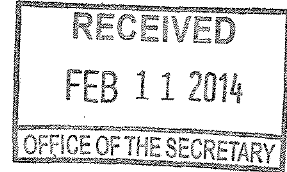

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

optionsXpress, Inc., and
Jonathan I. Feldman,

Respondents.

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

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INTRODUCTION

The parties agree on one thing: "the Commission should enforce the law as written[.]" (Div. Br. 4.) Indeed, the Division does not dispute that the Supreme Court requires "a "literal, 'mechanical' application of" strict-liability Rule 204. *Gollust v. Mendell*, 501 U.S. 115, 122 (1991). Doing so here leads to an inescapable conclusion—the Initial Decision must be vacated.

The Division attempts to avoid this result by mischaracterizing Rule 204(a), arguing repeatedly that the Commission should look to CNS data when deciding whether optionsXpress "immediately close[d] out its fail to deliver position." (Div. Br. 8-10, 19.) In support of this position, the Division has truncated the Rule, inserting a period where none exists. But the Rule does not stop where the Division would like it to. Instead, it defines expressly how a fail-to-deliver position is to be closed out, requiring the broker to "immediately close out its fail to deliver position ***by borrowing or purchasing securities of like kind and quantity***." 17 C.F.R. § 242.204(a) (emphasis added). CNS data is irrelevant. To prove a violation, the Division must carry the burden of demonstrating that optionsXpress' "books and records" do not show "it purchased or borrowed shares in the full quantity of its fail to deliver position." *Rule 204 Adopting Release*, 74 Fed. Reg. 38266, 38272 (July 31, 2009). Yet the Division never even made such an assertion, much less proved this.

Indeed, the Division concedes that it "has never been in dispute" that optionsXpress' buy-write transactions at issue in this case included stock purchases in response to fail-to-deliver-positions. (Div. Br. 17-18.) The Division's sole theory of liability is that these stock purchases were a "sham," because they were paired with deep in-the-money calls as buy-writes. (*Id.* at 2.) But the plain language of Rule 204 does not support that theory.

A literal, mechanical application of Rule 204(a) merely requires stock purchases that indisputably occurred here. To the extent the Division wanted to pursue a "sham closeout"

theory, it needed to meet the Rule's definition of a sham closeout. Rule 204(f) fully addresses sham closeouts and requires an "arrangement" with the counterparty to circumvent close-out requirements. 17 C.F.R. § 242.204(f). The Division has conceded that no such arrangement existed in this case, and thus it "is not claiming that optionsXpress violated Rule 204(f)." (Decision 84.) This concession forecloses any Rule 204 liability here as a matter of law.

To hold otherwise, the Commission would not only have to ignore controlling Supreme Court precedent, it would have to violate optionsXpress' due process rights. The firm had no prior notice that its "[u]se of a buy-write transaction" to close out a fail-to-deliver position without the type of arrangement prohibited by Rule 204(f) would violate Rule 204(a). This certainly does not come from the Rule itself, and thus there was no "clear, rational decision-making that gave regulated members of the public adequate notice of their obligations." *S.G. Loewendick & Sons, Inc. v. Reich*, 70 F.3d 1291, 1297 (D.C. Cir. 1995).

Tellingly, the Division does not endorse the Initial Decision's bright-line rule barring all buy-writes in response to fail-to-deliver positions. This reading not only lacks support in the Rule's text, it would have the unintended consequence of rendering perfectly legitimate trading unlawful. Buy-writes are commonly used in the industry and even encouraged by regulatory guidance when used as a hedging strategy. Yet, according to the Initial Decision, even a single buy-write used as a hedging instrument in response to a fail-to-deliver violates the law.

Instead of pressing this untenable reading of Rule 204(a), the Division prefers to pick and choose which buy-writes are violative according to a "know it when I see it" standard. According to the Division, the firm "should have known" from vague industry guidance that "deep" and "persistent" buy-writes "likely" are not "bona fide" stock purchases in response to a fail-to-deliver. (Div. Br. 2, 8, 11-12.) But such a nebulous "standard" violates due process and

is entirely inconsistent with enforcement of a strict-liability rule. Thus, the Division's reading of Rule 204 is both wrong as a matter of law and is unconstitutional.

The Division's failure to prove a Rule 204 violation also requires dismissal of the fraud claims, which are based upon the same conduct. Even putting aside the deficiencies in the Division's Rule 204 case and its failure to show that Feldman committed fraud, the Division has failed to show that optionsXpress acted with extreme recklessness—which cannot be met where, as here, the broker encountered regulatory "green flags." Nor has the Division even attempted to distinguish the D.C. Circuit's decision in *Howard v. SEC* that an aiding and abetting fraud theory cannot be "based on a partly unwritten body of interpretation regarding what constitutes a 'bona fide' purchase of securities"—instead, the violation must be "clear" from the rule itself. 376 F.3d 1136, 1145 (D.C. Cir. 2004).

There was no violation here, let alone a clear violation. Indeed, the Division ignores testimony from a Director of CBOE, optionsXpress' primary regulator, that the CBOE closed an extensive Rule 204 investigation of the firm after finding that "no violation has occurred," and "a possible 10b-5 charge just wasn't lining up with the facts." In arriving at this conclusion, CBOE actually relied on advice from the SEC's Division of Trading and Markets. Given this and similar undisputed evidence, the *Howard* decision bars any finding of fraud here.

In sum, the Initial Decision must be vacated. The Division's misguided effort to expand the scope of Rule 204—a strict liability Rule—has only furthered market confusion concerning Reg. SHO and simply represents bad enforcement policy. If the Commission wishes to proscribe the type of trading at issue in this case, it should follow the proper procedure for doing so and amend Rule 204 through the rule-making process.

ARGUMENT

I. The Division Failed To Prove A Rule 204 Violation.

In its opening brief, optionsXpress explained that Supreme Court precedent requires a "literal, mechanical" interpretation of strict liability securities rules such as Rule 204. *Gollust*, 501 U.S. at 122. The Division does not—and cannot—dispute that this is the correct standard. Yet, the Division does not even examine, let alone apply, the literal language of Rule 204. Instead, the Division improperly asks the Commission to expand the plain language of the Rule.

A. The Division Ignores The Literal, Mechanical Application Of Rule 204.

The Division has failed to apply mechanically the literal text of Rule 204(a), which states in pertinent part:

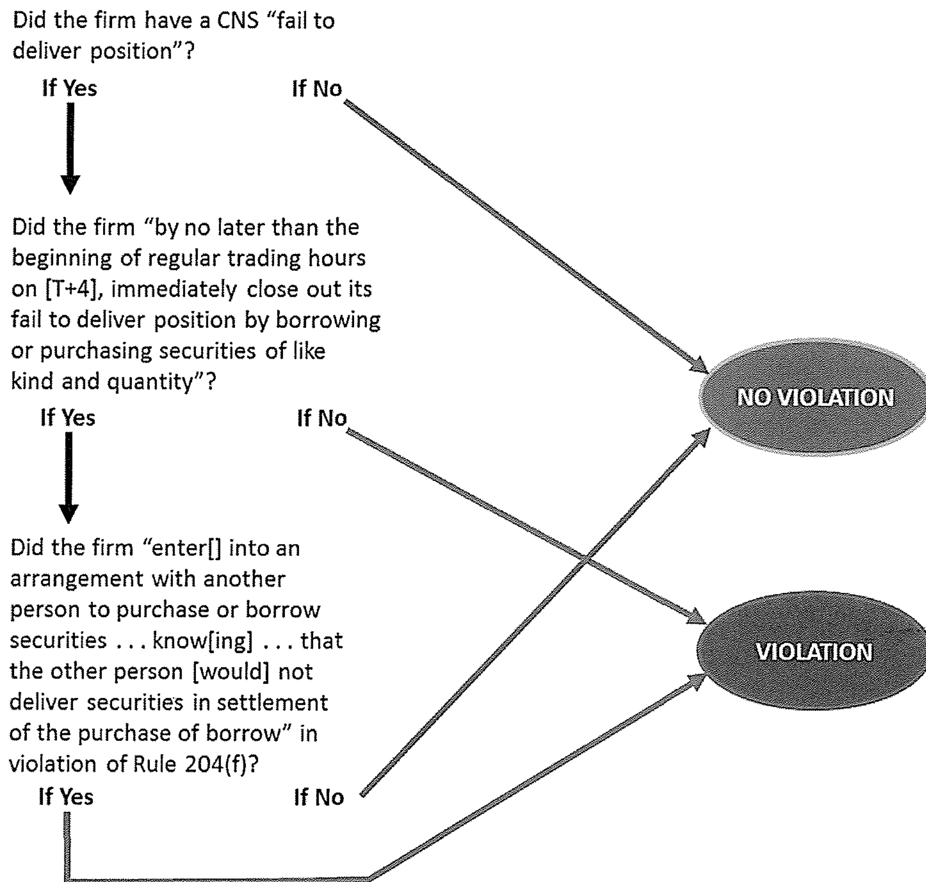
> [I]f a participant of a registered clearing agency has a fail to deliver position, ... the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date [T+4], immediately close out its fail to deliver position ***by borrowing or purchasing securities of like kind and quantity***.

17 C.F.R. § 242.204(a) (emphasis added). The Division focuses solely on the requirement that a firm "immediately close out its fail to deliver position"— ignoring the emphasized language of the Rule that explains how this close-out is to be accomplished, i.e., "by borrowing or purchasing securities of like kind and quantity." (Div. Br. 8-10, 19.) According to a literal, mechanical application of Rule 204(a), it is satisfied where (as here) a firm "purchas[es] securities of like kind and quantity" by market open on T+4 in response to a "fail to deliver position."

As the Division concedes: "when faced with a failure to deliver, optionsXpress executed a buy-write. That has never been in dispute." (Div. Br. 17-18.) According to the Division, however, Rule 204(a) was not satisfied with the stock purchase component of the buy-write, because the written call component "effectively cancel[ed] out" that purchase. (*Id.* at 8; Decision 79.) The Division has thus characterized the use of a buy-write in response to a fail-to-deliver

position as a "sham" or a "wash trade" that has the effect of nullifying the stock purchase used to satisfy Rule 204(a). But this type of alleged "sham," the Division admits, is not the type of circumvention expressly proscribed in Rule 204(f), which requires an "arrangement with another person" to circumvent the close-out requirements—a situation the Division concedes was not present here.[1]

The following demonstrative illustrates the only "literal, mechanical application" of Rule 204 here:



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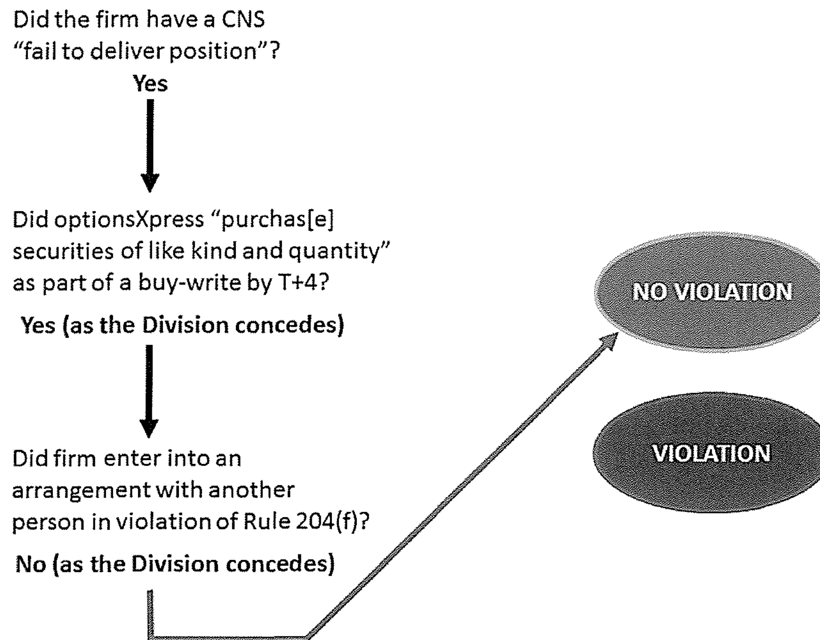
1 Tr. 4193:7-17; 4195:11-17.

Mechanical Application of Rule 204 to the Facts Here



The analysis should end here. The only legal and logical conclusion is that there was no Rule 204 violation.

The Division's theory has no basis in the plain language of the Rule. Instead, the Division has invented an entirely new standard—namely, that "optionsXpress ***should have known*** the 'buy' portion of the[se] buy-writes did not satisfy its delivery obligations because the buying (of the stock) and selling (of the deep-in-the-money calls) occurs simultaneously and effectively cancelled each other out, resulting in no shares actually being delivered to CNS." (Div. Br. 8 (emphasis added).) This theory is not tenable because Rule 204 imposes strict liability and thus does not turn on what optionsXpress knew or "should have known."

B. The Division Improperly Relies On CNS Data, As Opposed To optionsXpress' Books And Records, To Prove A Rule 204(a) Violation.

In its opening brief, optionsXpress explained that Rule 204(a) compliance turns solely on whether the firm's "books and records" show a transaction (borrow or purchase) of stock "of like

kind and quantity," not on what is found in CNS data. 17 C.F.R. § 242.204(a); 74 Fed. Reg. at 38272.[2]

The truth is, as the Division is well aware, optionsXpress' books and records cannot support a Rule 204 violation, because they reflect that the firm properly made stock purchases on T+4. In fact, Dr. Atanu Saha, optionsXpress' expert, examined the firm's books and records and found that the firm made stock purchases through buy-writes (thus satisfying Rule 204(a)), and that these purchases "close[d] out the short positions."[3] In response, the Division has made no effort to rely on optionsXpress' "books and records" to meet ***its burden*** of proving a Rule 204(a) violation. The Division thus tries to meet its burden by relying on CNS data instead. This effort is specious.

First, Rule 204(a) does not authorize the use of CNS data to prove a violation. Instead, as discussed, the inquiry is limited: the Rule is satisfied as long as the firm's records show it purchased stock of like kind and quantity on T+4. The Rule 204(a) inquiry ends there.

Second, CNS data cannot measure compliance with the Rule because it is unreliable and inappropriate to use for this purpose. There is no dispute that stock purchased on T+4 does not resolve a fail-to-deliver until the transaction settles three days later on T+7.[4] Thus, under any circumstance when stock is purchased on T+4 (assuming no other firm or customer activity in that stock), CNS will continue to show a failure to deliver for three additional days.[5] If, on T+7, the firm experiences a new failure to deliver from a different trade, CNS will continue to register

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2 *See also* Opening Br. 22; Tr. 3186:19-23.

3 OPX 248 at 32.

4 Tr. 435:19-436:9.

5 Tr. 436:18-22.

a "persistent" fail-to-deliver for the firm well past T+7, even though the initial fail was resolved on T+4.[6] Accordingly, a "failure to deliver can happen for multiple days in a row without any violation of Reg SHO."[7] No witness disputed this. The Division's witnesses—including the CNS representative—testified that one cannot measure Rule 204 compliance by looking at CNS data.[8]

C. The Division Improperly Relies On Policy And Extrinsic Evidence To Extend The Literal Text Of Rule 204(a).

The Division urges the Commission to extend strict-liability Rule 204 to purported "shams" not addressed in the Rule based on policy concerns and extrinsic evidence. But this is an invitation to reversible error.

The Supreme Court has consistently and repeatedly made this point clear, emphasizing that strict liability rules must be construed literally, "even though in some cases a broader view of statutory liability could work to eliminate an evil that Congress sought to correct through [the rule itself]." *Gollust*, 501 U.S. at 122 (citations omitted). As the Court has explained, if the conduct at issue "is thought to give rise to the kind of evil that Congress sought to correct through [the strict liability statute], those transactions ***can be more effectively deterred by an amendment to the statute*** that preserves its mechanical quality ***than by a judicial search....***" *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 425 (1972) (emphases added); *see also In re George C. Kern Jr.*, SEC Rel. No. 34-29356, 1991 WL 284804, at *2 (June 21, 1991)

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6 Tr. 91:9-25.

7 Tr. 4462:21-25.

8 Tr. 91:9-25; 132:17-21; 1455:8-24.

(Commission adhering to "established principles of statutory construction"). The Division's efforts to avoid this binding precedent are meritless.

1. Only The Division's Reading Of Rule 204 Leads To Absurd Results.

The Division argues that optionsXpress' reading of Rule 204 is too narrow because it purportedly would lead to "absurd results." (Div. Br. 10-13.) In support, the Division argues that a literal reading of Rule 204 would allow certain "sham" transactions that do not involve arrangements with counterparties. But that is not an *absurd* result—it is an *intentional* result designed by the Commission. Again, binding judicial authority prohibits a broad construction of strict-liability rules to avoid unintended consequences that can disrupt the functioning of the markets by ensnaring trading assumed legitimate.

The Commission itself promulgated a specific rule for "sham closeouts"—Rule 204(f)—and determined that buy-write trading does not constitute a sham for purposes of Rule 204 absent an "arrangement" between counterparties. 74 Fed. Reg. at 38278. This limitation makes sense. As explained by CBOE in its written guidance from 2007, in effect for the entire period at issue here, Reg. SHO was not designed to discourage legitimate buy-write activity: "we recognize that most transactions pairing options with stock," i.e. a buy-write, "may be used as part of a general trading/hedging strategy, and ***we do not want to discourage their use for that purpose.***"[9] Notably, the Division does not dispute that the call component of Feldman's buy-writes is consistent with this CBOE guidance—the call re-established his hedged, three-way strategy.

Given this CBOE guidance and the language chosen by the Commission for Rule 204(f), it would be absurd, and patently unfair to Respondents, to expand Rule 204 beyond its literal text as barring all buy-write transactions in response to a failure to deliver. But that is the precise

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

ruling in the Initial Decision: "Use of a buy-write transaction comes within the Commission's definition of a naked short sale" and thus violates "the goal" of Rule 204. (Decision 79.)

The Division does not appear to defend the Initial Decision's extreme holding that ***all*** buy-writes in response to CNS fail-to-delivers necessarily violate Rule 204. Rather, it has failed to articulate any standard at all, much less a clear standard that would avoid marketplace confusion. Instead, the Division speculates in its brief that "use of a ***deep***-in-the-money buy-write to address a close-out is ***likely*** unlawful," particularly if it results in "***persistent*** failures to deliver and naked short selling." (Div. Br. 12; *see also id.* at 15 (arguing that there existed "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") (emphasis added)). But these are unhelpful qualifications for a strict-liability rule, and as explained in the opening brief (at page 27), the trading here does not fit within the definition of naked short selling; in fact, the Division's own expert conceded the trading did not depress the prices of the underlying securities.[10] Nowhere does the Division specifically define the terms "deep" or "persistent," or explain why a deep in-the-money buy-write strategy is only "questionable" or "likely" to violate the Rule (or just "indicative of" a violation). Where is the line between permitted and prohibited conduct? The Division does not say.

Indeed, throughout this case, the Division's theory has raised more questions than it answered: For example, does the use of a single buy-write in response to a failure-to-deliver violate Rule 204(a)? If so, why? Does the written call have to be deep in-the-money? If so, how "deep"? Does Rule 204(a) prohibit buy-writes only if they are used persistently? If so, how many buy-writes constitute a persistent failure to deliver? Are the buy-writes permitted in

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[10] DX310 ¶ 39; Tr. at 1557:19-25.

circumstances designed to facilitate a hedging strategy, as CBOE's published guidance suggests? If so, what are the limitations?

A strict-liability rule cannot contain such ambiguity. Instead, it should provide clear guidance for firms to ensure an informed and efficient marketplace. This is precisely the point of this appeal—to prevent a broad construction of a strict-liability rule that has led to market confusion. Such confusion is unnecessary because the Commission has clearly explained in Rule 204(f) when a buy-write is a sham i.e., ***only*** if it furthers an "arrangement" with counterparties to circumvent the close-out requirement. The Division thus blithely asks the Commission to read a new "sham" provision into Rule 204(a) that would render Rule 204(f) superfluous.

2. The Division Cannot Rely On Regulatory Guidance And Settlements To Alter The Literal Language Of Rule 204.

Unable to draw any support from the actual language of the Rule, the Division looks to regulatory guidance in an effort to support its broad reading of Rule 204. As discussed, this is improper as a matter of law, because the Supreme Court requires "a "literal, 'mechanical' application of" strict-liability Rule 204. *Gollust*, 501 U.S. at 122.

Regardless, the Division has mischaracterized the record:

- 2003 SEC Interpretive Release: This release, which does not address Rule 204 or buy-writes, discusses married-put transactions, which are not at issue here.
- 2004 Initial Reg. SHO Adopting Release: The Division relies on a section of this release pertaining to an entirely different regulation, Regulation M, also not at issue here.
- 2007 American Stock Exchange Guidance: The Division argues that this AMEX guidance "did not suggest that 'an improper arrangement' between parties was the only way to not properly close out a failure to deliver." (Div. Br. 14.) The Division's point is lost. The language of Rule 204(f)—which, unlike the AMEX guidance, was issued by the Commission—***does*** require such an arrangement.

Regardless, this guidance did not even apply to optionsXpress, because it is not a market maker.[11]

- 2007 & 2008 CBOE Regulatory Circulars: As discussed, these CBOE circulars explained that shams require "arrangements between market participants," because "most transactions pairing options with stock" i.e. a buy-write, "may be used as part of a general trading/hedging strategy, and we do not want to discourage their use for that purpose."[12] The Division ignores this language and focuses, instead, on a section that discuses "pairing the close-out with one or more ***short-term*** options" to circumvent Reg. SHO. But Feldman did not use short term options (or "FLEX" options); instead, he used standard options that had expiries spanning weeks.[13]

- *Hazan*, *TJM*, and *Arenstein* Settlements: The Division cites these settlements even though "the Commission has stressed many times, ... settlements are not precedent." *In re Del Mar Fin. Servs., Inc.*, SEC Rel. No. 188, 2001 WL 919968, at *29 n.61 (Aug. 14, 2001). Regardless, they are distinguishable for the reasons explained in optionsXpress' opening brief. (Opening Br. 30-31.)

  The Division also misleadingly argues that "the respondents in *Hazan* used both FLEX options and standard, exchange-traded options"—implying that this settlement involved similar trading to that at issue here. (Div. Br. 32 n.24.) The Division fails to mention that standard options were used only when they expired the next day—effectively rendering them FLEX options.[14] In contrast, there is no evidence Feldman wrote call options that expired the next day.[15]

- 2008 Rule 204T Adopting Release: This release actually supports optionsXpress' reading: "[W]e note that borrowing securities, ***or otherwise entering into an arrangement with another person*** to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO." *Rule 204T Adopting Release*, 73 Fed. Reg. 61706, 61714 n.78 (emphasis added).

- Footnote 82 of the Rule 204 Release: The Division cites this footnote for the proposition that a firm cannot simultaneously purchase and sell stock to re-establish or otherwise extend the participant's fail position. But footnotes in an adopting release do not have the force of law. *Langbecker v. Elec. Data Sys. Corp.*, 476 F.3d 299, 311 n.22 (5th Cir. 2007) ("[a] footnote constitutes at best a

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11 *Compare* DX 384 *with* Tr. 3278:16-17.

12 DX129 at 5; *see also* DX124 at 5.

13 OPX248 at 12; Tr. 1584:21-1585:6.

14 DX130 at n.9.

15 Tr. 1584:21-1585:6; 2520:7-15; 3362:17-3363:3; OPX248 at 12.

comment on the regulations, and is not itself a regulation"); *see also* Office of the Fed. Reg., Nat'l Archives and Records Admin., Fed. Reg. Document Drafting Handbook, Ch. 7 (stating that footnotes are "explanatory, not regulatory.").

Moreover, the Initial Decision did not rely on this footnote. (Decision 93 n.133.) Nor could it have. The buy-writes here did not involve a "sale transaction" (they involved options) and, in any event, furthered "a legitimate economic purpose" (i.e., to reestablish Feldman's hedged position).

In short, none of these regulatory materials can alter the language of the Rule itself—which unambiguously provides that optionsXpress' timely stock purchases satisfied Rule 204 because they were "of like kind and quantity" to the short positions giving rise to CNS fails to deliver, and were not nullified by the existence of an "arrangement" proscribed by Rule 204(f).

3. The Division Cannot Rely On Internal optionsXpress Correspondence To Prove A Rule 204 Violation.

The Division has peppered its brief with quotes from internal optionsXpress correspondence, but these select quotations are legally irrelevant to whether the trading at issue violated Rule 204. Again, Rule 204 is a strict liability provision that turns solely on whether the firm purchased stock of like kind and quantity by market open on T+4—the firm's intent is irrelevant. Regardless, as discussed later, the quotes merely demonstrate that optionsXpress engaged in a robust and candid debate regarding a Rule that caused confusion within the firm, throughout the industry, and among regulators.

4. The Division Cannot Rely On Conduct By Other Firms To Prove A Rule 204 Violation.

The Division improperly asks the Commission to find that optionsXpress violated Rule 204 because "every other firm that confronted Feldman's trading promptly shut it down." (Div. Br. 17.) Conduct by other market participants has no bearing on a "literal, 'mechanical' application of" this strict-liability Rule. *Gollust*, 501 U.S. at 122. The Division cites no authority saying otherwise.

The Division's argument is particularly misleading here given that: (a) there is no evidence that any other broker shut down Feldman's trading based on Rule 204 or fraud concerns[16]; (b) two of the three firms mentioned in the Initial Decision stopped Feldman's trading ***after*** optionsXpress had already stopped the trading[17]; and (c) the third firm shut the trading down due to capital concerns.[18]

D. The Initial Decision Also Violates optionsXpress' Due Process Rights.

As demonstrated in its opening brief, enforcing the Initial Decision also would violate optionsXpress' due process rights, because the Commission failed to provide adequate notice that the trades at issue were unlawful. (*See* Opening Br. 31-34.) The Initial Decision did not even address this argument, and the Division's brief fails to overcome this fatal hurdle.

First, the Division argues that there is no due process violation because optionsXpress' conduct purportedly comes "close" to the line of proscribed conduct. (Div. Br. 19.) But the cases the Division cites do not address strict-liability statutes or rules. As discussed, the Supreme Court has rejected this type of analysis in the strict-liability context, requiring a "limited, mechanical" application. *See Gollust*, 501 U.S. at 122; *Reliance Elec. Co.*, 404 U.S. at 425. Thus, any reading of Rule 204 as capturing purported "shams" beyond those literally proscribed by Rule 204(f) necessarily means the Commission failed to provide "clear, rational decision-making that gave regulated members of the public adequate notice of their obligations." *Reich*, 70 F.3d at 1297.

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16 Tr. 2286:10-14; 907:1-8.

17 Tr. 2286:10-14; 4802:8-10.

18 Tr. 837:22-838:4; 898:22-899:2.

Second, the Division responds to this due process infirmity with a strawman argument that it matters not that these issues have never been previously litigated. (Div. Br. 20.) optionsXpress has never asserted that the Initial Decision violates due process on the ground that it is a case of first impression. Instead, optionsXpress' point is that it had no notice—from the Rule itself, judicial or administrative decisions, or regulatory guidance—that buy-writes without counterparty arrangements were a "sham" when used to close out a failure to deliver. Indeed, the former Director of the Division of Trading and Markets in charge of promulgating Rule 204T read the Rule the same way as optionsXpress.[19] Thus, to the extent the Commission wishes to expand the literal reading of the Rule, it must amend the regulation through proper notice-and-comment procedures. The Division ignores this point completely.

Third, the Division accuses optionsXpress of "distort[ing] the record," arguing that Trading and Markets never said the trading was beyond the reach of Rule 204. (*Id.* at 21.) But this argument ignores contrary testimony from a CBOE Director, who said he asked Trading and Markets "a point blank question"—namely, "Does the trading appear to be a sham closeout?" The response he got was "it appears to be something else."[20] The CBOE Director further testified that the CBOE—which investigated a potential violation by optionsXpress itself, not just its customers[21]—relied on this very advice from Trading and Markets ultimately to conclude that "no violation has occurred," and "a possible 10b-5 charge just wasn't lining up with the

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19 Tr. 3186:19-23.

20 Tr. 4003:10-4004:9.

21 OPX141.

facts."[22] Trading and Markets told optionsXpress the same thing, as confirmed by FINRA's contemporaneous notes—the firm's "activity would ***not*** be considered a violation of 204."[23]

It is clear that the Division of Enforcement read Rule 204 one way, while the Division of Trading and Markets (along with CBOE) read it another way; but Due Process is not satisfied where "different divisions of the enforcing agency disagree about [a regulation's] meaning." *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1332 (D.C. Cir. 1995).

E. The Division Failed To Prove Its Rule 204 Theory Based On Late Buy-Ins.

In its opening brief, optionsXpress explained that "the Division failed to prove that any specific trades were late, and thus did not meet its burden" of proving a Rule 204 violation on that ground. (Opening Br. 46-48.) In response, the Division provided merely two buy-ins (out of thousands of trades) that purportedly were a few hours late—showing, at worst, trade anomalies that cannot support an enforcement action, much less a penalty.

II. The Division Has Not Proven Fraud.

The Division's brief confirms that no fraud liability can be imposed here.

A. There Was No Primary Fraud Violation.

The Division's fraud theory depends entirely on proving an underlying Rule 204 violation.[24] And as optionsXpress has demonstrated, there was no such violation. The Initial Decision's finding of fraud against optionsXpress must be dismissed for this reason alone.

As explained in optionsXpress' opening brief, the Division also failed to meet its burden of proving a primary violation because there was no evidence of market manipulation, and no

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22 Tr. 3901:10-14, 4001:3-15; OPX141 at 3.

23 DX237 (emphasis added).

24 *See* OIP ¶ 2; Decision 2-3.

fraudulent misrepresentation or omission. (Opening Br. 34-37.) In response, the Division conceded that its fraud theory is based on Feldman's trading, alone. (Div. Br. 23.) Yet, the Division made no effort to rebut his legitimate business justification for using buy-writes, i.e., to reestablish his hedged position—trading addressed in more depth in Feldman's brief.

B. optionsXpress Did Not Act With Severe Recklessness.

In its opening brief, optionsXpress further explained that it did not act with negligence, much less with "extreme recklessness" under the controlling *Howard* standard. The Division concedes that *Howard* controls here. (Div. Br. 38.) Yet it has failed to distinguish *Howard*'s key holdings.

1. optionsXpress Encountered Green Flags, Not Red Ones.

In its opening brief, optionsXpress explained that its primary regulator (CBOE) thoroughly investigated the trading and "decided that [the firm] did not violate the rule [204T]"[25] and that the trading was not fraudulent.[26] CBOE then sent optionsXpress a letter informing the firm that CBOE had "completed its investigation."[27] Significantly, that letter did not even hint of a Rule 204 violation, much less a fraud. That notice from the firm's primary regulator was an indisputable "green flag"—sufficient in its own right to defeat a finding of extreme recklessness. *Howard*, 376 F.3d at 1147.

In fact, optionsXpress encountered additional green flags. The firm voluntarily reached out to FINRA and Trading and Markets for the express purpose of asking if the trading should be shut down. The contemporaneous records confirmed that optionsXpress did so because it

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[25] OPX127 at 6; Tr. 4061:1-25.

[26] Tr. 4001:3-15.

[27] OPX138.

actually wanted to "throw ... out" its customers if the SEC regulators found the trading troubling, but the firm was concerned it could "lose[] arbitration" and be held liable for trading losses if the strategy was, in fact, appropriate (as CBOE previously found).[28] Despite notifying both FINRA and Trading and Markets that the trading involved same-day assignments of "deep in the money calls," which were "bundled" with the stock "buy-ins,"[29] neither regulator asked optionsXpress to shut the trading down.[30] Moreover, typed notes of a conversation between the SEC and FINRA confirm that Trading and Markets "told [optionsXpress] that [this] activity would not be considered a violation of 204"[31]—yet another green flag.

The Division attempts to minimize the importance of this evidence by arguing that optionsXpress provided a "misleading fact pattern" to Trading and Markets, but there is no evidence to support that accusation.[32] At worst, optionsXpress did not tell Trading and Markets that a FINRA inquiry was pending (although there is conflicting testimony on this point).[33] But even if Trading and Markets lacked this information, it would be irrelevant to whether the trading itself violated Rule 204.

The Division also tries to argue that optionsXpress received red flags, not green ones. (Div. Br. 41-44.) The Division cites internal optionsXpress correspondence reflecting a debate over whether Feldman's trading posed regulatory risks. But these communications are what

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28 DX243.

29 OPX579; Tr. 3676:14-3678:10.

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

31 DX237.

32 *Compare* Div. Br. 45 *with* Tr. 3676:6-3678:3.

33 Tr. 3423:10-19.

prompted the firm to reach out to its regulators in the first place. To be sure, the Commission should encourage firms to act proactively to avoid regulatory risk and, if appropriate, seek advice from regulators—precisely what optionsXpress did here. When it did, neither CBOE, FINRA, nor Trading and Markets ever told optionsXpress to shut down the trading, even when the firm proactively contacted them and said it was looking for that specific guidance. Once the Division of Enforcement suggested the trading cease, optionsXpress immediately complied.[34] This does not meet the standard for severely reckless conduct under *Howard*.

2. Rule 204 Is Silent As To Whether Buy-Writes Without "Arrangements" Are Sham Close-Outs.

As explained above and in optionsXpress' opening brief, the Division's fraud theory against the firm independently fails because Rule 204 is "silent" when it comes to the Division's theory that buy-writes (at least those with deep in-the-money calls) are sham close-outs. *Howard*, 376 F.3d at 1147.

In response, the Division argues that "[a]ny reasonable market participant would have realized that Feldman's pattern of buy-writes would lead to CNS failures." (Div. Br. 39.) This argument not only ignores the conclusions by CBOE and Trading and Markets, as well as the testimony by Dr. Sirri, it also misses the real point. The D.C. Circuit has held that there can be no extreme recklessness as a matter of law where, as here, the Division's interpretation of a rule does not appear in its actual text. The Division makes no argument that Rule 204 expressly bars the use of buy-writes in the absence of "arrangements." That omission, alone, defeats the Division's fraud claim as a matter of law under *Howard*.

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34 Tr. 3441:11-18; 1700:9-1701:1.

3. The Division's Reading Of Rule 204 Has Never Been Clear.

Howard defeats the Division's fraud theory for yet another reason—its reading of Rule 204 "has never been clear, and has been based on a partly unwritten body of interpretation regarding what constitutes a 'bona fide' purchase of securities for purposes of the rules...." *Howard*, 376 F.3d at 1145.

In its opening brief, optionsXpress pointed out that the Government Accountability Office ("GAO") sharply criticized Trading and Markets because Reg. SHO had led to confusion in the industry. (Opening Br. 40-41.) In response, the Division states that the report does not support optionsXpress' argument. (Div. Br. n.32). But the report is not ambiguous, stating that Rule 204T generated "a lot of ***uncertainty*** and ***confusion*** related to the scope and application of the new requirements"[35] and that "Trading and Markets' varied and, at times, untimely responsiveness to ... requests for interpretive guidance on Regulation SHO ... conflict with the goals articulated in the SEC's current *Strategic Plan*."[36] This report also warned that "[w]ithout timely and ***clear*** interpretive guidance from SEC, SROs [self-regulatory organizations such as CBOE] may be unable to effectively enforce SEC rules and regulations, and SEC cannot ensure the consistent implementation of the rules and regulations."[37]

The Division has only added to this "uncertainty and confusion" by reading Rule 204 as prohibiting "sham close-outs" beyond the limited definition of that term in the Rule itself. This confusion is confirmed by the fact that the regulators themselves disagreed on Rule 204's scope. Indeed, it is hard to imagine a sharper disagreement between the Division's position and that

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35 OPX646 at 64 (emphasis added).

36 *Id.* at 64-5.

37 *Id.* at 65 (emphasis added).

taken by CBOE during the relevant period—namely, that "no [Rule 204] violation has occurred," and "a possible 10b-5 charge just wasn't lining up with the facts."[38] And while the Division tries to paint CBOE as a rogue actor, CBOE's findings were based on multiple and "point blank" communications with Trading and Markets.[39] As one of the CBOE witnesses testified, it was "crystal clear from [his] conversation with the SEC" that "no violation has occurred"—that is, "***there wasn't a violation of Reg. SHO***."[40] As the Division concedes, the Commission itself found in its CBOE settlement that CBOE "failed to detect" any Rule 204 violation by optionsXpress. (Div. Br. 50-51.)

The Division cannot credibly argue that its broad reading of Rule 204 was "clear" given that at least one regulator examined the trading in depth and found no violation. Missing from the Division's brief is any authority holding that a respondent acts with extreme recklessness where, as here, its primary regulator cleared the firm of the underlying violation and other regulators knew about the trading and allowed it to continue.

Instead, the Division points to the inapposite holding in *SEC v. Graham*, 222 F.3d 994 (D.C. Cir. 2000), where the defendants argued that SEC was estopped from sanctioning them, because SEC had "observed [customer's] trading and failed to alert petitioners to it or identify it as a securities violation." *Id.* at 1000. Here, estoppel is not even an asserted defense; rather, optionsXpress argues that the regulator's activities and guidance negated any possibility of scienter. Also, unlike in *Graham* where the trading was economically irrational, here the buy-writes maintained Feldman's hedged position. *Id.* at 1005. The Division never disputes this.

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38 Tr. 3901:10-14, 4001:3-15.

39 Tr. 4003:10-4004:9.

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

Moreover, in *Graham*, the court found that "neither the NASD nor the SEC made any representations at all to [petitioners], and petitioners do not assert that they acted in reliance on any such representations." *Id.* at 1007. Here, in stark contrast, CBOE notified optionsXpress that it closed its Rule 204 investigation without any violation of that Rule. And Trading and Markets initially told the firm to "keep doing what you're doing" (later retracting that statement only because of pending FINRA inquiries).[41]

4. The Division's "Sound Bites" Do Not Show Extreme Recklessness.

The Division attempts to divert the Commission's attention from the legal issues raised in this appeal by pointing to myriad "sound bites" that purportedly show that optionsXpress knowingly violated Rule 204. While this evidence is irrelevant, optionsXpress provides some context below to set the record straight:

Frequent assignments and resulting CNS fails. The Division argues that optionsXpress knew that Feldman was frequently assigned, and this resulted in CNS fails-to-deliver. (Div. Br. 41.) But the record shows that optionsXpress cooperated with regulatory investigations looking into this trading, concluded that Rule 204 was inapplicable, received "green flags" suggesting the regulators agreed, and promptly shut down the trading once the Division asked the firm to do so.[42]

Regulatory Concerns. The Division also cites a number of internal communications where optionsXpress employees expressed concerns that Feldman's trading was similar to that addressed in the *Arenstein* and *Hazan* settlements (which, of course, are non-precedential). (*Id.* at 42.) Once again, these concerns were vetted within the firm and brought to the regulators'

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41 OPX729; Tr. 3437:8-23; 3741:5-12.

42 Tr. 3843:23-3844:6; 3441:11-18; OPX678; OPX138.

attention. For example, Compliance Officer Kevin Strine (an attorney) prepared a detailed email analyzing the situation and concluded there was no Rule 204 violation.[43] As he explained at the hearing, he was concerned that certain regulators, who were not experienced in options trading, could view the trading as unlawful, which could lead to burdensome compliance investigations.[44] In response to Mr. Strine's concerns, the firm immediately reached out to its regulators for advice (and, as discussed, was not told to shut the trading down).[45] A contemporaneous email to the traders confirms these facts: "Compliance has reviewed [the case] and *is not convinced this applies. They have asked our regulator for an opinion* and have not received it."[46] These contemporaneous records show legitimate efforts to construe Rule 204 properly—a far cry from extreme recklessness.[47]

C. Rule 10b-21 Is Inapplicable.

The Division has no credible basis to invoke Rule 10b-21, which focuses on sellers who misrepresent their ability to deliver shares to their broker-dealers. In fact, the adopting release's first paragraph explains that "[a]mong other things, Rule 10b-21 will target short sellers ***who deceive their broker-dealers*** about their source of borrowable shares...." *Rule 10b-21 Adopting Release*, 73 Fed. Reg. 61666 (Oct. 17, 2008) (emphasis added). But there is no evidence that Feldman ever represented to his broker, optionsXpress, that he intended to deliver shares to optionsXpress (much less misrepresented that fact). Thus, this Rule has no application here.

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43 OPX678.

44 Tr. 3388:1-3389:13.

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

46 DX35 (emphasis added).

47 *See* OPX678; Tr. 217:2-10; Tr. 3405:6-23.

III. The Imposed Remedy Is Excessive.

If the Commission decides to affirm liability, the penalties should be reduced. First, the Division seeks a cease and desist order because optionsXpress "is still a registered broker dealer and thus has the opportunity to commit future violations." (Div. Br. 55.) But such "automatic" cease and desist orders are improper. *WHX Corp. v. S.E.C.*, 362 F.3d 854, 859 (D.C. Cir. 2004). The Division cannot demonstrate otherwise by noting that optionsXpress' new owner, the Charles Schwab Corporation, had unrelated settlements with the SEC. (Div. Br. 55.) This is irrelevant. (*See also* Decision 101 (noting that new ownership will *add* protection).) The settlements have no bearing on the allegations in this case—which address trading at optionsXpress that occurred over a year *before* Schwab purchased the company. And to the extent the Division is arguing that a cease-and-desist order is warranted against a respondent simply because a successor company previously settled an unrelated matter with the SEC, that proposition has no support.

Second, the Division ignores optionsXpress' argument that the Initial Decision improperly ordered disgorgement of gross ***revenue***, given that disgorgement "needs to be a reasonable approximation of ***profits*** causally connected to the violations." *In re Ronald S. Bloomfield*, SEC Rel. No. 416A, 2011 WL 1591553, at *35 (Apr. 26, 2011) (Murray, Chief ALJ) (emphasis added). The Division presented no evidence of such "profits," and thus failed to meet its burden of proof.

Instead, the Division improperly asks the Commission to impose an alternative theory despite failing to file a cross-petition. 17 C.F.R. § 201.410. Regardless, as the Initial Decision properly found, that theory—namely, that the firm be ordered to disgorge $7.2 million of hard-to-borrow fees it purportedly avoided by purchasing stock—should be summarily rejected. (Decision 98). Rule 204 allows a firm to "purchase ***or*** borrow" securities in response to a fail to

deliver. 17 C.F.R. § 242.204(a). optionsXpress chose to purchase, thus borrowing is not even an issue in this case, and disgorgement based on hard-to-borrow fees "avoided" makes no sense. This point is confirmed by Commission settlements, which (although not precedent) have measured disgorgement with net profits (or a fraction thereof), not hypothetical borrowing costs avoided. *See In re Gonul Colak and Milen Kostov*, SEC Rel. No. 9522, 2014 WL 345644, at *5-6 (Jan. 31, 2014).

Finally, the Division has failed to defend the $2 million civil penalty, which is excessive given that optionsXpress voluntarily and proactively sought guidance from its regulators. A third-tier penalty is unwarranted for this reason alone. Nor did its trading harm market participants or undermine market integrity. Dr. Harris, the Division's expert, admitted that "[t]here is no data that supports that"—i.e., there is no evidence that "Feldman and optionsXpress ... undermined market integrity."[48] While the Division cites "intent to buy-in" notices as purported evidence of market harm (Div. Br. 26), these notices are irrelevant to Rule 204 compliance, merely representing "a grace period for participants that owe CNS shares to get the shares to make the delivery,"[49] which optionsXpress did.[50]

CONCLUSION

The Commission should vacate the Initial Decision and dismiss this enforcement action against optionsXpress with prejudice.

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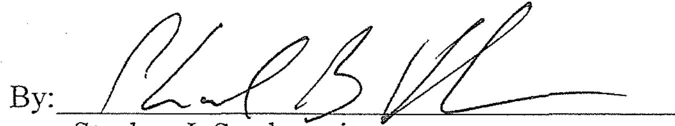
[48] Tr. 1551:8-1552:5.

[49] Tr. 79:18-22; 138:19-22; 105:19-22.

[50] OPX248 at 32.

Dated: February 10, 2014

Respectfully submitted,

By: 

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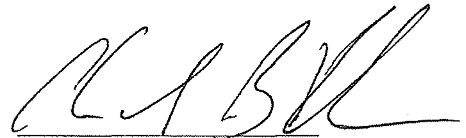
CERTIFICATE OF COMPLIANCE WITH RULE 450(d)

I, Charles B. Klein, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 450(c), as it contains 6,946 words, excluding the parts of the brief exempted by the Rule. 17 C.F.R. § 201.450(c).



Dated: February 10, 2014

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