" and adopting releases. Opposition at 48. While this argument concerning optionsXpress is unpersuasive, it in any event is wholly inapplicable to Mr. Feldman. First, it is entirely undisputed that Mr. Feldman was explicitly told that regulators had approved his trading. Instead of fairly addressing this dispositive and undisputed fact, the Division attacks yet another straw man by arguing that the SEC did not approve of the trading in its call with optionsXpress. Opposition at 24 n.10. What the SEC staff actually told optionsXpress is absolutely irrelevant to Mr. Feldman's liability, because what optionsXpress undisputedly conveyed to Mr. Feldman was unequivocal approval. optionsXpress

never wavered on this point or told Mr. Feldman of any subsequent conversations with the SEC that would call into doubt the unequivocal approval.

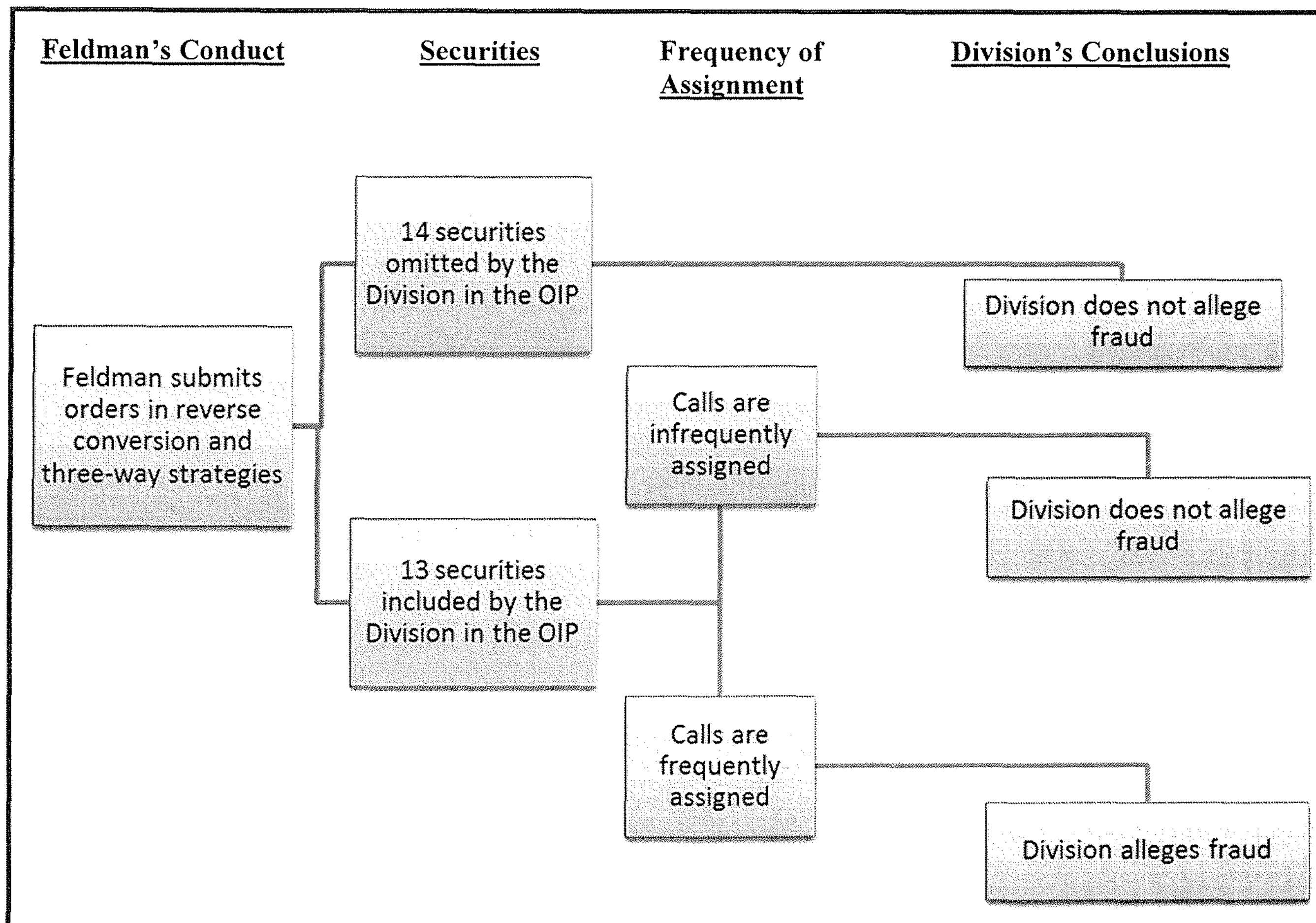
Second, Mr. Feldman was not privy to the red flags the Division references, such as the Wall Street Journal article and internal e-mails between compliance personnel at optionsXpress. Opposition at 42. To the contrary, the same individuals who sent the internal e-mails cited by the Division were the same individuals sending e-mails to Mr. Feldman assuring compliance.

Third, Mr. Feldman did not read adopting releases and other industry guidance referenced by the Division. Accordingly, Mr. Feldman cannot be found to have been reckless under the analysis set forth in *Howard.*

D. Division Provides Non-Response to Record of Cherry-Picking

In response to the clear record that the Division selectively chose and excluded trading data to support its hypothesis that Mr. Feldman was always assigned, the Division offered the following misstatement of Mr. Feldman's argument: "Feldman[] claim[s] that he cannot be liable because the Division did not include in the OIP every security he traded." Opposition at 30, n.21. Instead, Mr. Feldman is actually and credibly making the salient point that fraud liability cannot be based on hindsight analysis using skewed and selective data. By not evaluating and considering all of Mr. Feldman's trades for reverse conversion and three-way strategies, the Division and Initial Decision rely on a distorted record of the frequency of same-day assignments. In turn, the Division and Initial Decision conclude that the calls were frequently assigned on a daily basis and assert that the percentage was over 90%. *See* Opposition at 30. In truth, the rate of same-day assignments varied widely, including one security (FEED) that was never fully assigned and experienced partial same-day assignments only 27% of the time. Brief at 30. The illogic of the Division and the Initial Decision's conclusion of fraud for only periods

of high rates of assignment is demonstrated as follows:



The only difference between the presence or absence of a fraud charge is the frequency of assignment. This is untenable, as Mr. Feldman conducted himself in an identical, non-deceptive manner in placing the uniform trades.

The Division also points to phone conversations and e-mails referencing frequent assignment that likewise provide a skewed view. Opposition at 30-31. The phone conversations and e-mails cited by the Division are all dated during times of frequent assignment, but there were many other periods where assignments were not frequent, and Mr. Feldman notes that in his various communications. *Compare* Div. 217, 246, 89, 303, 247, 300 *with* Sirri Report, Ex. 16. Moreover, much of this evidence is mischaracterized by the Division. The Division points

to a conversation between Jeremy Coronado, an employee on the trade desk at optionsXpress, and Mr. Feldman where Mr. Coronado said that Mr. Feldman would "normally" be assigned. Opposition at 30. When Mr. Coronado told Mr. Feldman he was normally going to be assigned, he was speaking hypothetically and warning Mr. Feldman that assignment was always a possibility even though the assignment process was random. Tr. 586:6-15; 611:15-612:10 (Coronado). Similarly, the Division takes Mr. Feldman's comments regarding being assigned every night in July and September completely out of context. The full conversation demonstrates that Mr. Feldman was explaining ways to lessen assignments and that assignments were not guaranteed:

> Dean Kolocouris: what month do you recommend?
> Dean Kolocouris: july or sept
> Jonathan Feldman: it [al]most doesn't matter, JUL or SEP, as u get assigned that night anyway, so what's the diff?
> Jonathan Feldman: it seems SEP gets assigned a bit less i think.
> Jonathan Feldman: i tried selling SEP 2 calls instead of SEP 1 calls.
> Jonathan Feldman: since i saw open int is a lot higher, maybe they let u stay w the calls longer and don't get assigned.
> . . . .
> Jonathan Feldman: last night it worked, got assigned maybe 50% of my SEp 2's.

Div. 246.

Moreover, the Division's contention that Mr. Feldman's scienter is established by his continuing to sell deep-in-the-money calls instead of closer-to-the-money calls even during periods he was frequently assigned is meritless. Opposition at 30, n.22. Mr. Feldman's intention was to remain fully hedged. Writing a less-in-the-money call would defeat that purpose because it does not fully hedge the position and exposes the strategy to directional price risk. Tr. 4501:1-10 (Saha). Thus, the fact that Mr. Feldman did not write closer-to-the-money calls does not mean that he wanted to be assigned.

IV. **Division Ignores Distinctions Between Feldman's Trading and Actual Schemes**

The Division completely fails to address the material distinctions between Mr. Feldman's trading and examples of truly fraudulent trading in cases cited in the Initial Decision. To begin, the Division merely restates the Initial Decision's flawed analysis of *Wharf (Holdings) Ltd. v. United Intern. Holdings, Inc.*, 532 U.S. 588 (2001), without addressing any of the distinctions identified in Mr. Feldman's Brief. Opposition at 23. The Division ignores that the transaction in *Wharf* was a private, negotiated sale of a non-standard option to purchase stock in a privately held company that would not be settled in the CNS system, and the seller made direct representations to the buyer. By contrast, this case concerns standard, exchange-listed options traded in the open market with unknown counterparties, and the trades are delivered through the CNS system by brokers, not customers.

The Division likewise ignores material distinctions between Mr. Feldman's trading and wash sales and matched orders. The Division offers no response to the fact that wash sales and matched orders are engaged in to manipulate stock prices. This is critical because the Initial Decision concludes rightly that Mr. Feldman did not intend to manipulate stock prices and that Mr. Feldman's trading did not affect stock prices. *See* ID at 90. The Division also ignores that matched orders and wash sales involve conduct that is inherently deceptive and not dependent on the violation of another rule. Here, the purported fraud resulted from knowingly failing to deliver in violation of Reg SHO. *See* Section I. The Division cannot argue otherwise—it cannot contend that it could have brought a fraud charge if optionsXpress had complied with Reg SHO.

The Division baselessly claims that courts have long held that trading like Mr. Feldman's is fraudulent. Opposition at 23. In fact, no court has ever addressed using a buy-write to cover an assignment of a call option exercise. Similarly, no court has found it improper for a trader to

submit orders while intending to submit subsequent orders if call options are exercised and assigned. More broadly, no court has found trading fraud in the absence of collusion, market manipulation, or deception of a broker, none of which is present in this case. *See,* Opposition at 23, 25, 28 (citing to cases of trading fraud all involving making false statements to a broker, collusion, or market manipulation); *see also, e.g.*, *In re Gonul Coak and Milen K. Kostov* 2014 WL 345644 (S.E.C. January 31, 2014) (short selling scheme perpetrated by, among other things, colluding to match the buying and selling of deep-in-the-money call options).

V. Division Misstates Customer-Broker Relationship to Overcome Lack of Control

The Division wrongly argues that because Mr. Feldman was a self-directed customer who submitted his own orders, he had the requisite control to be a primary violator under *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296 (2011). Opposition at 28. The Division certainly does not dispute that once Mr. Feldman placed his order to buy with optionsXpress he lost all control over delivery because optionsXpress assumed the obligation to deliver to CNS completely. Nor does the Division dispute that optionsXpress could, at any time, refuse to place an order submitted by Mr. Feldman or go into Mr. Feldman's account to purchase shares in order to comply with delivery obligations. That the Division nonetheless ignores that customers rely on their brokers for delivery, and correspondingly that brokers have complete control over delivery, is indeed striking given that the Division's own expert testified to this fact:

> Q. . . . And you understand based on the record in this case that optionsXpress, not Mr. Feldman, assume[d] the obligation for logistics of delivery?
>
> A. Yes, that's correct.
>
> Q. And, therefore, you understand that Mr. Feldman relied on optionsXpress to effect delivery of the securities?
>
> A. That's correct.

Tr. 1497:25-1498:20 (Harris). Equally conclusive, the witness from the SEC's Division of Trading and Markets agreed that optionsXpress could have complied with Reg SHO by either purchasing or borrowing stock, and neither option required approval from the customer. *See* Tr. 3773:7-12, 3775:5-12 (Tao).

In the same vein, the Division's selective quoting of the optionsXpress Customer Agreement does not withstand scrutiny. Opposition at 35. The Division ignores and omitted much of the pertinent language of this agreement, including the following:

> If we make a sale of any securities and/or other property at your direction, and if you fail to deliver to us any securities and/or other property that we have sold at your direction, we are authorized to borrow or otherwise obtain the securities and other property necessary to enable us to make delivery, and you agree to be responsible for any cost or loss we may incur, including the cost of borrowing and obtaining the securities and other property.

Div. 98 at 5-6 (emphasis added). This evidence, none of which is contradicted by the Division, definitively shows that optionsXpress retained complete control over Mr. Feldman's account and delivery.

Even were the Division correct that Mr. Feldman had requisite control over his trade orders submitted to optionsXpress, its theory of liability fails because the submission of trade orders, without accompanying deceptive conduct, is not fraud. *U.S. v. Finnerty*, 533 F.3d 143, 148 (2d Cir. 2008). The Division's attempts to distinguish *Finnerty* are unavailing because none of these distinguishing factors addresses *Finnerty*'s unequivocal holding that the submission of a trade order is not, in and of itself, deceptive. *Id.* at 148-49.

The Division's contention that a later administrative proceeding nullifies the Second Circuit's ruling in *Finnerty* is incorrect. Opposition at 25, n.16. In the administrative proceeding against Mr. Finnerty, the Commission found an additional fact—that when he became an NYSE specialist, Mr. Finnerty expressly represented to the NYSE that he would comply with its rules—

and thus he engaged in deceptive conduct when he traded in violation of those rules. *VanCook v. S.E.C.*, 653 F.3d 130, 140 n.8 (2d Cir. 2011). No such representation is alleged here.

Further, the Division is simply wrong that *Finnerty* is inapplicable because the purchasers of Mr. Feldman's options did not get what they bargained for. As explained at length in the Brief, the purchasers did receive their shares in a timely manner almost 100% of the time. Regardless, even if this were not the case, *Finnerty*'s finding that the submission of a trade order itself without some accompanying deceptive conduct is unaffected.

Finally, the Division's analogy to *S.E.C. v. Pentagon Capital Management PLC*, 725 F.3d 279 (2d Cir. 2013) is flawed because the defendants in that case submitted false information. The defendants in *Pentagon* executed a "late-trading" scheme—they instructed their brokers to submit trade sheets time-stamped before 4:00 p.m., notwithstanding that the decision to trade had been made after 4:00 p.m. using the price that had been set for the next day. *Id.* at 283. Thus the trade sheets were fraudulent because they misrepresented that the decision to trade had been made prior to 4:00 p.m. In contrast, Mr. Feldman's buy-writes were exactly as they claimed to be: no false documentation, backdating, or any other act of deception was committed.

Finally, the Division's contention that this is not a Rule 10b-5(b) case, but rather a 10b-5(a) and (c) case is directly contradicted by the Initial Decision, which the Division did not appeal. The Initial Decision found that Mr. "Feldman's actions constitute fraud because by writing calls he <u>represented</u> . . . that he was going to make delivery if his calls were exercised and assigned when he had no intention of doing so." ID at 89 (emphasis added). *See, e.g.*, *S.E.C. v. Kelly*, 817 F. Supp. 2d 340, 343 (S.D.N.Y. 2011) ("[C]ourts have routinely rejected the SEC's attempt to bypass the elements necessary to impose 'misstatement' liability under

subsection (b) by labeling the alleged misconduct a 'scheme' rather than a 'misstatement.'").

VI. Division Failed to Present Credible Evidence of Deceit and Harm

A. No Evidence Anyone Deceived

The Division identifies two facts that the marketplace was allegedly deceived about—the volume of the trading and that purchasers would receive shares on T+3. Opposition at 24. The first of these is completely irrelevant, and the second is false. Regarding the volume of trades, the Division notes that Mr. Feldman acknowledges that anonymous commenters on the message board were allegedly panicking. In addition to Internet postings being an entirely unreliable and inappropriate basis for serious charges, these comments are ultimately meaningless because the Division does not allege that any harm was caused by the volume of trading (as distinct from delivery) or that Mr. Feldman deceived anyone about the volume of his trading.

Regarding T+3 as a basis for deception, the Division simply continues to ignore entirely that Reg SHO does not require delivery on T+3, and thus no one was deceived when they did not receive shares on T+3. The Division cannot deny that the plain language of Rule 204 allows a broker-dealer to comply with Reg SHO by purchasing or borrowing shares to close out its position by the beginning of trading on T+4 or that Reg-SHO compliant delivery can occur on T+7 or T+8.

The Division erroneously attempts to bolster its T+3 deception argument by noting that the options at issue required "physical delivery" on T+3. Opposition at 24, n.13. "Physical delivery" is distinct from other forms of delivery, like cash settlement, whereby an exercise results only in a transfer of cash. Sirri Report at ¶69. And physical delivery settlement is effected through CNS, which is again governed by Reg SHO and is exclusively the broker's obligation. Any reference to T+3 in any options product specification does not supersede Reg

SHO, and thus a broker is not somehow representing actual delivery on T+3 notwithstanding Reg SHO by entering into options transactions.

Tellingly, the Division is unable to produce any evidence or argument to rebut that Mr. Feldman was completely open and honest about his trading strategy to everyone who asked. In the face of this evidentiary failure, the Division points to an anonymous commenter on a blog that it is undisputed that Mr. Feldman did not read. *See* Tr. 2339:24-2340:11 (Feldman). Unread, anonymous Internet postings have no evidentiary value whatsoever and should be disregarded.

Finally, the Division likewise is unable to oppose the fact that market participants had full view of Mr. Feldman's trading through public reporting of options' open interest and volume. Opposition at 24, n.12. In response, the Division argues that not all stock purchasers can be expected to view and decipher this information. *Id.* This is a non-sequitur, because the point is that the information is not concealed in any way and thus is not deceptive. Moreover, it is the sophisticated clearing firm participants that the Division claims were deceived and harmed by not collecting stock borrow fees, and surely these entities read and analyzed such basic reports as open interest.

B. <u>No Evidence Anyone Was Harmed</u>

The Division makes the unsupported allegation that other firms were harmed because they failed to receive shares in a timely manner and thus could not lend the stock at high rates. Opposition at 26, n.17. But the Division presented no evidence that this actually occurred, and its expert acknowledged that he had not done any analysis to determine which brokers were harmed or what the damage to these brokers was between T+3 and T+7 or T+8, when over 96% of them received their shares. Tr. 1495:2-5 (Harris); *see also* Harris Report, Div. 311 at ¶196.

The fact that, unbeknownst to Mr. Feldman who had no view into the CNS system, other firms were issuing notices of intent to buy-in, is similarly uninformative. First, there is no evidence that the fails-to-receive were a result of Mr. Feldman's trading. *See* Brief at 40. Second, the buy-in notices could have occurred as a result of Reg SHO-compliant behavior because the firm with a fail-to-receive can initiate a buy-in notice on T+3 or T+4. Tr. 105:19-106:3, 106:21-107:21 (Colacino). It is a normal event for a firm to have a fail-to-receive and issue a buy-in notice, and it does not indicate that there was a Reg SHO violation, that the firm was harmed, or that it was optionsXpress that caused the fail-to-receive. *Id.*

The Division's other harm argument—that trades must "reliably settle" and if they do not, traders will not be willing to arrange trades with strangers—is even more of a stretch. Opposition at 26, n.17. The Division presented no evidence that any firm or trader has been reluctant to trade because shares are not being delivered in a timely manner, and their expert admitted to having no data to support this proposition. Tr. 1551:17-1552:5 (Harris).

The Division also makes the moot point that "investor harm" is not required to be shown in fraud cases brought by the Commission. Opposition at 27. In this case, proof of investor harm is indeed required to be established, because that is the only basis for the Division's claim of deception. It is simply axiomatic that if optionsXpress complied with Reg SHO, then no one was deceived. No one was deceived because they received shares within the time permitted by Reg SHO, and thus no investors were harmed. The cases cited by the Division regarding harm, by contrast, ironically involve real situations in which significant losses were proven. *See, e.g.*, *U.S. v. Naftalin*, 441 U.S. 768, 772 (1979) (broker had to buy shares to cover for short sales by customer who lied about having shares to deliver).

Finally, the Division's claim that mapping to Mr. Feldman was possible because Mr.

Feldman's trading was larger than anyone else's does not withstand even minimal scrutiny. Opposition at 31, n.23. First, the Division's assertion is belied by their own statistics—they claim this was true on only 5% of the 385 days (*i.e.*, 20 days) Mr. Feldman executed buy-writes. The obvious corollary to this is that on 365 of the 385 days Mr. Feldman executed buy-writes, his trading did not outsize other traders and it would be impossible to map fails-to-deliver at CNS to his trading. Second, simply because Mr. Feldman had a large percentage of the trading in a security on a particular day does not mean that the fails-to-deliver at CNS could be mapped to him. It is impossible to tell from CNS reports if a fail-to-deliver originated on the date of the report or existed for several days. Tr. 89:23-90:25 (Colacino). Dr. Sirri's analysis—that the CNS netting system does not allow for mapping to customers—stands unrebutted.

VII. <u>Division Misconstrues "Delivery" Under Rule 10b-21</u>

The Division's Rule 10b-21 response is uncandid in both its statement of the law and the facts. First, the Division acknowledges that CNS delivery is not the measure for delivery under Rule 10b-21, Opposition at 36-37, but then offers no alternative to what delivery means under this rule. In fact, it only means delivery to a broker under the circumstances here. In response to this truth, the Division makes the irrelevant complaint that the Respondents are reading restrictions into Rule 10b-21 by ignoring that it also covers misrepresentations by sellers to clearing firm participants and purchasers. Opposition at 37, 51. Of course it does, but it is of no moment that one could easily come up with other examples of liability under Rule 10b-21, such as follows: A seller in a private sale of securities in a privately held company deceives a purchaser about the seller's intent or ability to deliver the securities. But this case against Mr. Feldman concerns only CNS delivery failures—if there was none, there is no case—and no other "delivery" failure is identified by the Division or in the Initial Decision.

Second, the Division falsely states that Mr. Feldman "admittedly understood that his trading would not result in "delivery." Opposition at 37. Mr. Feldman admitted nothing of the sort, and moreover the "delivery" the Division is referring to in its Opposition is again CNS delivery.

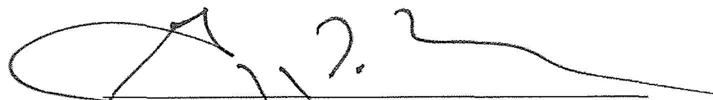
VIII. Division's Penalty Arguments Based on Patently False Information

The Division provides absolutely no response to four pages of thoroughly explained material flaws in the Initial Decision's disgorgement and penalty findings. Brief at 42-46. Instead, the Division blithely requests that the unsupported disgorgement be increased by more than $1.3 million. In addition to being baseless, the Division's suggestion is procedurally barred because the Division did not file a cross-petition for review. Rule 410. Moreover, for the unrebutted reasons cited in the Brief, no disgorgement or penalty amounts are appropriate.

CONCLUSION

For the foregoing reasons, and the reasons set forth in the Brief, Mr. Feldman respectfully requests that the Commission reject the adverse findings in the Initial Decision and dismiss these proceedings.

Respectfully submitted,



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CERTIFICATE OF COMPLIANCE WITH RULE 450(d)

I, Hannah Kon, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 450(c), as it contains 6,875 words, excluding the parts of the brief exempted by the Rule. 17 C.F.R. § 201.450(c).

Hannah Kon