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

REPLY IN SUPPORT OF RESPONDENT JONATHAN I. FELDMAN'S 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 Reply in Support of his Motion for Leave to Adduce Additional Evidence and to Supplement Respondent's Briefing to the Commission. In support, Mr. Feldman states the following:

I. Distinctions Concerning Penson Orders are Incorrect and Immaterial

The Division's distinctions between the conduct at issue in the Penson Orders and those at issue here are incorrect and immaterial as follows:

Division Distinction # 1: *The Penson Orders "reveal that Penson's Reg. SHO violations had nothing to do with any misconduct by its customers."* Opposition at 7.

The Division's first distinction is a fallacy because in both cases the customers placed orders with their brokers (Penson or optionsXpress) and their brokers bore complete responsibility for delivery and assumed the obligation to deliver shares *in toto*. Correspondingly, both Penson and optionsXpress gave themselves complete control over their customers' accounts so that they could take any action necessary to comply with Reg SHO. This similarity highlights a fundamental truth applicable to both circumstances: Absent an affirmative representation from

a customer, it is never the customer's conduct that causes a broker to violate Reg SHO. *See* Sirri Report, OPX-EX-915 at ¶¶ 75, 80-81, 127; *see also* Testimony of Josephine Tao, Tr. at 3768-3769 (testifying that customers have no obligations under Reg SHO and that Reg SHO requires no action on the part of the customer). Penson and optionsXpress could have taken different action to attempt to comply with Reg SHO—for example, they could have borrowed shares—but this decision was completely outside the control of their customers. *See* Testimony of Josephine Tao, Tr. 3775 (testifying that optionsXpress could have complied with Reg SHO by either purchasing or borrowing stock, and neither option required approval from the customer).

According to the Penson Orders, Penson allowed its customers to remain short (by only conducting a locate which it believed complied with Rule 204) and allowed borrowers to return stock after the time for delivery required by Reg SHO. *In the Matter of Lindsey Alan Wetzig*, Release No. 7218, 2014 WL 2038879 (May 19, 2014). By the same token, optionsXpress allowed Mr. Feldman and other customers to execute buy-writes, which optionsXpress believed satisfied its obligation under Rule 204. *See, e.g.*, OPX-EX-875; OPX-EX-902. The Division's false distinction between customer conduct in the two cases thus only underscores the impropriety of the charges against Mr. Feldman. The conduct at issue in Penson resulted from customers' placing orders and Penson's determining how to respond to those orders and whether to allow them. So too, in this action, Mr. Feldman placed orders, and optionsXpress retained complete control as to whether to allow those orders and how to respond to them. In short, the level of customer involvement and control is exactly the same in the Penson action and this action.

Division Distinction # 2: "*Penson took bona fide steps in recognition of its close-out obligations, but those steps were ultimately insufficient to meet its Reg. SHO Rule 204 obligations*." Opposition at 7.

It is bemusing that the Division contends Penson's steps to comply with Reg SHO were bona fide, but optionsXpress's were somehow not bona fide. Just like Penson, optionsXpress took steps to meet its close-out obligations—by requiring customers like Mr. Feldman to buy-in. Indeed, evidence at the hearing in this action demonstrated that optionsXpress both recognized that it had close-out obligations under Reg SHO and made repeated, written, explicit, and fulsome representations to Mr. Feldman that it was taking all necessary steps to comply with those close-out obligations. *See, e.g.*, OPX-EX-875 (optionsXpress representative describing Rule 204 close-out requirement and explaining to Mr. Feldman that buy-writes comply with this requirement as long as they are done at the market open); OPX-EX-902 (optionsXpress explaining to Mr. Feldman that Rule 204 required early buy-ins). The Division's "bona fide" distinction is arbitrary, and it leads to the unfounded—indeed, ridiculous—third distinction below.

Division Distinction # 3: *Penson did not misunderstand "the requirements of Reg. SHO or its obligations under Rule 204."* Opposition at 7:

It is nonsensical for the Division to claim that (1) Penson did not misunderstand Rule 204; (2) Penson took "bona fide" steps to comply with Rule 204; but (3) Penson did not comply with Rule 204. Logically, either Penson misunderstood Reg SHO or Penson deliberately violated it. In either case, Penson's misunderstanding or deliberate flouting of Reg SHO provides material exculpatory evidence for Mr. Feldman because Penson's policies and practices were used by the Division to show that the Respondents violated the rule.

The Division's questionable claim that it did not tout Penson as compliant with Reg SHO at the hearing in this matter is beside the point. The Division indisputably used Penson's interpretation of Reg SHO to bolster its case, and the ALJ relied on Penson's interpretation of Reg SHO to find that Mr. Feldman's trading caused violations. *See* Initial Decision at 50, 79. Tellingly, the Division nowhere addresses in its Opposition the detailed discussion of the Division's and the ALJ's reliance on Penson's Reg SHO interpretation in Mr. Feldman's Motion. *See generally* Motion at 9-11. The Division's tenuous side-step—claiming that it never stated that Penson was Reg SHO compliant—is a non-sequitur.

II. Material Similarities With Penson Orders Demonstrate Materiality

The flip side of the incorrect and immaterial distinctions raised by the Division are the overwhelming similarities between the Penson Orders and the charges here. Namely, both clearing firms assumed complete responsibility for Reg SHO compliance, which is the only manner of delivery relevant in either action. And both clearing firms could not and did not blame their customer for the choices they made for Reg SHO compliance.

The similarities between the two actions are illustrated in the following chart:

	Penson Action	**optionsXpress Action**
Conduct Alleged	Short Sales: Penson contacted other broker-dealers before market open on T+4 to confirm they had shares to lend (*i.e.*, performed a "locate") when customers had sold short but did not actually borrow or purchase on T+4 to close-out delivery obligations. The SEC alleges that this conduct did not satisfy Penson's close-out obligations under Rule 204.	optionsXpress randomly allocated its assignment of call exercises to its customers that had written calls. Assignment resulted in the customers' having a short position in that security for the quantity assigned. If optionsXpress did not have the shares in inventory, optionsXpress required the customer to buy shares. optionsXpress allowed its customers to enter "buy-write" orders to concurrently

	Long Sales: Penson issued recalls for stock it had loaned from its customers' margin accounts after margin customers sold the stock but allowed borrowers until close of business (or later) on T+6 to return stock instead of by market open on T+6.	satisfy a buy-in by optionsXpress and reestablish a customer's hedge. The SEC alleges this conduct did not satisfy optionsXpress's close-out obligations under Rule 204.
Delivery Obligation Assumed By	Broker (Penson)	Broker (optionsXpress)
Cause of Violation	Short Sales: Relied on a locate (did not clear up fails-to-deliver) Long Sales: Did not require customers to return stock in time to comply with delivery obligation (did not clear up fails-to-deliver)	Relied on a buy-in executed with a new written call (allegedly did not clear up fails-to-deliver)
Alleged Result of Conduct	Persistent fails-to-deliver at CNS.	Persistent fails-to-deliver at CNS.
Rule Allegedly Violated	Rule 204—failure to close-out delivery obligations.	Rule 204—failure to close-out delivery obligations.
Customer Involvement	Customer placed order. The decision to perform a locate and not to borrow shares or require the customer to buy-in was exclusively Penson's.	Customer placed order. The decision to require a buy-in and allow a buy-write, and not to borrow shares, was exclusively optionsXpress's.

The Penson Orders and investigation are material to the reliability and credibility of Penson's interpretations of Reg SHO that were provided at the hearing in this matter. Given the similarities in these two cases and Penson's misunderstanding and misapplication of Reg SHO, Penson's closure of Mr. Feldman's account could not be interpreted as evidence that his conduct

caused any Reg SHO violation. This information is both material and exculpatory to Mr. Feldman.

III. Crain's Employment During Relevant Period Was Source of Bias

The Division argues that Mr. Crain could not have been biased during the hearing because he was no longer an employee of Penson at that time. This argument misses the point. Mr. Crain was an employee of Penson during the period Penson engaged in the alleged Reg SHO violations at issue in the Penson Orders. The investigation of Penson was thus relevant to Mr. Crain's testimony for several reasons.

First, Mr. Crain's role at the hearing was to testify as to Penson's Reg SHO practices and to defend those practices. Specifically, the Division repeatedly asked Mr. Crain to testify as to Penson's practices and policies, as well as Penson's beliefs. *See, e.g.*, Tr. at 800 ("[D]oes Penson think it's okay to continue to fail to deliver in that system?"). Indeed, the Respondents objected to Mr. Crain's testimony in this regard because he was not offered as a corporate designee of Penson, but the objections were overruled. *See id.* at 800-801. Mr. Crain was the only employee of Penson that testified, and his was the only testimony regarding Penson's policies, practices, and opinions concerning Reg SHO. The knowledge that Penson was itself being investigated based on its Reg SHO policies is thus entirely relevant to the credibility, reliability, and importance of testimony concerning how Penson addressed its Reg SHO obligations vis-à-vis Mr. Feldman's trading. Moreover, the existence of the investigation of Penson's practices concerning Reg SHO compliance could have been used to impeach Mr. Crain based on his bias as a witness testifying as to those very policies. *See United States v. Lena*, 670 F. Supp. 605, 610 (W.D. Pa. 1987) *aff'd*, 849 F.2d 603 (3d Cir. 1988) (holding that questioning

witness about employer's purchase of witness's property at elevated purchase price was proper to test credibility and to show whether witness had bias or interest in favor of employer).

Second, Mr. Crain's prior employment at Penson may have motivated him to cooperate with the Division because of his professional relationships with his colleagues at Penson. Mr. Crain was testifying as to Penson's conduct at the hearing and defending its practices. He likely knew that, at the same time, Penson was being investigated by the SEC for similar conduct. His testimony could thus have been motivated by a desire to paint Penson in a favorable light and to cooperate with the Division so as to favorably influence the outcome of the Division's concurrent investigation into Mr. Crain's former employer and colleagues. *See, e.g.*, *United States v. Maynard*, 476 F.2d 1170, 1174 (D.C. Cir. 1973) ("[E]xternal facts from which may be inferred a specific bias, or motive to testify in a particular way, are admissible to impeach a witness–e. g., facts which show a familial, employment, or litigious relationship.").

Third, because Mr. Crain was an employee of Penson during the conduct at issue in the Penson and optionsXpress investigations, his own potential culpability during this period could have motivated him to cooperate with the Division so that he would not be charged. Even if an explicit agreement in this regard was not reached, Mr. Crain could still have been motivated to cooperate with the Division so as not to increase the chances that he would be charged. *DuBose v. Lefevre*, 619 F.2d 973, 979 (2d Cir. 1980) ("The fact that the promise may not have taken a specific form did not allow the prosecution to avoid disclosing to the jury the fair import of its understanding with the witness."). This basis for concern by Mr. Crain is not based on speculation, but rather the position he held while at Penson. As Vice President of Risk at Penson, Mr. Crain was responsible for, among other things, "credit risk management with the

U.S. clearing operations for Penson." Tr. at 763. As such, he had direct exposure to, and role in, Penson's Reg SHO compliance.

IV. Feldman's Motion is Timely

The Division's contention that the Motion was filed after unexplained delay is indefensible because Mr. Feldman's Motion was timely under the Rules of Practice:

> A party may file a motion for leave to adduce additional evidence at any time prior to issuance of a decision by the Commission.

Rule 452. The Commission obviously has not issued any decision, and thus the Motion is indisputably timely.

In any event, Mr. Feldman did not delay in filing this action for 8 months as the Division contends. Mr. Feldman does not monitor the SEC's docket and does not read every press release and order that is issued. While the Penson Orders were released in May, this is not when Mr. Feldman learned of them. Once he did learn of the Penson Orders, Mr. Feldman's counsel timely contacted the Division and requested that the Division produce the relevant documents. Mr. Feldman then took time to evaluate the Division's response and the relevant legal issues prior to filing his Motion. No prejudice resulted from this careful consideration, and it is warranted under Rule 452.

Similarly, Mr. Feldman's request that the Commission reconsider its ruling regarding the CBOE Orders is not untimely because it was not made pursuant to Rule 470, which allows motions for reconsideration made within 10 days after an order is issued:

> A motion for reconsideration shall be filed within 10 days after service of the order complained of.

Rule 470. Rule 470 is not applicable here because Mr. Feldman's request that the Commission revisit its ruling is made only in light of the Penson Orders, which were not released until May

2014, or 7 months after the Commission's Order denying Mr. Feldman's Motion for Leave to Adduce Additional Evidence Regarding the CBOE Order.

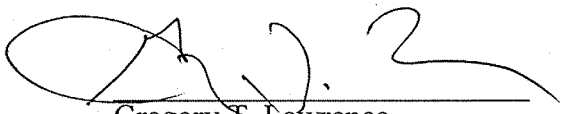
Moreover, Mr. Feldman is not requesting that the Commission simply reconsider its ruling, but rather that it look at his request to adduce additional evidence regarding the CBOE Orders in light of the cumulative effect of both the Penson and CBOE investigations. The cumulative effect of both CBOE's and Penson's incorrectly interpreting Reg SHO has significant implications for Mr. Feldman's defense, including due process implications. That the primary options regulator (CBOE) and another broker/key witness (Penson) also did not understand Rule 204 or how to apply it demonstrates that Rule 204 was "not sufficiently clear to warn a party about what is expected of it." *United States v. Approximately 64,695 Pounds of Shark Fins*, 520 F.3d 976, 980 (9th Cir. 2008) (quoting *Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1328-29 (D.C. Cir. 1995)). This is especially true here, in the context of the industry's misunderstanding of Rule 204. Indeed, an issue that arose in the Penson investigation was one of the Penson Respondent's repeated representation that it was industry practice not to follow Rule 204. *In re Thomas R. Delaney and Charles W. Yancey*, Release No. 72185, 2014 WL 2038877, at *7 (May 19, 2014). This is likely because there was great confusion within the industry and among regulators as to what the rule meant. This information should have been available to Mr. Feldman during the hearing and presented to the Commission.

Conclusion

For the reasons stated above, and the reasons set forth in his Motion, 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 documents concerning the Penson investigation and

Orders including, at a minimum, (1) testimony from Michael Johnson, Bill Yancey, and Lindsey Wetzig; (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; and allow Mr. Feldman to supplement his briefing to the Commission after the receiving and taking of additional evidence.

Respectfully submitted,



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