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

MOTION FOR LEAVE TO ADDUCE ADDITIONAL EVIDENCE AND TO SUPPLEMENT RESPONDENT'S BRIEFING TO THE COMMISSION

Respondent Jonathan I. Feldman, by his attorneys and pursuant to Rule 452, hereby files this Motion for Leave to Adduce Additional Evidence and to Supplement Respondent's Briefing to the Commission. In support, Mr. Feldman states the following:

I. Introduction

The Commission's recent charges against executives of Penson Financial Services, Inc. ("Penson") for violating Reg SHO are exonerating evidence for Mr. Feldman in this matter, and this matter must be remanded so that Mr. Feldman can adduce additional evidence in light of this evidence. This is because a centerpiece of the Division of Enforcement's case against Mr. Feldman was the supposed fact that Penson closed his account because it believed his trading would cause Penson to violate Rule 204 of Reg SHO and that this put Mr. Feldman on notice that his trading was improper. In this regard, the Division touted Penson as fully compliant with Reg SHO, which the Division contrasted with Respondent optionsXpress, Inc.'s allegedly improper interpretation of Reg SHO. The Division's theory was accepted by the Chief Administrative Law Judge (the "ALJ"), and she relied on it heavily in her Initial Decision.

Indeed, the ALJ highlighted Penson's purported opinion that Mr. Feldman's trading caused Reg SHO violations as evidence of Mr. Feldman's scienter.

At the same time that the Division was holding Penson up as the model for Reg SHO compliance at the hearing in this matter (but unbeknownst to Mr. Feldman or the other Respondents in this case), it was contemporaneously investigating Penson and its executives for Reg SHO violations. The Division did not disclose this material fact to the Respondents.

This newly revealed evidence of an investigation (and now prosecution) of Penson executives based on Reg SHO violations is material for at least three sufficient reasons to require remand under Rule of Practice 452. First, this information is material to the reliability and credibility of Penson's interpretations of Reg SHO that were provided at the hearing in this matter. Specifically, Penson's closure of Mr. Feldman's account could not be interpreted as evidence that his conduct caused any Reg SHO violation if Penson itself did not understand what Rule 204 of Reg SHO required. Second, Penson's inability to understand Reg SHO and correctly apply it is material to Mr. Feldman's defense because it further evidences the general confusion in the industry and lack of clear guidance from regulators. Third, and equally important, the Penson investigation (and now Orders) are material to the credibility of the Penson representative, Robert Crain, who testified as a key witness for the Division. The fact of this contemporaneous investigation (and now Orders) could have been used by Mr. Feldman as impeachment evidence to show the bias or interest of this witness because the investigation of Penson was ongoing at the time of the hearing. Mr. Crain would have been concerned about Penson's and his potential liability in that investigation, which may have impacted his decision to cooperate with the Division by providing supportive testimony against Mr. Feldman and optionsXpress.

The charges against the Penson executives in May 2014 follow earlier charges against the Chicago Board Options Exchange ("CBOE') for approving of optionsXpress's compliance with Reg SHO for trading that included Mr. Feldman's orders.[1] The CBOE Order provides exonerating evidence to Mr. Feldman for the same reasons as the Penson Orders and charges, and the effect is cumulative. This information is unquestionably material, and Mr. Feldman could not have known of it at the time of his hearing. In addition to accepting the Penson Orders into evidence, due process requires that Mr. Feldman be afforded an opportunity to offer additional witness testimony and/or cross-examine witnesses for the Division. Depending on the Commission's ruling on the concomitant *Brady* violation discussed below, the Commission should allow Mr. Feldman to reexamine the Penson, CBOE, and SEC witnesses, and to examine new witnesses, based on the fact of these investigations and Orders.

Separately, *Brady v. Maryland*, 373 U.S. 83 (1964), incorporated into Rule of Practice 230(b)(2), requires the Division to produce to the Respondents documents concerning the investigation of, and settlement with, Penson executives, as well as the same information concerning the CBOE. This is because there is a reasonable probability that the ALJ would have determined that Penson's interpretations of Reg SHO were unreliable and that Mr. Crain's testimony could not be credited. The ALJ would have correspondingly found that both substantive and procedural due process constraints prevented her from finding Mr. Feldman, a lay person, liable based on rule that confused sophisticated industry participants like Penson. Once this information has been provided, Rule 452 compels that the Commission permit Mr.

[1] Mr. Feldman previously filed a Motion for Leave to Adduce Additional Evidence Regarding the CBOE Order, which the Commission granted in part and denied in part. *See* Oct. 17, 2013 Order Granting in Part and Denying in Part Motion for Leave to Adduce Additional Evidence Regarding CBOE Settlement. As detailed herein, Mr. Feldman requests reconsideration of the partial denial of that Motion in light of the cumulative effect of the Penson and CBOE Orders.

Feldman the option to submit any such additional evidence into the record, to reexamine witnesses, or offer any new witnesses after review of, and based on, the *Brady* material. At the conclusion of adducing additional evidence, due process also compels that Mr. Feldman be permitted to supplement his briefing to the Commission concerning this additional evidence.

II.
Background

On April 16, 2012, the Commission issued the Order Instituting Proceedings in this matter. An evidentiary hearing was held in September and October of 2012. On June 10, 2013, Mr. Feldman was served with the Initial Decision in this matter. The Initial Decision found that Mr. Feldman violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rules 10b-5 and 10b-21. Initial Decision at 86. The ALJ determined that Mr. Feldman's conduct was fraudulent because when writing call options "he represented to the market as a whole and to purchasers of his deep-in-the-money calls that he was going to make delivery if his calls were exercised and assigned when he had no intention of doing so." *Id.* at 89. The ALJ's finding was predicated upon her finding that optionsXpress had violated Rule 204 of Reg SHO because "optionsXpress did not close out its CNS fail to deliver positions by executing consecutive buy-write transactions." *Id.* at 86.

In her opinion, the ALJ relied on the fact that other broker-dealers—most notably Penson—had stopped Mr. Feldman's trading because those broker-dealers were purportedly complying with Reg SHO. In particular, the ALJ found that "Penson did not consider that a buy-write covered its CNS delivery obligation" and informed Terra Nova (the introducing broker) that it did not want Mr. Feldman's account. Initial Decision at 50-51. In her analysis of why optionsXpress violated Reg SHO, the ALJ "found support" for her position in the fact that

"Penson's former Vice President of Risk, Crain, did not believe the buy-writes satisfied" the requirements of Reg SHO. *Id.* at 79.

The Initial Decision also discusses at length the CBOE investigation of Mr. Feldman's trading strategy. *Id.* at 32-35. In finding that Mr. Feldman committed fraud, the ALJ noted that Mr. Feldman's trading strategy "raised market concerns" among regulators, including the CBOE, and that he could not defend against a fraud by simply relying on his broker if he knew his broker was conducting "illegal" transactions. *Id.* at 92. The ALJ also "found support for [her] position" in testimony from a CBOE staff member who stated that he believed that "anyone" can violate Reg SHO, including customers. *Id.* at 79.

On June 11, 2013, only one day after Mr. Feldman was served with the Initial Decision, the Commission announced a settlement with CBOE (the "CBOE Order"). *In re CBOE, Inc.*, SEC Release No. 69726, 2013 WL 2540903 (June 11, 2013). The CBOE Order issued a series of sanctions against CBOE concerning the trading and investigation at issue in the Initial Decision, finding that the CBOE staff "were confused as to whether Reg. SHO applied to a retail customer" and "erroneously focused on whether the member firm's customer, as opposed to the member firm itself, was in violation of Reg. SHO." CBOE Order at 7. The CBOE Order also found that the CBOE staff "did not have a basic understanding of what a failure to deliver was." CBOE Order at 6. The CBOE Order notes that in addition to being confused as to how Reg SHO applied to customers, the CBOE also wrongly concluded that Reg SHO delivery failures were not occurring. *Id.* at 7.

Upon learning of the CBOE Order, Mr. Feldman filed a Motion to Adduce Additional Evidence seeking an order requiring the Division to produce all documents relevant to the investigation of the CBOE. Mr. Feldman also requested the option to submit additional evidence

into the record and reexamine or examine witnesses with information relevant to these documents. The Commission granted Mr. Feldman's request to include the CBOE Order in the record, but denied his request to compel the Division to produce relevant documents concerning the CBOE investigation or to reexamine witnesses. *See* Oct. 17, 2013 Order Granting in Part and Denying in Part Motion for Leave to Adduce Additional Evidence.

Almost a year after Mr. Feldman was served with the Initial Decision, the Commission announced charges against four Penson executives (the "Penson Orders"). Two of the executives, Lindsey Wetzig and Michael Johnson, settled the charges with the Commission. *In re Lindsey Alan Wetzig*, Release No. 72187, 2014 WL 2038879 (May 19, 2014); *In re Michael H. Johnson*, Release No. 31049 2014 WL 2038878 (May 19, 2014). The Commission is proceeding with an administrative hearing against the other two executives, Thomas R. Delaney and Charles W. Yancey. *In re Thomas R. Delaney and Charles W. Yancey*, Release No. 72185, 2014 WL 2038877 (May 19, 2014).

The Penson Orders allege that the Penson violated Rule 204 of Reg SHO by waiting until T+3 to recall stock loans when margin customers sold securities that had been lent to third parties. This practice created serial fails-to-deliver. The Penson Orders allege that Penson conducted this activity between 2008 and 2011, thus overlapping with the time period that Mr. Feldman's trading was cleared by Penson and optionsXpress.

On September 15, 2014, Mr. Feldman requested that the Division produce the investigatory file concerning its investigation of Penson because it is material to this action. The Division refused to produce any documents in response to this request.

III.
Analysis

A. Commission Should Allow Additional Evidence and Witness Examination

The Penson Orders and further examination of witnesses regarding these Orders qualify for admission as additional evidence under Rule 452's standard. Under Rule 452, a party seeking leave to adduce additional evidence must "show with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously." Rule of Practice 452, 17 C.F.R. § 201.452. This standard is easily met under the circumstances here.

The fact of the investigation of Penson and subsequent Penson Orders are material because they demonstrate that Penson was misinterpreting Reg SHO. This information is exculpatory and a definitive rebuttal to the Division's theory of liability against Mr. Feldman. The Penson Orders were issued on May 19, 2014, almost a year after the issuance of the Initial Decision. Mr. Feldman did not know that the Commission was investigating Penson for Reg SHO violations (or that the Penson Orders would be issued) and there is no way that he could reasonably have known of this information such that he could have introduced it during the hearing. Moreover, the Division did not produce any documents concerning the SEC's investigation of Penson to Mr. Feldman at any time before or after the hearing. Thus, Mr. Feldman was unable to adduce evidence of the SEC's investigation of Penson and Penson's alleged violations of Reg SHO at the hearing.

The materiality of the Penson investigation (and now Orders) cannot be seriously disputed. First, this information is material to the credibility of testimony from Robert Crain, a Penson representative, who testified as a key witness for the Division. The fact of this contemporaneous investigation (and now Orders) could have been used by Mr. Feldman as

impeachment evidence to show the bias or interest of Mr. Crain because the investigation of Penson was ongoing at the time of the hearing. The Division's investigation of Penson began long before the hearing in this matter—the Formal Order of Investigation in the Penson matter was issued on June 2, 2011, over a year before the hearing against Mr. Feldman began. Regardless of whether the Division discussed the Penson investigation with Mr. Crain, or whether the attorneys representing the Division at the hearing knew of the Penson investigation, Mr. Crain undoubtedly knew of the Division's investigation of his employer. Mr. Feldman should now be permitted to reexamine Mr. Crain and potentially other witnesses depending on what the *Brady* material (addressed *infra*) reveals.

The problem of undisclosed biased and interested testimony is especially acute because individuals involved in Penson's consideration of Mr. Feldman's trading also gave testimony to the Staff in the Penson investigation. Charles Yancey, Michael Johnson, and Lindsey Wetzig, respondents in the Penson matter, were intimately involved in determining whether to terminate Mr. Feldman's account. *See, e.g.*, Div. Ex. 346 (email from Michael Johnson to Lindsey Wetzig regarding Mr. Feldman's account); Div. Ex. 347 (email from Ryan Dill to Bill Yancey regarding Mr. Feldman's account); optionsXpress Ex. 714 (email from John Kenny to Bill Yancey regarding Mr. Feldman's account); optionsXpress Ex. 716 (email from Michael Johnson to Ryan Dill regarding Mr. Feldman's account); optionsXpress Ex. 726 (email from Bill Yancey to Robert Crain and others asking for a complete analysis of Mr. Feldman's account). Penson employees were thus well aware of the Staff's investigations in both matters. Mr. Crain may have been motivated to give testimony in favor of the Division at the hearing to influence the Division to treat Penson and its employees favorably in its investigation.

Second, Penson's opinion and practices concerning Reg SHO compliance were a foundation of the Division's case and the ALJ's Initial Decision. During the hearing, the Division offered testimony of a Penson representative to prove that Penson properly interpreted Reg SHO as prohibiting Mr. Feldman's trading. The Division offered evidence that Penson complied with Reg SHO and determined that Mr. Feldman's trading could not continue:

> [MR. BLOCK]: And at this point in time did Penson consider the use of a buy-write as a cover of the CNS delivery obligations?
>
> [ROBERT CRAIN]: No, we did not.
>
> [MR. BLOCK] Why not?
>
> [ROBERT CRAIN] The strategy, as we understood it at that point, was that we would see a perpetual daily buy-write in the account; and meaning, those fails would never be satisfied until trading ceased on the account.
>
> JUDGE MURRAY: So what? Why is that bad?
>
> [ROBERT CRAIN] Well, at this point a fail to deliver is -- was an obligation of our firm that we had to meet under a regulatory requirement.
>
> . . . .
>
> [ROBERT CRAIN] There was no disagreement within the firm that we should continue clearing for him.
>
> [MR. BLOCK] So, the decision was made this is not business you guys wanted to do?
>
> [ROBERT CRAIN] That's correct, yes.

Hearing Transcript, Testimony of Robert Crain at 799, 827.

Mr. Feldman, conversely, presented evidence that Penson terminated his account because Penson could not afford to put up sufficient capital, not because of any Reg SHO concerns:

> [MR. LAWRENCE] It was communicated to Mr. Feldman before you found this memo [concerning Reg SHO] that you didn't want his business anymore, right?
>
> [ROBERT CRAIN] Yes, that's correct.
>
> [MR. LAWRENCE] And that is because the capital requirements were too high?

> [ROBERT CRAIN] The risk and capital associated with this account was significant and a determining factor, yes.

Id. at 901. In fact, Penson did not conclude that Mr. Feldman's trading caused Reg SHO concerns until after it had asked him to close his account and that Penson never communicated to Mr. Feldman or optionsXpress that it was concerned about Reg SHO violations. *Id.* at 907. The ALJ completely failed to address these indisputable facts in the Initial Decision.

The Division used Penson's interpretation of Reg SHO and its closing of Mr. Feldman's account as a critical piece of evidence in their case against optionsXpress:

> Penson believed that the buy-writes did not satisfy its delivery obligation to CNS and had a policy against using buy-writes to cure fails to deliver. After less than a month, Penson made it clear that they no longer wanted Feldman's business because the failures to deliver caused by Feldman's trading were affecting the clearing broker's ongoing operations, and the firm recognized it was creating Reg SHO Rule 204 regulatory problems.

Division Post-Hearing Brief at 32.

> Penson immediately began borrowing shares to cover Feldman's trades—satisfying the firm's Rule 204 responsibilities. This demonstrates that other market participants quickly realized that buy-write trading could lead to Rule 204 issues.

Division Opposition to Respondents' Appeal Brief at 20.

The ALJ accepted Mr. Crain's testimony and credited the Division's representation of Penson as a Reg SHO-compliant broker that interpreted Mr. Feldman's trading as causing Reg SHO problems:

> Penson concluded that Feldman's account was causing it to violate Reg. SHO. Crain testified that there was agreement within Penson that the firm should not clear for Feldman's account. . . .
>
> . . . .

> Penson's former Vice President of Risk, Crain, did not believe the buy-writes satisfied" the requirements of Reg SHO.[2]

Initial Decision at 50, 79.

At the same time it was touting Penson's purported Reg SHO compliance during Mr. Feldman's hearing, however, the Division was in fact investigating Penson for violations of Reg SHO. The investigation was non-public, and Mr. Feldman had no knowledge of it. The fact of the investigation and the subsequent Penson Orders are material evidence in this matter and Mr. Feldman should be permitted to reexamine Mr. Crain (the Penson witness), call any new witnesses (depending on the substance of the *Brady* material), and supplement his briefing to the Commission regarding it. Accordingly, the Commission should remand these proceedings to adduce additional evidence.

B. Commission Should Reconsider CBOE Ruling in Light of Penson Orders

The Commission denied in part Mr. Feldman's Motion to Adduce Additional Evidence regarding the CBOE Orders well before the issuance of the Penson Orders. The effect of both the CBOE Order and the Penson Orders is cumulative. The Division built its case against Mr. Feldman around the false proposition that regulators and brokers viewed his trading as violative of Reg SHO. In fact, the regulators and broker that the Division was relying on to prove its case—CBOE and Penson—were themselves habitually violating and misunderstanding Reg SHO according to the Commission. Any reasonable factfinder would find the withheld information exonerating to Mr. Feldman. The Commission did not have the benefit of the cumulative effect of the CBOE Order and Penson Orders when it denied in part Mr. Feldman's

[2] The ALJ, in turn, ignored the indisputable evidence presented by Mr. Feldman that Penson did not conclude that Mr. Feldman's trading caused Reg SHO concerns until after it had asked him to close his account and that Penson never communicated to Mr. Feldman that it was concerned about Reg SHO violations. Tr. at 892:15-17 (Crain); Tr. at 898:9-13, 899:1-13 (Crain).

first Motion to Adduce Additional Evidence. However, the issuance of the Penson Orders renders the materiality of this information undeniable. Moreover, the Commission's finding was based in part on the fact that Mr. Feldman reasonably could have known of the investigation of CBOE during his hearing. However, Mr. Feldman could not have known of the issuance of the CBOE Orders or the Penson Orders in advance. Accordingly, the Commission should remand this proceeding to a hearing officer for the re-examination or new examination of witnesses with information relevant to the CBOE Orders.

C. *Brady* Requires Production of Penson Documents

1) Penson Documents Would Have Altered Findings Against Feldman

The Division's withholding of material exculpatory evidence related to the findings in the Penson Orders in violation of Rule 230(b)(2) has impeded Mr. Feldman's ability to effectively question fact witnesses from Penson during these proceedings. This is no small matter because a key witness for the Division was the Penson representative who testified that Penson determined that the trading activity at issue violated Reg SHO. If Penson itself was being investigated by the Division for Reg SHO violations, this fact goes directly to this witness's bias and credibility, and Mr. Feldman's counsel could have used this investigation in its questioning of the Penson representative. This type of impeachment evidence falls within the *Brady* rule. *See Giglio v. U.S.*, 405 U.S. 150, 154 (1972) ("When the reliability of a given witness may well be determinative of guilt or innocence, nondisclosure of evidence affecting credibility falls within this general rule.").

There is also a reasonable probability that this evidence, coupled with the fact that the primary options regulator—the CBOE—also did not understand Reg SHO, would have altered the outcome of the hearing. *See Smith v. Crain*, 132 S. Ct. 627 (2012) (*Brady* requires

production of evidence when "there is a reasonable probability that, had the evidence been disclosed, the result of the proceeding would have been different."). This is true for two reasons. First, there is a reasonable probability that the ALJ would have determined that Penson's and CBOE's interpretations of Reg SHO were unreliable and could not be credited, and thus Mr. Feldman's conduct was not violative of any rule and he lacked scienter. Second, there is a reasonable probability that the ALJ would have determined that Penson's and CBOE's inability to understand Reg SHO and correctly apply it evidenced the general confusion in the industry and lack of clear guidance from regulators concerning this rule. The ALJ would have correspondingly found that due process constraints prevented her from finding Mr. Feldman, a lay person, liable based on a rule that confused even regulators and broker-dealers.

For this reason, the Commission should compel the Division to produce exculpatory documents concerning the Penson investigation and Orders including, at a minimum, (1) testimony from Michael Johnson, Bill Yancey, and Lindsey Wetzig, who are both Respondents in the Penson Orders and were intimately involved with Mr. Feldman's account at Penson; (2) any Wells Memoranda submitted by anyone in the Penson investigation; and (3) any correspondence from Penson and any of its employees or executives to the Division regarding its compliance with Rule 204 of Reg SHO.

2) <u>Penson Documents Are Not Exempt Under Rule 230</u>

The Penson documents do not fall under one of the exceptions to *Brady* and Rule 230. Rule 230, which incorporates *Brady*, does not allow for the withholding of information because it is "confidential and nonpublic." Rule 230(b). This is especially true in light of the fact that the Division required undersigned counsel to execute a Confidentiality Agreement before producing any documents in this matter.

Rule 230 explicitly dictates that the Division cannot withhold any "documents that contain material exculpatory evidence." Thus, regardless of whether these documents were contained in this action's investigatory file or another investigatory file, the Division was required to produce them. *Brady* requires production of evidence when "there is a reasonable probability that, had the evidence been disclosed, the result of the proceeding would have been different." *Smith*, 132 S. Ct. 627. As the *Smith* Court noted, a "reasonable probability does not mean that the defendant would more likely than not have received a different verdict with the evidence." *Id.* (internal quotations omitted).

The Penson Orders and related documents are material to Mr. Feldman's defense for the reasons described above. Moreover, the Division's obligation to produce these documents under *Brady* and Rule 230 continues as the Initial Decision has not been made final. *See, e.g., Fields v. Wharrie*, 672 F.3d 505, 515 (7th Cir. 2012) ("a prosecutor's *Brady* and *Giglio* obligations remain in full effect on direct appeal and in the event of retrial because the defendant's conviction has not yet become final"). The Division was already investigating Penson at the time of the hearing in this matter and was obligated to provide the information to the Respondents prior to the hearing.

There is no legitimate reason for this information to have been withheld. This is true regardless of whether the Penson documents were contained in a separate file and whether other Division attorneys conducted the Penson investigation. The Division was required to produce the information concerning its investigation of Penson under *Brady*. For all these reasons, the withholding of material, exculpatory information concerning the Penson investigation was improper. Accordingly, the Division is under an obligation to produce the documents concerning the investigation of Penson, including, at a minimum, testimony from Michael

Johnson, Bill Yancey, and Lindsey Wetzig, the Penson Wells Memorandum, and any correspondence from Penson to the Division regarding its compliance with Rule 204 of Reg SHO. The Division's continued refusal to provide Mr. Feldman with this information hinders Mr. Feldman's ability to prepare and present his defense and violates his due process rights. This conduct warrants an order from the Commission directing the Division to produce the requested documents and, pursuant to Rule of Practice 452, allow Mr. Feldman the opportunity to submit additional evidence into the record based on the withheld exculpatory evidence.

D. Commission Should Permit Supplementation of Respondents' Briefs

After the Division produces the requested documents and the Respondents have had an opportunity to reexamine witnesses from Penson and CBOE, the Commission should permit the Respondents to submit additional briefing concerning this new evidence. The new evidence will undoubtedly be relevant to the Commission's evaluation of the Initial Decision's findings and the Commission's determination as to whether the Initial Decision's adverse findings against Mr. Feldman should be rejected. Accordingly, the Commission should allow the Respondents to supplement their briefing to the Commission regarding its review of the Initial Decision to address the significance of the Penson and CBOE investigations and settlements and to address the new evidence.

III. Conclusion

For the reasons stated above, Mr. Feldman requests that the Commission accept the Penson Orders into the record and allow for the reexamination or examination of witnesses concerning the Penson and CBOE Orders and investigations; order the Division to produce all documents relevant to the investigation of Penson and its executives leading up to the issuance of

the Penson Orders and CBOE Order; and allow Mr. Feldman to supplement his briefing to the Commission after the taking of additional evidence.

Respectfully submitted,

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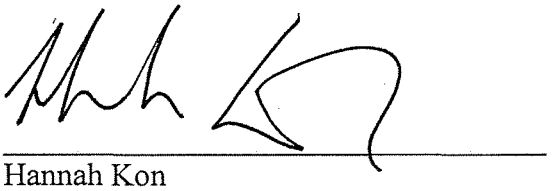
CERTIFICATE OF COMPLIANCE WITH RULE 450(d)

I, Gregory T. Lawrence, certify that this brief complies with the word limitation set forth in Commission Rule of Practice 154(c), as it contains 4,422 words, excluding the parts of the brief exempted by the Rule.



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