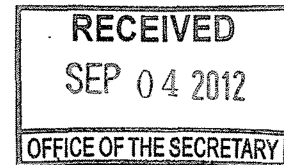

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

HARD COPY

In the Matter of

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

Respondents.

PREHEARING BRIEF OF RESPONDENT THOMAS E. STERN

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I. Introduction

In this action, the Securities and Exchange Commission's Division of Enforcement (the "Division") inexplicably alleges that Respondent Thomas E. Stern ("Stern") caused and willfully aided and abetted violations of Rules 204 and 204T of Regulation SHO of the Exchange Act ("Reg. SHO"), Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 thereunder. The Division apparently bases these charges on the mistaken belief that Stern somehow participated in a "complex short selling scheme" designed to circumvent the delivery requirements of Reg. SHO. As discussed herein—and as Stern will show at hearing—no such "scheme" took place, and Stern did not knowingly assist any securities law violations.

Stern incorporates by reference, in its entirety, the Prehearing Brief of Respondent optionsXpress, Inc. (the "OXPS Brief"), which meticulously describes the trading activity at issue in this matter, accurately chronicles the regulatory advice provided to optionsXpress, extensively reviews applicable law, and thoroughly explains why the Division's claims fail.

II. Background

Respondent optionsXpress, Inc. ("optionsXpress"), a wholly-owned subsidiary of the Charles Schwab Corporation, is a self-clearing, on-line brokerage firm that services self-directed retail customers who trade options and futures. At all times relevant to this action, Stern was the Chief Financial Officer ("CFO") of optionsXpress and the firm's Series 27 registered Financial Operations Principal ("FINOP"). At all times relevant to this action, respondent Jonathan I. Feldman ("Feldman") was a self-directed retail customer of optionsXpress.

Six optionsXpress customers, including Feldman, pursued the non-directional, delta neutral, options trading strategies at issue in this case (described in the OXPS Brief), but the

Division only brings charges against Feldman. In the Order Instituting Administrative and Cease-and-Desist Proceedings (the "OIP"), the Division alleges that Feldman committed fraud under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 by selling options contracts without any intention of fulfilling his regulatory obligations under those contracts, and that optionsXpress and Stern caused and willfully aided and abetted Feldman in this fraud. The Division further claims that optionsXpress repeatedly engaged in a series of sham reset transactions for Feldman's benefit, and failed to satisfy its close-out obligations under Rules 204 and 204T of Reg. SHO. The Division claims Stern also caused and willfully aided and abetted optionsXpress' alleged Reg. SHO violations.

III. <u>Argument</u>

A. Given The Regulatory Environment In Which optionsXpress Operated, It Made Sense To Use Buy-Writes.

In the OIP, the Division alleges that Feldman and optionsXpress committed certain securities law violations and that Stern caused and aided and abetted these primary, predicate violations. As a preliminary matter, Stern amplifies the point, made eloquently in the OXPS Brief, that there were no primary violations here. Feldman did not commit fraud or otherwise attempt to manipulate the market—he simply pursued a non-directional, delta neutral trading strategy that in no way relied upon directional movement in stock prices. To be clear, Feldman's trading strategy was ***not*** an abusive, naked short-selling strategy. In fact, in the trading at issue in this case, Feldman's "short" positions came from the assignment of call options—not from short-selling stock. As a result, Feldman's trading strategy was not manipulative, nor did it rely on being short in stock.

Additionally, optionsXpress did not circumvent its delivery obligations in violation of Reg. SHO. As the context makes clear, there was nothing improper about the firm's decision to allow its customers to use buy-writes to close out short positions. In the OIP, the Division argues that the "[l]aw [w]as [c]lear" that it was improper to use two common options trades—a buy-write and a deep-in-the-money call—in order to comply with Reg. SHO and renew a hedge in a common option trade. The law, however, was not clear, particularly as it applied to options trading. Although the Securities and Exchange Commission ("SEC") disciplined certain market participants for using pre-arranged sales of short-term FLEX options in apparent violation of Reg. SHO, the regulators remained silent on the use of buy-writes.

In fact, there are no regulatory notices advising brokerage firms to avoid using buy-writes when closing out fails resulting from option assignments, other than the guidance on pre-arranged trades combined with the use of FLEX options where assignments were guaranteed. Indeed, the guidance was to the contrary. The write portion of the buy-write was entirely consistent with the CBOE regulatory circulars that sanctioned the execution of option transactions at the same time as the close-out transaction, provided they were part of a legitimate hedging strategy. CBOE Regulatory Circular RG07-87, Aug. 9, 2007, p. 5; CBOE Regulatory Circular RG08-63, May 9, 2008, p. 5. The evidence in this case demonstrates that the write portions of the buy-writes were executed in connection with a legitimate hedging strategy that had economic substance. Thus, given the regulatory guidance available to optionsXpress, it was reasonable for optionsXpress to use buy-writes to meet its close-out obligations for customers engaged in delta neutral options hedging strategies.

In light of this uncertainty, optionsXpress looked to its regulators for guidance. Certainly, from its first inquiry into the use of buy-writes until the Division brought charges in this matter, optionsXpress never received definitive guidance. To the contrary, optionsXpress received comfort from its regulators. As a result, it was reasonable for optionsXpress to allow its customers to use buy-writes to close out short positions, particularly since its primary regulator gave it comfort that such trades did not violate Reg SHO. Indeed, optionsXpress sought guidance from its regulators on numerous occasions. The Chicago Board Options Exchange ("CBOE"), the designated self-regulatory organization ("DSRO") for optionsXpress, thoroughly investigated the trading in question and gave optionsXpress comfort that using buy-writes was an appropriate method for handling close-outs.

CBOE investigators also contacted the SEC's Division of Trading and Markets ("Trading and Markets") to discuss the buy-write trades. CBOE staff explained the mechanics of the trades and both regulatory agencies came to the agreement that there were no "fails" to deliver securities and, as such, no Reg. SHO violations to pursue against optionsXpress. On June 16, 2009, CBOE investigators gave Trading and Markets a detailed memo that further described optionsXpress' buy-write trades (*See* June 16, 2009 CBOE Memo to SEC). Ultimately, it was the SEC's Division of Trading and Markets itself that blessed optionsXpress' use of buy-writes, prompting CBOE to give optionsXpress a clean bill of health (*See* June 19, 2009 CBOE Internal Report; Feb. 3, 2010 Letter from Timothy Thompson to Jill Henderson)[1]. In short, the evidence will show that optionsXpress'

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[1] The June 16, 2009 CBOE Memo to the SEC, the June 19, 2009 CBOE Internal Report, and the Feb. 3, 2010 Letter from Timothy Thompson to Jill Henderson are included on a compact disc sent contemporaneously to the

regulators had full and complete information regarding the buy-write trading activity by the second quarter of 2009, and could have stopped these trades if they were truly inappropriate; they took no such action. It was therefore reasonable for optionsXpress to believe—after having received no guidance to the contrary despite having been investigated, audited, subjected to surveillance by, and having repeatedly sought advice from, its regulators—that the buy-writes were an appropriate way to meet short positions while allowing its clients to remain hedged.

In short, optionsXpress' regulators had full knowledge of the use of buy-writes and gave optionsXpress their blessing. Further, it is common knowledge in the industry and stated clearly in the CBOE regulatory circulars that, while closing out a fail with a stock purchase, a customer can write an in-the-money or "short" call so long as the close-out is a bona fide purchase and the short call is part of a legitimate hedging strategy. However, there is no clear guidance indicating at what point a regulator might interpret a series of these transactions as an attempt to employ sham resets rather than a legitimate hedging strategy. If, as the SEC's action suggests, broker-dealers ought to, in certain circumstances, prohibit their customers from selling short-calls when closing out a short stock position, the absence of clear guidance on the issue will cause chaos in the options industry. The SEC's interpretation would apply to a number of options trading strategies using short, in-the-money calls and market participants would have no way of knowing whether the SEC truly intended to prohibit such strategies. Instead, the Court ought to reject the SEC's novel

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Administrative Law Judge. Stern submits these documents privately in light of the fact that CBOE has asked for a restrictive protective order covering such documents.

theory and send them back to the rule-making process, as nothing in the current set of rules or applicable guidance prohibits what optionsXpress did here.

B. Stern In No Way Caused Or Aided And Abetted Any Violations Of Federal Securities Laws.

Given Stern's role as a "utility infielder" at optionsXpress, and his lack of authority over compliance and trading procedures, he could not have caused or aided and abetted violations of securities laws as the Division alleges. The Division's claims thus have no merit.

1. No Causing

a. Stern's Role At optionsXpress

As CFO of optionsXpress—a title he received because of his FINOP registration—Stern had limited responsibility. He was not a member of the firm's Management Committee and he did not make decisions regarding financial planning or strategy. Stern also had no authority over trading, operations or clearing.

Despite his lack of authority, the evidence will show that Stern's colleagues often consulted him about various aspects of the business, primarily because he had more than 35 years of options-focused securities industry experience and they valued his opinions. In this respect, the evidence will demonstrate that optionsXpress essentially relied on Stern as a "utility infielder" – someone with a broad skill set who could step in and provide general advice and assistance as needed in a number of different areas. This reliance did not change the fact that Stern was not the ultimate decision maker regarding the firm's trading, operations or compliance policies.

Stern also served as the firm's *de facto* regulatory liaison. optionsXpress trusted Stern to handle regulatory communications because he had long-established, professional

relationships with many regulatory employees, particularly at the CBOE and OCC, and had historically communicated effectively with these individuals on behalf of optionsXpress. While Stern occasionally discussed compliance and operations issues with optionsXpress' regulators, he did not have ultimate responsibility for compliance or operations decisions.

b. Stern's Reg SHO Involvement

With regard to the buy-write trades at issue in this case, Stern became involved only after his colleagues asked him for his thoughts about the underlying customer trading strategies and their impact on the firm's net capital requirements. Stern assisted various optionsXpress employees who had primary responsibility for compliance and customer service in thinking through customer trading strategies and their impact on optionsXpress' Reg. SHO close-out requirements. Stern also discussed close-out requirements and their impact on the firm's capital with the CFO of optionsXpress' parent corporation. Finally, as noted in the OXPS Brief, Stern, along with other optionsXpress employees, also participated in various calls and discussions concerning the buy-write trading activity with regulators from CBOE, the SEC and the Financial Industry Regulatory Authority ("FINRA").

Stern's participation in a handful of phone calls and discussions does not rise to the level of causing or aiding and abetting alleged securities violations. Stern was not in charge of optionsXpress' Reg. SHO compliance. It was not his role or within his authority or job responsibilities to change optionsXpress' Reg. SHO policies or to stop the buy-write trades. Stern also had no control over which customers optionsXpress serviced. He did not get involved in decisions about how or when optionsXpress closed out short positions as required by Reg. SHO. Stern, therefore, could not have authorized optionsXpress' buy-in procedures or allowed the buy-writes to continue, as the Division suggests, because he fundamentally lacked the authority to make such decisions.

2. No Aiding And Abetting

The SEC will find one liable for aiding and abetting where: (1) there is an independent, primary securities law violation; (2) the aider and abettor generally was aware or knew that his actions were part of an overall course of conduct that was improper or illegal; ***and*** (3) the aider and abettor substantially assisted the primary violation. *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956-57 (7th Cir. 2004) (emphasis added). For the reasons stated below, the Division cannot prove any of these elements with respect to Stern, let alone all three.

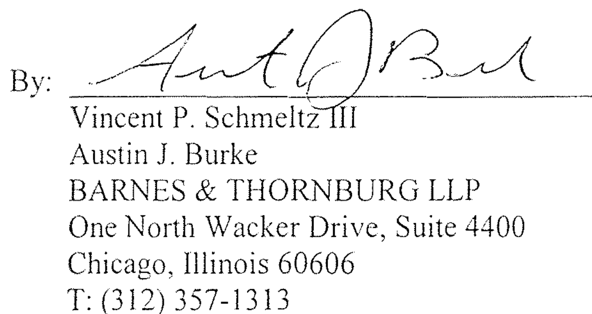
First, as discussed at length in the OXPS Brief, there was no primary violation here. No plausible reading of Reg. SHO reaches the buy-writes at issue in this case, and the Division has no evidence of any "scheme to defraud." ***Second***, Stern had absolutely no reason to believe "that his actions were part of an overall course of conduct that was improper or illegal." As the CFO of optionsXpress, Stern was not responsible for interpreting SEC rules related to trading—he reasonably relied on optionsXpress management and compliance personnel for guidance on such regulatory matters. In this case, senior-level compliance staff at optionsXpress thoroughly researched the firm's obligations under Reg. SHO and, after seeking advice from numerous regulatory officials, reasonably concluded that there was nothing improper or illegal about the buy-write trades in question. Stern was not reckless in relying on the reasoned determination of optionsXpress management and the guidance received from regulators. ***Third***, Stern could not have assisted the alleged violations described in the OIP because he lacked the requisite power and authority to do so and was not involved. As noted above, Stern never had any responsibility for compliance decisions, played no role in shaping optionsXpress' compliance or operations policies, and had no authority or responsibility for trading.

IV. Conclusion

For the foregoing reasons, Stern respectfully urges this Court to: (i) rule that Stern did not cause or willfully aid and abet any violations of Rules 204 and 204T of Reg. SHO, Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, or Rules 10b-5 or 10b-21 thereunder; and (ii) dismiss this administrative proceeding.

Dated: August 31, 2012

Respectfully Submitted,



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I. INTRODUCTION AND OVERVIEW

The Division of Enforcement ("Division" or "Enforcement") unfairly attempts to enforce a reading of Reg. SHO that stretches far beyond its language and purpose. There is no basis in law or fact for holding optionsXpress, Inc. liable for its customers' self-directed trading at issue here, all of which plainly had a legitimate economic purpose.

The Division takes aim at "buy-writes" – a textbook transaction in which a customer purchases shares and writes a call option – where the call was "deep-in-the-money." The customers conducted these transactions on the open market to maintain a hedged option position as part of an arbitrage strategy. These customers were not "short sellers" and did not profit, or seek to profit, from a decline in share prices. Nor did their trading cause the decline in share prices that Reg. SHO was enacted to remedy. According to the Division's novel theory, however, they were engaged in a fraudulent scheme to circumvent Reg. SHO and manipulate the market through "sham resets." The Division cannot link its theory of liability to the plain language of Rule 204 of Reg. SHO adopted by the Commission after notice and comment – a rule that does not address, much less prohibit, the buy-write trading at issue here. Instead, the Division inexplicably seeks to "promulgate" (through enforcement action) a vague new rule that, if accepted by the Court, would sow further uncertainty and unease and create an unlevel playing field among market participants.

The hearing will show that there was no Reg. SHO violation here. And there certainly was no fraud. optionsXpress looks forward to its opportunity to set the record straight and establish, once and for all, that it did not violate Reg. SHO by executing open market buy-writes for its retail customers.

Trading at Issue. Respondent Jonathan I. Feldman and other self-directed customers pursued a hedged option trading strategy based on arbitrage. Unlike short sellers, instead of

betting that stock prices would go down, they wrote and purchased a suite of options (commonly referred to as a "spread") on the open market designed to eliminate any directional risk from stock price movement. They hoped to profit based on option mispricing, not changes in stock prices.

Like any arbitrage strategy, this one carried risk. A key risk of the strategy was that the call option written to hedge the "synthetic long" (i.e., where the customer bought a call and sold a put at the same strike price) would be exercised and randomly assigned to the customer. When that happened, the hedge disappeared and exposed the customer to significant trading losses. Naturally, the customer had a strong economic incentive to write a new call, thus reestablishing the hedge to mitigate any losses.

The holder of the exercised call was entitled to delivery of the stock – and this is where Reg. SHO comes in. To satisfy the regulation, optionsXpress needed to deliver the stock to the registered clearing agency (for delivery to the holder who exercised) "by borrowing ***or*** purchasing" the shares no later than the beginning of regular trading hours on the fourth day after the call option was exercised ("T+3 window"). 17 C.F.R. § 242.204(a) (emphasis added). To that end, optionsXpress elected to require its customers to "buy-in" – that is, to *purchase* the stock so it can be delivered to the clearing agency. Doing so would cure the "failure to deliver" and thus satisfy Reg. SHO.

Here, Feldman and the other customers accomplished the dual goals of satisfying the buy-in requirement and reestablishing the hedge by entering into a buy-write, a combination trade that provided better execution (lower transaction costs) than two separate trades. The "buy" component of the transaction cured the fail position, allowing optionsXpress to satisfy Reg. SHO. The "write" resulted in a replacement call that reestablished the hedged option

position. These buy-write transactions all were standard transactions transparently conducted on the open market with anonymous counterparties, consistent with both Reg. SHO and optionsXpress's duty to provide best execution for its customers.

Division's Theory. In the Order Instituting Administrative and Cease-and-Desist Proceedings ("OIP"), the Division alleges that the buy-writes were not legitimate transactions but, instead, were "sham resets." Although optionsXpress entered purchase orders as part of the buy-writes, the Division nonetheless alleges that these purchases were essentially nullified because "most, if not all, the calls that were sold as part of the buy-writes [were] exercised and assigned on the same day they were sold, resulting in shares not being delivered on settlement." OIP ¶ 27. Reg. SHO, however, did not create such an ambiguous legal standard.

While Rule 204(f) proscribes an "*arrangement* with another person" to circumvent the delivery requirement, the rule does not proscribe standard buy-writes entered on the open market with anonymous counterparties just because "most, if not all" (whatever that might mean) calls happen to be exercised and assigned the same day. When optionsXpress "purchas[ed] securities of like kind and quantity" to cover the assigned calls within the T+3 window, this satisfied the plain language of Reg. SHO. 17 C.F.R. § 242.204(a)

The Division thus eschews the plain language of the rule. It relies, instead, solely on a single footnote in the regulatory guidance to allege: "Where a participant of a clearing agency subject to the close-out requirement purchases . . . securities on the applicable close-out date and *on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose*, the participant will not be deemed to have satisfied the close-out

requirement" of Reg. SHO. OIP ¶ 15 (citing 74 Fed. Reg. 38266, 38272 n.82 (July 31, 2009)) (emphasis added). But this footnote is not law and, in any event, does not apply here.

Footnote 82 plainly is designed to address "*arrangements* with another person" to circumvent Reg. SHO, as stated in Rule 204(f). But the Division, after a nearly three-year investigation, does not even allege such an arrangement in the OIP. Moreover, a plain reading of this footnote does not prohibit buy-writes with deep-in-the-money calls because such calls are not "sale transactions" – they are mere options that may lead to stock sales. The Division thus stretches the rule even further than this footnote, alleging that "[s]elling deep-in-the-money calls is *essentially the economic equivalent of selling shares*" because they purportedly "were generally exercised the same day they were sold (and thus were assigned to the [c]ustomers later the same day)." OIP ¶¶ 28, 30 (emphasis added). But selling calls is *not* the same thing as selling stock.

To be sure, the Division's theory stands on shaky legal ground. In essence, the Division is arguing that Respondents violated the *spirit* of a regulatory guidance *footnote*. In doing so, the Division presses a novel theory of liability under Reg. SHO and the fraud provisions that no tribunal has ever adopted. In fact, to our knowledge, this is far and away the most aggressive interpretation of Reg. SHO ever to be pressed by the Commission. The hearing will confirm that the Division could not be more wrong – legally, factually, and as a matter of public policy.

No Reg. SHO Violation. As discussed, the Reg. SHO claim fails as a matter of law. No plausible reading of Reg. SHO reaches the buy-writes at issue here, which were designed to further a hedged option strategy. The Court should decline the invitation to distort Reg. SHO beyond recognition, a ruling that would raise serious due process concerns and disrupt the market.

Putting aside the legal flaws in the Division's theory, and even assuming footnote 82 carries the force of law, the record will not show a violation of that footnote for two additional and independent reasons. First, when optionsXpress executed the "buy" component of the buy-writes, it did not – "*on that same date*" – engage in "sale transactions that can be used to re-establish or otherwise extend the [firm's] fail position." 74 Fed. Reg. at 38272 n.82 (emphasis added). These written calls had standard expirations averaging more than 30 trading days and thus were not guaranteed, or even virtually guaranteed, to be exercised and assigned back the same day. The anonymous counterparties had control over when to exercise those calls, and assignments were subject to a random clearing process. And, as Dr. Atanu Saha, optionsXpress's economic expert, explained in his report, *the data show that the "buys" in the buy-writes covered all short sales within the T+3 window virtually 100% of the time*. *See* Saha Rpt. at 29-32. That is, optionsXpress delivered stock as required by Reg. SHO.

Second, there was no "*sham* reset" – an allegation that requires proof that the buy-write transactions had no "legitimate economic purpose." As the fact and expert witnesses will confirm, the buy-writes were an integral part of a *legitimate* option-trading strategy based on arbitrage: the buy was designed to cure the "fail to deliver," and the written call maintained the customer's hedge. There was no economic incentive – or, for that matter, ability – on the part of the customers to get assigned at all, much less on the same day the call was written. On the contrary, the customers' strategy was based on avoiding assignments, because such assignments resulted in commission costs that eroded the profitability of the strategy.

The Division nonetheless asserts for the first time in its expert reports that the customers engaged in buy-writes as a sham to avoid paying fees for borrowing hard-to-borrow securities. But this theory is ludicrous. As permitted by the rule, optionsXpress generally *purchased* – it did

not borrow – stock to cover fails. And even when the firm did borrow stock, it never charged its customers borrowing fees. The notion that the customers here engaged in a sham to avoid fees they never would have been charged is nonsense. The Division's theory is like saying a consumer schemes to avoid food delivery charges by either ordering from a take-out restaurant, or by ordering from a restaurant that offers free delivery. Either way, the theory is absurd.

No Fraud. The Division has absolutely no evidence of any "scheme to defraud," much less evidence that optionsXpress aided and abetted such a fraud. According to the OIP, the purported Reg. SHO violation allegedly furthered "a stock-kiting scheme that deprived true stock purchasers of the benefits of ownership." OIP ¶ 4. But, as discussed, there was no Reg. SHO violation. And the data confirm that no purchaser was deprived of any stock ownership benefits.

The fraud claim is doubly flawed because the Division also cannot meet its burden of showing that optionsXpress acted with the requisite scienter (extreme recklessness) to aid and abet any alleged fraud. The evidence will show that optionsXpress made good faith efforts to comply with the law, including requesting guidance from its regulators. Indeed, the firm's primary regulator, the Chicago Board Options Exchange ("CBOE"), asked SEC's Trading and Markets Division "point blank" whether the buy-writes here were "a sham closeout." And the response was no. An internal regulatory report confirms that *Trading and Markets "told the firm [optionsXpress] that the activity would not be considered a violation of 204.*" Division of Enforcement Trial Exhibit ("DX") 237 (emphasis added). CBOE accordingly found no Reg. SHO violation despite *two* separate investigations, and it was "comfortable" confirming to optionsXpress in writing that "*Trading and Markets informed CBOE that Trading and Markets did <u>not</u> believe that [optionsXpress] violated Regulation SHO.*" optionsXpress Trial Exhibit ("OX") 84 (emphasis added).

The notion that optionsXpress violated Reg. SHO, much less aided a fraud, is a theory developed by Enforcement staff *litigators* after-the-fact – not a position advanced by the *regulators* in real time. Indeed, it defies logic and credulity that a firm allegedly engaged in fraud would proactively and affirmatively call its regulators to discuss the fraud and ask them whether it was acceptable to continue.

In sum, as a matter of law and fairness, market participants are entitled to clear notice of the rules governing their trading. In the face of uncertainty, firms, market makers and customers are reluctant to commit capital, with collateral impacts to market efficiency and liquidity. Moreover, inconsistent practice and interpretation of rules results in competitive disparities and an uneven playing field among firms. The standard of conduct the Division asserts should be applied for the first time here – i.e., that certain activity not contemplated in a rule can nevertheless be deemed a "sham" at the discretionary whim of SEC litigators – has left market participants up-in-arms about where the lines are drawn. The result has been to discourage acceptance of certain trading and arbitrage strategies that would otherwise promote efficient pricing in the options market. For these reasons, among others that will be addressed at the hearing and in post-hearing briefs, the Court should rule for optionsXpress and dismiss the OIP.

II. BACKGROUND

The Division's allegations in this case relate to open market trading conducted in accounts for six optionsXpress customers ("Customers").

A. Respondents

optionsXpress is an online brokerage founded in 2001 in Chicago, Illinois. The firm services self-directed retail customers who trade in all types of investment products, and specializes in providing tools and support for customers who engage in sophisticated options

strategies. These customers make their own trading decisions for their own accounts with no recommendations or advice from optionsXpress' management.

While six Customers conducted the trading at issue, the Division has brought this case against only one of them – Feldman. The Division also names Thomas E. Stern, optionsXpress's former Chief Financial Officer, as a Respondent.

B. Trading at Issue

The trading at issue in this preceding is explained in depth in Dr. Saha's report (pages 6-17), which is incorporated by reference. In general, the Customers pursued hedged strategies involving call and put options that are known as a "three-way" or a "box spread." These strategies are neither "novel nor exotic." Saha Rpt. at 9-10. A box spread strategy involves four options, two pairs of puts and calls, that create what is known as a "synthetic long" and a "synthetic short." By taking these positions, the Customers are able to profitably lock in pricing discrepancies among the options contracts.

For the most part, the trading at issue here involved a variant of a box spread referred to as a "three-way strategy." In this strategy, the Customers used a deep-in-the-money call in lieu of a synthetic short to hedge the synthetic long. The three-way strategy involves fewer transactions (three transactions instead of four) and thus lower transaction costs, but the position is not perfectly hedged. That is, the Customer faces directional risk if the stock price drops below the strike price of the call – thus explaining why low strike prices were chosen to create a deep-in-the-money call. *See id.* at 19.

Box spreads and three-ways are materially different from a third hedged strategy initially used by Feldman called a "reverse conversion," where a customer actually shorts stock instead of creating a synthetic short (box spread) or writing a deep-in-the-money call (three-way). When initiating a reverse conversion, the customer must borrow stock for the short sale. In a box

spread or three-way, however, no stock is actually sold short because the strategy uses only option trades. As the Division's economic expert, Professor Lawrence Harris, explained in his report: "Unlike selling stock, option writers do not have to borrow contracts to sell them. They simply write the contracts." Harris Rpt. ¶ 53. Thus, the Customers had no obligation to borrow stock when they initiated three-ways or box spreads – only when they initiated reverse conversions, which are not the focus of this proceeding.

Regardless of which strategy was used here (i.e., box spread, three-way, or reverse conversion), the Customers hoped to profit by identifying mispricing in options, a classic arbitrage approach. Such mispricing can occur for various reasons, such as when securities are "hard to borrow" – that is, when it becomes difficult for investors to borrow the stock to sell it short. In that circumstance, some firms charge "hard-to-borrow fees" when a customer seeks to sell such a stock short, and the market may take this fee into account in option pricing. This, in turn, can result in put and call option prices that provide arbitrage opportunities.

As we expect Feldman to testify, he initially was attracted to optionsXpress because the firm did not charge its customers stock borrowing fees. (There is no legal requirement that such fees be charged.) He identified this policy (akin to a marketing promotion) as creating an opportunity for him to profit from option mispricing by engaging in a reverse conversion, because he did not have to pay a stock borrowing fee charged by some other brokers.

One of the risks of this arbitrage strategy was that optionsXpress could require Feldman to "buy-in." This could happen if the firm decided the costs for borrowing stock to support the short became too high, or if the firm no longer was able to locate stock to borrow. When the firm ultimately issued a buy-in, it had two consequences for Feldman. First, he needed to purchase the stock to satisfy the buy-in. Second, he needed to address the fact that the buy-in

eliminated his hedge, thus exposing him to undesirable directional risk. He realized that winding down his position could have led to trading losses, so he looked for alternatives.

As explained above and in Dr. Saha's report, Feldman and the other Customers often chose to enter into a buy-write transaction – a routine, combination transaction that resolved both issues while minimizing transaction costs and directional price risk. As a result of this buy-write, stock was purchased to satisfy the "buy-in" (and allow optionsXpress to satisfy Reg. SHO), and a call was written to reestablish the fully hedged position. The counterparties to this transaction were not necessarily the same; the transactions simply were combined to promote efficiency and comply with the firm's policy to provide "best execution" for its customers.

The unknown counterparty who purchased the call had the option to exercise each call (whether deep-in-the-money or otherwise) at any time before expiration, which averaged about 36 trading days after the call was written. Saha Rpt. at 12. If and when the holder exercised the call, it was assigned randomly to broker-dealers under the continuous net settlement ("CNS") system. If optionsXpress were assigned the call, the firm would randomly assign that call to one of its customers who had written a call for the particular stock. Thus, a call written by a customer would not necessarily be exercised the day it was written – and, regardless of if and when it was exercised, it would be randomly assigned and not necessarily assigned back to that same customer. But if and when a Customer like Feldman was assigned, he responded by entering into another buy-write transaction to satisfy the buy-in requirement and reestablish the hedged position with minimal transaction costs. Diagrams illustrating this strategy are attached to this brief.

When optionsXpress required Feldman to purchase stock as required by Reg. SHO, the firm did not advise Feldman on whether he should write another call to reestablish his hedged

position – that decision was left to him. Feldman was a self-directed customer who neither sought nor obtained trading advice from optionsXpress.

The Division does not appear to challenge the legitimacy of reverse conversions, three-ways, or box spreads – or, for that matter, arbitrage strategies in general. Instead, it takes issue with how the strategy here was implemented over time. According to the Division, the calls (particularly when deep-in-the-money) written as part of the buy-write were part of a *scheme* to facilitate same-day assignments – thus, as the theory goes, perpetuating a failure to deliver. According to this theory, assignments on the same day calls were written offset stock purchases (the "buy" part of the buy-write). To be clear, however, the Division is not alleging (nor could it allege) that the Customers actually arranged with one or more counterparties to exercise calls continuously on the same day they were written. The Division's theory of liability is that the Customers purportedly hoped this would occur by writing deep-in-the-money calls.

But this theory is contradicted by both the facts and simple economics. No Customer wanted to be assigned – much less assigned on the day the call was written. On the contrary, as explained by Dr. Saha in his report (pages 14 and 16), assignment was the key downside *risk* of the arbitrage strategy. Buy-ins resulting from assignments destroyed the hedged position, thus exposing the Customers to directional risk, as discussed above. If the Customer wound down the remaining positions, or decided to hold them without reestablishing the hedge, he could have faced severe losses as a result of movements of the underlying stock price in either direction. While Customers were able to reestablish the hedge through a buy-write, this trading incurred additional transaction costs (on top of the costs of the assignment itself) that eroded the limited profit margin in the arbitrage strategy (*see* Saha Rpt. at 14). Directly contrary to the Division's

theory, the Customers thus hoped to *avoid* assignments. This basic point does not turn on documents or testimony – it is a matter of simple economics and common sense.

C. Coordination With Regulators

Throughout 2008 and 2009, optionsXpress worked with its regulators in connection with various routine inquiries regarding compliance with Reg. SHO, and proactively contacted regulators for guidance as questions were raised internally about how to interpret the buy-in requirements of Reg. SHO. As discussed in greater detail below (pages 30 through 40), the CBOE and the Financial Industry Regulatory Authority ("FINRA") conducted routine inquiries regarding the very same trading strategy and some of the same Customer accounts that are at issue in this case. Those inquiries spanned months and involved extensive requests for data and information. Throughout those inquiries, optionsXpress diligently provided the requested information and even brought additional relevant information to the regulators' attention, despite the fact that the information was not specifically requested.

But optionsXpress's regulators were unable to reach a consensus as to the propriety of the Customers' trading strategy. The SEC, FINRA, and CBOE each considered the trading strategy, and each reached varying conclusions. Indeed, during the CBOE's inquiry, the CBOE actually reached out to the Trading and Markets Division of the Commission to seek guidance regarding the applicability of Reg. SHO to the Customers' trading. After numerous conference calls with the CBOE and receiving a detailed memo from the CBOE that summarized the trading activity in question, Trading and Markets told the CBOE that the trading did not violate Reg. SHO. Ultimately, neither CBOE nor FINRA ever found that any of the trading at issue in this case violated Reg. SHO.

In sum, the evidence will demonstrate that the regulators did not agree about the application of Reg. SHO to the trading, leaving optionsXpress without clear guidance. And in

March 2010, when the regulators ultimately asked optionsXpress to stop the trading, optionsXpress did so immediately.

III. THE DIVISION CANNOT PROVE THE ALLEGED REG. SHO VIOLATION.

The Division cannot carry its burden of proving by a preponderance of the evidence that optionsXpress violated Rules 204T and 204 of Reg. SHO.[1] Rule 204(a) states, in relevant part:

> A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, *or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, 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 term "settlement date" means "the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security" – i.e., three days after the trade date. *Id.* § 242.204(g); OIP ¶ 12. In short, the registered clearing agency must cure a fail to deliver by initiating a purchase within the T+3 window (by the beginning of regular trading hours on the fourth day after the trade, or T+4).

The driving force behind Reg. SHO, originally adopted in 2004, was to reduce "naked" short selling – i.e., selling shares short without borrowing shares in time to make delivery within the standard 3-day settlement period – which the Commission perceived as causing "sudden and unexplained declines in the prices of equity securities[.]" 74 Fed. Reg. at 38266-67. In its release announcing Rule 204, the SEC explained its concerns leading to the regulation: "Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a

[1] The Division alleges violation of Rules 204 and 204T of Reg. SHO, but the differences between the temporary and final rules are not material to this proceeding. For convenience, therefore, this brief will refer to both rules together as "Rule 204" or simply "Reg. SHO."

security, or possibly to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high." *Id.* at 38267.

The trading at issue cannot, as a matter of law, fall within the scope of Reg. SHO when properly construed. Even under the Division's overbroad reading of Reg. SHO, the record will not support the asserted "sham reset" theory.

A. The Reg. SHO Claim Fails As A Matter Of Law.

According to the Division's theory of liability, Reg. SHO bars buy-writes purchased on the open market to maintain a hedged option-trading strategy if some unspecified percentage of the standard "calls that were sold as part of the buy-writes [are] exercised and assigned on the same day they were sold[.]" OIP ¶ 27. But this is not – and should not be – the law.

Rule 204 applies to fails to deliver that result from a "long or short sale transaction" in an equity security. The rule does not reference options, much less exercises or assignments of options. But even assuming it applies in the option context (which has not been established), the "buy" component of the buy-write satisfies the plain language of Reg. SHO for exercised calls as long as optionsXpress either borrowed or purchased the stock within the T+3 window. That is all the rule requires.

Critically, the Division does not dispute that optionsXpress routinely purchased shares, as part of a buy-write, to cover calls no later than the beginning of regular trading hours on T+4. Instead, the Division's theory is that the "write" component of the buy-write negates this purchase when (as they allege) "most, if not all" the written calls are exercised and assigned the same day. OIP ¶ 27. The purported support for this theory does not come from the rule itself but, instead, from footnote 82 in Amendments to Regulation SHO first published on July 31, 2009 – *after* the trading at issue here began. That footnote says, in relevant part: "[W]here a participant subject to the close-out requirement purchases or borrows securities on the applicable

close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement." 74 Fed. Reg. at 38272 n.82.

The Division's theory, purportedly based on this footnote, raises four legal questions of first impression – each of which defeats the Reg. SHO claim as a matter of law if decided in Respondents' favor. These questions of law are not only critical to resolving this case, they are necessary to provide clarity for other market participants and the options industry as a whole.

1. Rule 204 Does Not Prohibit Standard, Open Market Buy-Writes With Anonymous Counterparties.

As a matter of law, the Division cannot rely on footnote 82 to support its theory that the trading at issue here violates Reg. SHO – particularly given that this footnote does *not* carry the force of law. Like all footnotes to a rule, footnote 82 is merely "explanatory, *not regulatory.*" Federal Register Document Drafting Handbook, Ch. 7 (emphasis added); *see also Langbecker v. Electronic Data Sys. Corp.*, 476 F.3d 299, 311 n.22 (5th Cir. 2007) (finding "footnote constitutes at best a comment on the regulations, and is not itself a regulation"). To the extent this footnote explains any part of the rule, it addresses "sham close-outs" under Rule 204(f), which covers certain "arrangements" between counterparties to circumvent Reg. SHO. That rule states:

> A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this section *where the participant enters into an arrangement with another person* to purchase or borrow securities as required by this section, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow.

17 C.F.R. § 242.204(f) (emphasis added); 74 Fed. Reg. at 38278.

Rule 204(f) thus captures a situation where the buyers and sellers essentially conspire with one another to engage in "sham close-outs" or "sham resets" used to re-establish or

otherwise extend the participant's fail position. *See* DX 121, 123, 130, 132, 135. But that was not the situation alleged here. The Customers merely wrote standard, deep-in-the-money calls on the open market (1) with *anonymous* counterparties, (2) having an average expiration period of 36 trading days, and (3) subject to a random assignment process. This is ***not*** engaging in an "arrangement" with counterparties to violated Reg. SHO. 17 C.F.R. § 242.204(f). In fact, the Division does not even allege any such "arrangement with another person" here, thus rendering its entire theory flawed as a matter of law.

Nor was the trading allegedly designed to facilitate same-day "*sale transactions* that can be used to re-establish or otherwise extend the participant's fail position." 74 Fed. Reg. at 38272 n.82 (emphasis added). A written call is *not* a "sale transaction." The Division acknowledges this fact, alleging that "selling deep-in-the-money calls is *essentially the economic equivalent of selling shares*." OIP ¶ 28 (emphasis added). But the Division cites no authority to extend footnote 82 to covering "economic equivalent[s]" of a "sale transaction." And it would make no sense to do so, either as a matter of law or economics.

A call option is not a stock sale. The Customer who writes the standard, open-market call as part of the buy-write has no control over whether and when the anonymous counterparty will exercise that call. There certainly is no guarantee that any written call contract, much less all the contracts, will be exercised "*th[e] same date*" they were written and thus result in a same-day "sale transaction" that purportedly offsets the stock purchased in the buy-write. 74 Fed. Reg. at 38272 n.82.

In fact, even if the written call were *exercised* that same day, neither optionsXpress nor its customers would have any control over whether that exercise will be assigned back to optionsXpress. The assignment process, controlled by the Options Clearing Corporation

("OCC"), is random. Thus, to the extent some (or even all) written call contracts were exercised and assigned the same day, that necessarily would be due to chance – *not* design.

This is true even if the written calls were deep-in-the-money. The Division appears to allege that deep-in-the-money calls are virtually certain to be executed and assigned on the same day they are written. But the Division's own expert does not go so far – Dr. Harris says only that "deep-in-the-money options are *more likely to be exercised early* than are options that are close to the money." Harris Rpt. ¶ 75 (emphasis added). According to the data, however, even that statement does not necessarily hold true. *See* Saha Rpt. at 26, Table 7 (40%-50% in-the-money calls assigned as frequently as 90-100% in-the-money calls). Regardless, one need not look at the data to know that, absent a prior "arrangement" (not alleged here), the unknown counterparty who holds the call retains full control over when to execute the deep-in-the-money call. And, if exercised, the assignment process still would be random. That is, a combination of market conditions and chance – *not* the Customer or optionsXpress – dictates whether any standard call written on the open market will be exercised and assigned the same day.

The transactions here are thus a far cry from the cases discussed in the OIP that resulted in SEC *settlements* – which, in any event, obviously carry no legal significance when construing Reg. SHO. *See In re Del Mar Fin. Servs., Inc., et al.*, SEC Rel. No. 188, 2001 WL 919968, at *29 n.61 (Aug. 14, 2001) ("It goes without saying, and the Commission has stressed many times, that settlements are not precedent."). As discussed by Dr. Saha, those settlements focused on customized (FLEX) options that expired the day after they were written and were transparently designed, pursuant to "arrangements," to circumvent Reg. SHO – *not* standard open-market options with expiration dates typically exceeding 30 trading days. Saha Rpt. at 12-13. In

contrast to this case, those settlements essentially involved a conspiracy between buyer and seller to guarantee that the options would be exercised immediately to perpetuate a fail-to-deliver.

The evidence also will show that even in the event that a fail occurred on consecutive days, each fail was a new fail resulting from a new assignment and a different transaction. As stated above, the buy-writes consisted of two separate trades that were bundled for economic efficiency and best execution purposes, and were executed against anonymous counterparties. Again, such transactions were not rolling transactions going back and forth between parties pursuant to "arrangements," as occurred in the situations that were subject to prior enforcement actions brought by the CBOE and the SEC.

To be clear, therefore, the Division's theory here is *not* that the trading here violated the letter of Rule 204, or even the letter of footnote 82. Instead, it surmises that the trading at issue merely violated the *spirit* of that regulatory guidance *footnote*. But even if one were to assume the Commission intended Reg. SHO to cover such trading (despite no evidence to that effect), it is well settled that "regulations cannot be construed to mean what an agency intended but did not adequately express." *L.R. Willson & Sons, Inc. v. Donovan*, 685 F.2d 664, 675 (D.C. Cir. 1982). To the extent the Commission believes the rule *should cover* standard, open market buy-writes with anonymous counterparties, it should amend the regulation to say so – not attempt to punish Respondents without giving them adequate notice that the trading at issue violated Reg. SHO.

As a matter of law, therefore, the Court cannot construe Reg. SHO as applying to the trading at issue here. No matter how one characterizes such trades, they were not "arrangements" under Rule 204(f), nor were they designed to facilitate "*sale transactions* that can be used to re-establish or otherwise extend the participant's fail position" under footnote 82. 74 Fed. Reg. at 38272 n.82 (emphasis added).

2. Reestablishing A Hedged Position Is A "Legitimate Economic Purpose" That Bars Application Of Reg. SHO.

As the Division acknowledges in the OIP, a Reg. SHO theory of liability based on footnote 82 can be viable *only* if the "participant is unable to demonstrate a legitimate economic purpose" for the transaction. OIP ¶ 15 (citing 74 Fed. Reg. at 38272 n.82). This Court should establish – as a matter of law – that there is nothing illegitimate about buying a call to reestablish a hedged option strategy.

Hedged options strategies, particularly strategies focused on arbitrage, are prevalent in the investment community and serve legitimate economic purposes. CBOE itself has made this precise point on numerous occasions. In 2007, CBOE noted that, "we recognize that transactions matching options with stock may be used as part of a legitimate hedged strategy, and we do not want to discourage their use for that purpose." "Short Sales, Regulation SHO Requirement to Close-out Short Positions in Threshold Securities," CBOE Regulatory Circular RG07-87 (August 9, 2007). In 2008, CBOE reiterated almost the exact same point: "we recognize that most transactions *pairing options with stock may be used as part of general trading/hedging strategies, and we do not want to discourage their use for that purpose*." CBOE Div. Of Member and Regulatory Servs., Regulatory Circular RG08-63, Regulation SHO (Short-Sales) Close-Out Requirement, Use of Option Transactions, at 5 (May 19, 2008) (emphasis added).

Indeed, as this Court is almost certainly aware, hedged strategies have been used for decades and are legitimate and perfectly legal. *See, e.g., Lyons Milling Co. v. Goffe & Carkener*, 46 F.2d 241, 248 (10th Cir. 1931) ("Hedging is lawful. *It is recognized as a legitimate and useful method* of insuring against loss on a contract for future delivery.") (emphasis added); *see also Rocker Mgmt., LLC v. Lernout & Hauspie Speech Products N.V.*, 2007 WL 2814653, at *2 (D.N.J. Sept. 24, 2007) ("Generally, short selling is a legitimate market strategy used to 'profit

from an unexpected downward price movement to provide liquidity in response to unanticipated buyer demand, and to hedge a risk of a long position.") (quoting SEC Div. of Market Regulation Key Points About Regulation SHO (April 11, 2005) http://www.sec.gov/spotlight/keyregshoissues.htm).

As a matter of law, therefore, the Court cannot construe Reg. SHO as applying to trading designed with the legitimate economic purpose of reestablishing a hedged position. That is precisely the situation here.

3. Even Under The Division's Sham Reset Theory, It Must At Least Prove Certain (Not Random) Assignments That Fully Offset Stock Purchases Made "*That Same Day*."

Footnote 82 expressly says the sale transaction purportedly "used to re-establish or otherwise extend the participant's fail position" must occur "*on th[e] same date*" of "the applicable close-out date," i.e., the day on which the buy was executed. 74 Fed. Reg. at 38272 n.82 (emphasis added). At the very least, the law does not allow the Division to expand the plain language of footnote 82. Yet, the Division's economic expert, Dr. Harris, disregards this language when opining that counterparties to the deep-in-the-money calls "regularly exercised their newly acquired call options on the day they traded *or the next day....*" Harris Rpt. ¶ 28 (emphasis added). Exercises and assignments on "the next day" or later days are necessarily irrelevant as a matter of law. Even under the Division's view of the law, assignments must occur on "th[e] same date." OIP ¶ 15.

Second, the assignments must *fully* offset stock purchased on that same day (referred to as "full assignments" in Dr. Saha's report). Otherwise, even under the Division's own theory, at least some of the buys would not be "reset." It is a matter of basic logic that stock purchases not offset by assigned calls cannot be "used to re-establish or otherwise extend the participant's fail

position." To the extent calls are not *fully* assigned *on the same day* they are written, therefore, such calls cannot – as a matter of law – violate Reg. SHO.

4. The Division's Ambiguous Interpretation Of Reg. SHO, If Adopted By This Court, Would Violate Due Process.

This Court cannot reject the legal arguments above and agree with the Division's interpretation of Reg. SHO without violating optionsXpress's constitutional right to due process. It had no notice – either from the regulation itself, regulatory guidance, or court decisions on the merits (of which there are none) – that the buy-writes at issue violate Reg. SHO even if they were written on the open market for the purpose of reestablishing a hedged position, and were not guaranteed (or even virtually guaranteed) to be assigned on the same day.

"Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule." *Satellite Broad. Co., Inc. v. FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987). Adequate notice of regulatory requirements is determined by the "ascertainable certainty" standard. "If, by reviewing the regulations and other public statements issued by the agency, a regulated party acting in good faith would be able to identify, with 'ascertainable certainty,' the standards with which the agency expects parties to conform, then the agency has fairly notified a petitioner of the agency's interpretation." *Hosp. of Univ. of Pa. ("HUP") v. Sebelius*, No. 11–464 (JDB), 2012 WL 928282, at *10 (D.D.C. Mar. 20, 2012). But when different divisions within an agency have different interpretations of the same regulation, it is unlikely the agency has met its obligation to provide "adequate notice." *See Gen. Elec. Co. v. EPA*, 53 F.3d 1324, 1332 (D.C. Cir. 1995) ("[A]s both *Gates & Fox* and *Rollins* recognized, it is unlikely that regulations provide adequate notice when different divisions of the enforcing agency disagree about their meaning. Such is the case here."); *see also In re American Funds Distributors, Inc.*,

Rel. No. 34-64747, 2011 WL 2515376, at *5-6 (June 24, 2011) (finding regulation ambiguous where party "raised valid questions about the clarity of the Rule's language," "evidence of potentially competing interpretations of the Rule's parameters was provided by [the agency] itself ....," and the agency "brought no enforcement proceeding under the Rule that could have helped elucidate its meaning").

That is precisely the situation here. As explained below (*infra* at 47-48), the regulators disagreed on whether the trading here violated Reg. SHO. Indeed, the CBOE found no Reg. SHO violation after two full investigations, based in part on advice from SEC's Trading and Markets Division. As one CBOE employee wrote at the time: "***I continue to be perplexed on how the SEC provides different guidance to different regulatory entities.***" OX 175 (emphasis added). It is hard to think of better evidence than "different divisions of the enforcing agency disagree about [the rule's] meaning." *Gen. Elec. Co.*, 53 F.3d at 1332.

The facts of this case further confirm that optionsXpress could not determine with "ascertainable certainty" whether or not its Customers' trading violated Reg. SHO, and in fact, optionsXpress repeatedly sought guidance from its regulators on whether the trading violated Reg. SHO and what the standard might be. Indeed, to this day, the Division still has yet to propose any specific legal standard delineating the propriety of deep-in-the-money calls written as part of a buy-write. Even the Division's expert merely opines that, *at the very most*, 82.2% or 91.9% (depending on the computation method) of the calls written were assigned that same day. *See* Harris Rpt. ¶ 130. We dispute this calculation as discussed infra and in considerable detail in Dr. Saha's report; and in any case we dispute its relevance, particularly because his analysis fails to account for the random nature of the assignment process and the fact that the Customer could not control whether or not his calls, as opposed to some other customer's call, would be

assigned. But Dr. Harris's analysis and numbers beg the following questions: Where is the line distinguishing legitimate and illegitimate trading? In the Division's view, are buy-writes unlawful only if same-day assignments exceed 80%? 90%? But wherever that line is drawn, should the legitimacy of trading be determined by calculating these percentages after-the-fact, or based on *ex ante* expectations? And, what method of calculation should be used?

The Division fails to address any of these basic questions or otherwise propose anything remotely resembling an ascertainable legal standard, thus leaving the industry in the dark. And, at the time, optionsXpress was given no guidance sufficient to put it on notice that it could be hailed into an SEC administrative proceeding and accused of fraud for the buy-write trading here. As the Division would have it, its litigators have sole discretion to determine whether deep-in-the-money calls traded through optionsXpress and other broker-dealers are lawful or not. This is a recipe for regulatory disaster: as Stern's expert John Ruth explained, from his perspective as a veteran in the securities industry, this uncertainty "would put clearing firms, brokers and market participants in an untenable position, without clear lines about what types of trades may not be accepted (especially given that the probability of assignment need not even be high in the SEC's view)." Ruth Rpt. ¶ 47.

To the extent deep-in-the-money calls written as part of a buy-write can violate Reg. SHO (which we obviously dispute), the standard must be clear. Otherwise, the standard would be unworkable. Again, to the extent the Division wishes to change the law to bar participants from allowing buy-writes to satisfy Reg. SHO, that is an issue for future regulation – after the notice and comment rulemaking required by the due process requirements of the Fifth Amendment.

B. The Evidence Will Not Support The Division's "Sham Reset" Theory.

The Division's "sham reset" theory of liability is not only legally flawed, it also has no factual basis. Even under the Division's reading of the law, it carries the burden of proving *both*: (1) that the deep-in-the-money calls resulting from the buy-writes were "sale transactions that can be used to re-establish or otherwise extend the participant's fail position," and (2) that the buy-writes were not transacted to further a "legitimate economic purpose." 74 Fed. Reg. at 38272 n.82. The record will show that the Division cannot prove either element. These issues turn on objective, economic analysis of the trading at issue. While the fact witnesses will educate the Court as to the pertinent background facts, we expect the Reg. SHO claim to focus primarily on trading data and expert testimony.

1. The Buy-Writes Here Could Not Be Used To Re-Establish Or Otherwise Extend The Fail.

According to the Division's theory, based on an improper interpretation of footnote 82 (which itself is not law), a buy-write with a deep-in-the-money call is a stock "sales transaction," and optionsXpress purportedly "used" this sales transaction "to re-establish or otherwise extend [its] fail position." 74 Fed. Reg. at 38272 n.82. The record will not support that theory.

As explained in John Ruth's expert report, the very nature of the options settlement process leaves it unlikely for call options to be fully exercised and assigned on the same day to the trader who sold them – even assuming, for the sake of argument, that this would re-establish or otherwise extend a fail position. Ruth Rpt. ¶ 34. As Dr. Saha's report explained, the data in this case demonstrate that this did not usually happen – and one would not have expected it to happen. Of all of the deep in-the-money calls written on the 25 stocks at issue in this case, fewer than one-third were fully assigned on the same day they were written. Moreover, the fact that the assignments occurred in these cases was the result of a random process and not under

the control of either the customer or optionsXpress. Thus, "any rational individual would conclude that these calls were not very likely to be fully assigned, let alone guaranteed to be assigned, the day they were written." Saha Rpt. at 25.

The Division may try to confuse the Court by mischaracterizing emails and telephone conversations, or cherry-picking data, in an effort to show that written calls sometimes were exercised and assigned on the same day of the buy-writes. To be sure, Feldman sent emails saying he was being assigned frequently, even daily at times, but these documents shed no light on whether those assignments pertained to calls written that *same day*. Nor do they address the volume of assignments, i.e., whether only 10% of the written calls were assigned, or 90%. This is why the Court cannot – and need not – rely on email snippets and other sound bites when considering this issue. All that matters is what the trading data show. And these data confirm that same-day assignments were not guaranteed to happen – certainly not same-day, *full* assignments. Once again, these were *not* pre-arranged trades as in the settled cases the Division relies on.

Dr. Saha further examined the data to determine whether optionsXpress actually met its Reg. SHO delivery obligations. As Dr. Saha explained in his report, the short stock positions resulting from assignments were, in fact, cured virtually 100% of the time within the T+3 window (i.e., before the fourth day after the assignment occurs). Saha Rpt. at 29-33. These undisputed data bar the Division from showing a Reg. SHO violation. In short, the shares purchased in buy-writes were delivered, and they were delivered within the window required under the rule.

2. The Buy-Writes Had A Legitimate Economic Purpose.

The Division's "*sham* reset" theory also requires a showing of no "legitimate economic purpose" to the buy-writes transacted here. OIP ¶ 15. The evidence will show overwhelmingly

that the Customers engaged in buy-writes with a legitimate economic purpose – i.e., they were an integral part of a hedged option-trading strategy based on arbitrage.

As Feldman himself put it in a contemporaneous email: "[D]oing the buy-writes is crucial to maintain the neutral hedge." OX 503. optionsXpress personnel will also testify as to their understanding at the time that the Customers used the buy-write to re-establish their hedged position. And Dr. Saha confirmed from an objective, economic standpoint that the "write" is, in fact, necessary to reestablish the hedged position and mitigate losses resulting from the assignment. *See* Saha Rpt. at 17-21, 40. Both Dr. Saha and Feldman's expert, Dr. Erik Sirri, will further discuss why the alternatives (a forced wind-down of the position, or remaining long) would make no economic sense. *See* Sirri Rpt. ¶ 53-54.

The record also will show that the Customers hoped to *avoid* assignments – the precise opposite of the Division's theory that they schemed to get assigned the same day. Assignments not only exposed the Customer to severe losses by eliminating the hedge, they also eroded profits because reestablishing the hedge increased transaction costs. *See* Saha Rpt. at 20. There was no motivation, economic or otherwise, to get assigned at all – much less on the day the call was written.

The record will confirm that the Division cannot show any such motivation. In the OIP, the Division recited two possible illegitimate motivations that can motivate a hypothetical trader to violate Reg. SHO: "Sellers sometimes [1] intentionally fail to deliver securities as part of a scheme to manipulate the price of a security, or [2] possibly to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high." OIP at ¶ 20. But neither motive applies here.

First, the Customers had no economic motive to manipulate any security – the driving force behind Reg. SHO. As stated in the release adopting Rule 204T, "[s]ellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security ...." Amendments to Regulation SHO, 73 Fed. Reg. 61706, 61707-08, (October 17, 2008). As the Rule 204T adopting release also said, "[t]o the extent that fails to deliver might be part of manipulative 'naked' short selling, which could be used as a tool to drive down a company's stock price, such fails to deliver may undermine the confidence of investors." *Id.* at 61710. Yet, as the OIP acknowledges, and the record will confirm, the Customers "eliminated directional risk in the stock price" through the hedged positions. OIP ¶ 22. Manipulating prices of the underlying stock would have absolutely no effect on profits from the Customers' arbitrage strategy. Indeed, the Division's economic expert, Dr. Harris, conceded "that the buy-write trades had little effect on prices in the underlying stock markets[.]" Harris Rpt. ¶ 39. Dr. Saha also conducted an economic analysis of the stock prices and confirmed that, in fact, they were not adversely affected by the trading here. *See* Saha Rpt. at 38.

Second, the Customers had no motive to avoid borrowing costs. According to Rule 204, optionsXpress had the choice either to borrow *or* purchase shares to cure a fail to deliver – and it routinely chose the latter. By causing its Customers to buy-in – i.e., purchase the security – this did not entail borrowing, much less borrowing costs. In fact, to the extent optionsXpress could not purchase the security and borrowed it instead, it *never* charged its customers borrowing costs. The notion that the Customers engaged in sham transactions to facilitate a perpetual fail for the purpose of avoiding costs optionsXpress did not charge obviously makes no sense. Yet, this nonsensical motivation inexplicably is the focus of the expert reports submitted by the Division.

The record (and common sense) will confirm that the sole purpose for the buy-write was the *legitimate* economic purpose of reestablishing the hedged position when the Customer was assigned. The Division has identified no other, plausible purpose for this trading – much less an illegitimate one. This is a complete defense, even under the Division's flawed legal interpretation of Reg. SHO.

IV. THE DIVISION CANNOT PROVE THE ALLEGED FRAUD.

The expert testimony conclusively demonstrates that the Division cannot prove its Reg. SHO claim, so it has attempted to recast that claim as one for fraud. But that claim, too, cannot be proven. To establish that optionsXpress aided and abetted an alleged fraudulent scheme by Feldman, the Division bears the burden of proving by a preponderance of the evidence, among other things: (1) Feldman engaged in a scheme to cause optionsXpress to violate Reg. SHO, to deceive the market into believing he intended to fulfill his obligations on the written calls, and to deprive stock purchasers of the benefits of ownership; *and* (2) optionsXpress acted with the requisite scienter (extreme recklessness) to assist Feldman with the purported fraud. The evidence does not support either element, much less both. In fact, the record will show that optionsXpress acted reasonably and in good faith throughout the relevant period.

A. The Evidence Will Show That optionsXpress Acted In Good Faith To Comply With Unsettled Law.

The following is a chronology summarizing key events during the relevant period that optionsXpress will present at trial to demonstrate its good faith efforts to comply with what was unsettled and ill-defined law.

1. *Fall 2008* – Immediately Upon Adoption of Rule 204T, optionsXpress Sought Regulators' Guidance And Adopted New Procedures.

Rule 204T, which for the first time imposed a requirement of taking close-out action (purchasing or borrowing securities) during the T+3 window for all equity securities failing to

deliver, became effective on September 18, 2008. The next day, Stern spoke with Larry Bresnahan at CBOE regarding the effect of 204T on retail options trading, including how to handle the risk of option assignments. Stern obtained assurances that directly addressed the trading in question: Bresnahan "confirm[ed]" in an email to Stern that optionsXpress traders "do not need to close out a position if [they] are concerned about assignment risk" as long as the company "meet[s] [its] delivery obligation." DX 326. optionsXpress quickly adopted new procedures to ensure that the Clearing Department informed the Trading Desk of necessary buy-ins to be executed during the T+3 window. *See* OX 242.

By November 2008, optionsXpress had observed that the trading in certain customer accounts controlled by Mark Zelezny (one of the Customers) raised questions about how the new rule should be interpreted. optionsXpress analyzed the trading and, on November 5, 2008, Ron Molnar (Director of Clearing for optionsXpress) suggested discussing the trading strategy with the SEC. He stated in an internal email to Peter Bottini (Executive Vice President of Trading and Customer Service) that "we should comment to the SEC regarding covering shorts from the result of an option assignment." OX 15.

Personnel in optionsXpress's Legal, Operations, Clearing, and Execution departments also analyzed the Zeleznys' trading in light of settlements in the *Arenstein* cases that were released in 2007 (referenced in the OIP at ¶¶ 48-49). They concluded that the trading was materially different from that in the *Arenstein* cases, which involved prearranged sham resets. Kevin Strine (Vice President of Compliance) also examined the Zeleznys' accounts in 2008 to consider whether their trading had a legitimate economic purpose. He will testify that, based on his review, he concluded that the Zeleznys engaged in box spreads, the strategy did have a legitimate economic purpose, and it did not violate any rules or regulations.

2. *Throughout 2009* – optionsXpress and Regulators Continue to Evaluate The Relevant Trading And Conclude That Buy-Writes Comply With Reg. SHO.

In 2009, CBOE conducted a routine examination for the year 2008, in addition to a specific investigation regarding the Zeleznys' use of buy-writes to close out fails-to-deliver. optionsXpress produced data and documents to CBOE in connection with this investigation, and also had numerous discussions with CBOE about the use of buy-writes to close out fails in customer accounts. *See*, *e.g.*, OX 339. optionsXpress personnel in multiple departments discussed the Customers' trades and the Firm's Reg. SHO procedures countless times in 2009. Those discussions centered on the Rule's requirements and how the Rule should be implemented, including the ramifications of Rule 204T becoming a final rule in July 2009.

(a) CBOE Provides Detailed Information to Trading and Markets and Both Conclude Trading Does Not Violate Reg. SHO.

As part of its investigation in 2009, CBOE conferred with, and sought guidance throughout the summer from, the SEC regarding whether the trading complied with Reg. SHO. Significant events relating to this interaction are summarized as follows:

- **May 20, 2009** – CBOE speaks with SEC (Trading and Markets) the first time.
    - According to a February 3, 2010 letter from CBOE to the Division, on a May 20, 2009 call between Linda Gerdes of CBOE and Josephine Tao and Victoria Crane of the SEC, "*SEC staff expressed to CBOE staff that as long as the customer does not have a 'fail,' there was no Regulation SHO violation. ... SEC staff felt that the Zelezny's were conducting and maintaining a hedge to their position appropriately.*" OX 176 (emphasis added).
    - The May 20, 2009 call was later memorialized by CBOE's Patrick Fay in a December 10, 2010 email: "CBOE and Trading and Markets discussed the [Zelezny] matter and the Trades/Trading numerous times, including with Tao and Crane, in a conference call on May 20, 2009, during which *Trading and Markets informed CBOE that Trading and Markets did <u>not</u> believe that OX violated Regulation SHO.*" OX 84 (emphasis added).

- **June 16, 2009** – CBOE sends SEC a detailed memo addressing CBOE's investigation into an anonymous complaint dated February 19, 2009, alleging that customers Mark and Jennifer Zelezny violated Reg. SHO by using buy-writes to "re-set or disguise potential buy-in and/or fails." OX 565.

- **June 19, 2009** – CBOE issues a report describing its investigation into the trading described in its June 16, 2009 memo to the SEC. According to CBOE's report, *"the Zelezny's were appropriately maintain[ing] hedged position in multiple securities" and "[n]o fails ever occurred in any account maintained by Zelezny." The regulators thus "recommended that this matter be Filed without Action[.]"* The report recapped the May 20, 2009, conversation with SEC and confirmed: *"the SEC felt that the Zelezny's were conducting and maintaining a hedge to their position appropriately.*" OX 129 at 3-5 (emphasis added).

- **August 5, 2009** – Internal email at Trading and Markets questions whether the Zelezny trades are a "sham" – noting that "[t]he cases have all been hanging on the sham provision so far (sort of Sham Plus)." OX 559. In that same email, Trading and Markets questions whether the SEC should "propose a rule" to cover this trading. *Id.*

- **August 6, 2009** – CBOE Department Head for Market Regulation Linda Gerdes emails CBOE Chief Investigator Daniel Overmyer: "*Let Eric know that we have been talking to Victoria and Josephine [SEC Trading and Markets] and they do not think this is a REG-SHO violation.* The [June 19] memo indicates that it might be REG-SHO." Later that day, Mr. Overmyer replies: "Just an FYI, this matter has been taken care of ...." OX 137 (emphasis added).

- **August 6, 2009** – CBOE Chief Investigator Daniel Overmyer emails Eric Ribelin of SEC Enforcement: "[W]e have been talking to Victoria and Josephine [SEC Trading and Markets] and *they do not think this is a REG-SHO violation.*" OX 136 (emphasis added).

(b) CBOE Reports to optionsXpress that Trading Did Not Violate Reg. SHO.

On September 23, 2009, the CBOE informed optionsXpress that it had completed its investigation and found no violations of Reg. SHO. *See* OX 138. The CBOE investigation resulted in a Letter of Caution that addressed a technical violation unrelated to this rule, i.e., optionsXpress telephonically contacted one of the customers before execution of the buy-in, in contradiction of optionsXpress's written supervisory procedures ("WSP's"). *Id.* The CBOE

itself labeled this technical violation as "ticky tacky" and "[n]ot even a real deviation off the WSP's." OX 573 at 21.

In the absence of any guidance from the regulators that the Customers' trading violated Reg. SHO, optionsXpress continued to execute the orders. In light of the regulatory inquiries, however, personnel at optionsXpress considered shutting down the trading out of concern that the regulators might take an overly aggressive view of the law. But the firm concluded that such extreme action – taken unilaterally, without a formal request by the regulators – could have exposed optionsXpress to litigation risk from the Customers. For example, requiring the Customers to wind-down their trades could have resulted in arbitration complaints alleging that optionsXpress improperly caused trading losses. And any effort to separate the "buys" from the "writes" could have resulted in arbitrations or litigation alleging that the firm violated its obligation to obtain best execution for its Customers' orders.

3. *August 2009* – optionsXpress Considered, and Distinguished, Settlements in Other Cases.

(a) Officers at optionsXpress Analyze *Hazan* and *TJM.*

On August 6, 2009, the Commission announced disciplinary settlements with Hazan and TJM. OIP ¶ 54. The same day, Compliance officials at optionsXpress analyzed those settlements and considered their application to the Customers' trading. As Strine (Vice President of Compliance) will testify, he reached a reasoned opinion that the relevant trading was different in a number of material respects from the trading in those settlements, including:

- The Customers were *not* colluding with counterparties as in *Hazan* and *TJM*;
- The Customers were retail customers, *not* market makers as in *Hazan* and *TJM*;
- The Customers were using standardized exchange-traded options with standard terms and expiration dates – *not* FLEX options with pre-arranged, short-term expiration dates agreed upon between colluding parties as in *Hazan* and *TJM*; and

- The Customers were *not* naked short selling stock *to depress the price of the stock* as in *Hazan* and *TJM*; rather, short stock positions created in their accounts occurred as a result of the customers' call options getting assigned after two random assignment allocation processes.

Strine shared his analysis with others at optionsXpress, and they had numerous discussions regarding the possible application of those disciplinary settlements to optionsXpress's business. optionsXpress reasonably concluded that the pre-arranged trading in *TJM* and *Hazan* was significantly different from the trading at issue.

(b) optionsXpress Advises The Trading Desk of its Analysis of SEC Settlements after Further Analysis.

In September of 2009, two optionsXpress traders – Jeremy Coronado and Gino Stella – became aware of the *Hazan* and *TJM* settlements, and noted what they perceived to be similarities between those settlements and the Customers' trading. After reviewing the *Hazan* case briefly, Coronado told Bottini that he would not be placing any trades that day. DX 35. Bottini explained to Coronado and Stella that "Compliance has reviewed" the *Hazan* settlement addressing Reg. SHO "and is not convinced this applies. *They have asked our regulator for an* opinion *and have not received it.*" *Id.* (emphasis added). After considering the *Hazan* settlement in more detail, Coronado recognized that the trading in *Hazan* was materially different from the Customers' trades.

That same day, Bottini and Hoeh discussed the *Hazan* and *TJM* settlements once more and again found the trading in *Hazan* and *TJM* differed materially from the Customers' trades. Hoeh then spoke with Stella and Coronado about the *Hazan* settlement. After the issue had been raised with Bottini and the Compliance Department, the traders at the Execution Desk felt comfortable that the appropriate individuals had analyzed the case and concluded it was inapplicable. Coronado and Stella then resumed their normal trading duties that day.

Also on September 23, 2009, Bottini sent the *Hazan* settlement to Feldman, who similarly pointed out how the *Hazan* settlement did not apply to his trading. OX 18. Yet, to avoid any confusion, Bottini told the firm to contact all the regulators and push them a little harder to get a specific opinion from them on the Customers' particular trading behavior. Bottini wanted to get specific guidance on whether the Customers could sell deep-in-the-money calls on the same day as a buy-in and to make sure that no new interpretation would be issued that might abruptly disallow the trading.

4. *September 2009* – optionsXpress Sought Further Specific Guidance From Regulators and Received Comfort from CBOE and Trading & Markets That Trading Did Not Violate Reg. SHO.

(a) optionsXpress Asked CBOE and FINRA for Guidance.

Given the lack of clearly relevant precedent or guidance regarding the application of Reg. SHO to retail customers' self-directed options strategies and recent inquiries by CBOE and FINRA, the firm contacted its regulators for further guidance in September 2009. optionsXpress contacted two regulators – CBOE and FINRA – that had previously reviewed the customers' trades.

As discussed above, CBOE's inquiry culminated in a letter dated September 23, 2009, cautioning optionsXpress for not following its written supervisory procedures relating to *notice* of buy-ins – but *not* any violations of Reg. SHO. OX 138. optionsXpress called CBOE after receiving the letter of caution to question whether it had reached any conclusions regarding the use of buy-writes to close out a fail to deliver position. DX 163 at 5-6. CBOE told optionsXpress that after reviewing the trades, the trade blotters, and who was being assigned and bought in, it had found no issues other than as stated in the letter of caution.

Seeking to ensure that all of the regulators reviewing the trading were comfortable with the Firm's approach, optionsXpress next reached out to FINRA on September 24, 2009, through

a call to Christina Aylward and Jocelyn Mello-Gibbon. optionsXpress asked FINRA if it could provide guidance regarding the intent of Reg. SHO, whether the use of buy-writes to close out complied with the Regulation, and whether the firm could combine the two orders (the buy and the write) according to its best execution policy. FINRA declined to give any guidance to optionsXpress, citing its open inquiries. FINRA advised that the Firm should contact the drafter of Reg. SHO at the Commission to seek guidance with respect to Reg. SHO and its intent.

(b) optionsXpress Contacted Trading and Markets, Who Told the Firm to "Keep Doing What You're Doing."

Following FINRA's advice, optionsXpress called Trading and Markets the very same day (September 24, 2009) to discuss the trading. optionsXpress employees Strine, Hoeh, Stern and Victor spoke with Trading and Markets employees Victoria Crane, Josephine Tao, and Steve Bartolek to ask whether the use of buy-writes to close out failures to deliver met the firm's close-out obligations as imposed by Reg. SHO, and whether best execution required the firm to combine the buy-in of stock with the Customers' sale of calls.

optionsXpress provided a detailed discussion of the trading and surrounding circumstances to Trading and Markets (*see* OX 579):

- optionsXpress explained that it had spoken with CBOE and FINRA, that FINRA had an ongoing inquiry into optionsXpress's compliance with Reg. SHO, and that optionsXpress was seeking specific guidance from Trading and Markets;
- optionsXpress provided a detailed explanation of the Customers' practice of using buy-writes to re-establish a box spread when call options were assigned;
- optionsXpress explained that it studied the *Hazan* and *TJM* settlements, and noted key differences between those settlements and the instant facts; and
- optionsXpress explained the process, nature, and frequency of assignments to Trading and Markets accurately and in detail. *optionsXpress made clear that the customers wrote deep-in-the-money calls* that may or may not get assigned and that the "pattern" continued.

After an extended discussion and an opportunity to ask any necessary questions, Trading and Markets unambiguously advised optionsXpress that it need not stop the trading at issue. Stern sent an email to Bottini the same day confirming that ***"SEC said to keep doing what we are doing re: the Reg SHO and short selling."*** OX 246 at 746-47. As to the issue of whether best execution required packaging the orders as buy-writes, Trading and Markets staffers said that they were not the most qualified to opine on the issue and would get back to optionsXpress. *See id.*

On October 2, 2009, Trading and Markets called optionsXpress, this time for a very brief call. The subject of this call is a matter of dispute: according to the sworn testimony of the optionsXpress employees on the call, Trading and Markets called to follow-up on the issue of best execution – the one issue Trading and Markets left open during the September 24 call, and the one issue about which Trading and Markets said it would get back to optionsXpress. According to the optionsXpress personnel on the call, Trading and Markets said it could not give the Firm advice either way about the Firm's best execution obligations. The Division, however, contends that Trading and Markets actually told optionsXpress during the October 2, 2009, call that based on new information they were retracting the entirety of their prior guidance, including their unambiguous instruction to "keep doing what you're doing."

The Division claims that Trading and Markets was retracting its prior guidance because optionsXpress purportedly did not provide full information to Trading and Markets during the September 24, 2009 call. *See* OIP ¶ 100. But any such claim would be false: optionsXpress provided very specific information to Trading and Markets about the trading in question, including the use of deep-in-the-money calls to re-establish a hedge.

In fact, an internal FINRA report of a call with the SEC on October 2, 2009, refutes any claim by the Division that it was misled. That report recounts Trading and Markets' recollection of the September 24, 2009 call, and reveals that the optionsXpress employees discussed the trading in question in great detail:

> OXPS stated that a small number of customers were engaging in call option activity and that the calls were assigned and resulting in fails. OXPS stated that it bought-in stock on T+4 in order to close out the fail position. The customers re-established their short position by selling calls. OXPS was concerned that it may be on the hook for 204 violations. OXPS stated that there was a random chance that the call options would be exercised, *but that the exercises occur on the same day as the buy-in.* OXPS did not indicate that the sales of the calls were occurring at virtually the same time as the buy-in was executed. OXPS further stated that its customers did not want the calls to be assigned as it was not as financially desirable as holding the calls.

DX 237. The report further reveals that optionsXpress "was concerned that its customers would try to sue the firm/take the matter to arbitration" "if the firm severed its relationship with the customer" without citing a rule that purportedly was violated. *Id.* In response, as the report says in black and white, ***Trading and Markets "told the firm [optionsXpress] that the activity would not be considered a violation of 204.*** " *Id.* (emphasis added).

Josephine Tao of Trading and Markets sent an email to other SEC staff on October 2, 2009, describing the information that optionsXpress supposedly withheld from Trading and Markets. *See* DX 210. But her accusations are untrue – the facts she accused optionsXpress of withholding from Trading and Markets were not only provided by optionsXpress, but also provided by CBOE months earlier. *See* OX 565. Moreover, the supposedly omitted information was immaterial to any analysis of the trading. For example, Tao's primary complaint appears to have been that optionsXpress purportedly did not disclose FINRA's ongoing investigation into the trading. *See* DX 210. Even assuming that is true (which we dispute), she never explained in

her email how the existence of an inquiry by another regulator changes the *substance of the trading*, of which Trading and Markets was fully informed well before the September 24 call. *See id.*

In her October 2, 2009, email recounting the alleged omissions from optionsXpress's description of the trading to Trading and Markets, Tao went so far as to claim that optionsXpress "flat out lied when asked if the customers are related." *Id.* This strong comment plainly was the result of a misunderstanding: although the Zelezny husband and wife accounts were related, those accounts had no relation to other accounts involved, i.e., Feldman and Kolocouris. This fact also is irrelevant to whether the trading violated Reg. SHO.

Despite the tone of Tao's email, the record will show that Trading and Markets never told optionsXpress the trading was unlawful or should be prohibited.

5. *Early 2010* – CBOE Observes That Different Divisions Within the SEC Provided Conflicting Guidance, and Again Concludes optionsXpress Did Not Violate Reg. SHO.

optionsXpress continued to receive incomplete or no guidance from its regulators into 2010. As late as January 15, 2010, Bottini wrote Feldman: "We have had discussions with the regulators about these strategies.... We continue to ask the regulators for guidance on these trades. We do not have the ability to stop a self-directed investor to make these trades absent direction from our regulator in this case, but it continues to be a drain on our compliance staff." DX 49.

On January 28, 2010, CBOE opened another investigation related to Reg. SHO and requested relevant documents. At the commencement of this investigation, Linda Gerdes of CBOE circulated an internal email in which she recapped prior conversations where "Trading and Markets said there was no case against the [Zeleznys]." OX 591. The email "[f]ast forward[s] to today" and says she "learned from an SEC lawyer [from the Division of

Enforcement], Jill Henderson . . . that they are looking to charge [Reg. SHO] violations and fraud." *Id.* The email concludes: ***"I continue to be perplexed on how the SEC provides different guidance to different regulatory entities."*** *Id.* (emphasis added).

In March 2010, Tim Thompson of CBOE sent a memo to the SEC discussing various topics, including both regulators' investigation into optionsXpress's compliance with Reg. SHO. Thompson wrote that "CBOE had discussed the case facts with SEC Trading and Markets staff and was informed that the Reg. SHO provisions do not apply to customer accounts, thus CBOE did not proceed to prosecute the potential Reg. SHO violations associated with this case. However, CBOE has recently come to understand that SEC Enforcement is proceeding to bring this case." OX 177. Nevertheless, a few days later, on March 9, 2010, notes taken by a CBOE participant in a call between optionsXpress, CBOE and the SEC state that "nothing in rule prevents – sell deep-in-the-money calls...." OX 198.

6. *March 2010* – Enforcement Directed optionsXpress to Stop the Customers' Trades, and the Firm Immediately Complied.

When, in March 2010, the Division expressed its "discomfort" with the trading strategy at issue in the OIP, optionsXpress revised its written supervisory procedures to no longer permit the use of buy-writes to close out fails-to-deliver. Had Trading and Markets, the Division, FINRA, or CBOE instructed optionsXpress to do so any earlier, optionsXpress would have complied with that instruction, avoiding the need for this entire proceeding. These regulators all had multiple opportunities to do so in 2008, 2009, and the first part of 2010, but they did not take those opportunities. Indeed, the record reflects that these regulators debated internally about the application of Reg. SHO to the trading at issue, and some even sent clear messages to optionsXpress that the trading did *not* violate Reg. SHO.

7. *December 2010* – CBOE Once Again Clears optionsXpress of Any Reg. SHO Violation.

On December 2, 2010, at the conclusion of the second investigation by CBOE, the regulator notified optionsXpress that it had completed *yet another* inquiry regarding "possible violations of SEC Rule 204T." OX 151. CBOE's inquiry "focused on activity between July 1, 2009, and September 30, 2009, and was initiated to determine whether the firm violated SEC Rule 204T …." (*Id.*). Importantly, CBOE's inquiry focused on the very same trading activity at issue in the OIP and for much of the same time period. Yet, contrary to the allegations in the OIP, CBOE "determined that no violations of the Securities and Exchange Commission or Exchange rules were apparent with respect to the materials reviewed in conjunction with this inquiry." CBOE thanked optionsXpress "for the courtesies and assistance extended to [CBOE's] representative[s] during this inquiry."[2]

B. The Division Cannot Prove A Scheme To Defraud.

1. There Can Be No Fraud Here Because optionsXpress Complied With Reg. SHO.

The Division has alleged a scheme to defraud under which Feldman purportedly sold "options knowing that he had no intention of fulfilling his obligations under those contracts." OIP ¶ 2. According to the Division, Feldman's buy-write transactions were "designed to give the appearance of having purchased shares to close-out an open failure-to-deliver position while in fact not doing so." OIP ¶ 1. In other words, the alleged scheme here involved causing optionsXpress to violate Reg. SHO.

As discussed above, and as will be fully demonstrated at the hearing, there was no Reg. SHO violation as both a legal and factual matter – that is, optionsXpress timely cured all

[2] Based on its investigation, FINRA did find a Reg. SHO violation, as memorialized in a letter dated December 15, 2009. *See* OX 441. But that finding did not pertain to any trading at issue in this case. Moreover, the agency "determined not to pursue disciplinary action." *Id.*

"failures to deliver." This alone defeats the fraud claims against both Feldman and optionsXpress. In addition, the trades clearly had a legitimate economic purpose in that the buy cured the "fail to deliver" and the call maintained the customer's hedge. Moreover, as explained above, the assignment process was completely random, and assignment was not guaranteed. These additional facts further undermine the Division's already untenable position.

2. Rule 10b-21 Does Not Apply To The Trading At Issue.

This case is a prime example of the manner in which the SEC's regulations do not always account for the depth and complexity of the options market. Here, the Division tries to fit a square peg into a round hole by claiming that this case involves a violation of Rule 10b-21. Rule 10b-21 specifies that it is unlawful for any person to submit an order to sell a security if that person deceives a broker-dealer, participant of a registered clearing agency, or purchaser regarding his intention, or ability, to deliver the security by settlement date and that person fails to deliver the security by settlement date. 17 C.F.R. § 240.10b-21 (2012). Rule 10b-21 was meant to prohibit short sellers from deceiving their broker-dealers about their ability to borrow shares for the purpose of complying with the locate requirements of Rule 203(b)(1) of Reg. SHO, or from misrepresenting to their broker-dealers that they owned the shares they were selling. Specifically, Rule 10b-21 states:

> It shall also constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of this Act for any person to submit an *order to sell an equity security* if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date.

Id. (emphasis added).

In this case, there were no orders to sell equity securities, only assignments of option contracts. Similarly, no customers of optionsXpress deceived the firm about the delivery of such

securities. No obligation to locate or deliver stock arises when a customer sells call options. In response to each assignment, optionsXpress bought-in the stock. It did not look to the Customer to deliver the stock. It is obvious that Rule 10b-21 addresses an order to sell a security, not the assignment of option contracts and thus is not applicable to this matter.

3. There Is No Evidence Of Any Scheme To Deceive Market Participants Through Open Market Buy-Writes.

Even if the Division could show a Reg. SHO violation (despite the lack of evidence), and regardless of whether Rule 10b-21 applies, the Division still would need to show that Feldman actually acted to "deceive participants of clearing agencies and purchasers" by "depriving [stock purchasers] of the benefits of ownership, such as voting and lending[.]" OIP ¶ 20. But there is no such evidence.

The Division's expert, Dr. Lawrence Harris, purports to address this allegation throughout his report, and he concludes that the purchasers of the stock lost the opportunity to earn millions of dollars in stock loan fees. But both the Division and Dr. Harris have ignored the fact that if the stock were not delivered, the purchasers could have requested that CNS buy-in the stock they were supposed to receive. In such case, CNS would have forced a buy-in from another firm and the purchasers would have been able to profit from whatever stock loan opportunities were available in the marketplace. This never happened, and the reason is simple: as explained in the expert reports of Dr. Saha, Mr. Ruth and Dr. Sirri, the buy-ins effected by optionsXpress did, in fact, result in timely deliveries of stock to the purchasers.

Indeed, the Division's theory of fraud is counter-factual. There is no evidence that Feldman had any objective or subjective financial motive to deceive purchasers through buy-writes transacted on the open market – he was simply reestablishing his hedge. He had nothing to gain by perpetuating a fail. On the contrary, he much preferred to hold his options to

expiration because each assignment eroded his profit margin. This explains why the Division is not calling a single stock purchaser to testify that he or she was deprived of the benefits of stock ownership as a result of Feldman's trading. Nor has the Division identified a single complaint to that effect on its exhibit list. Instead, the Division would have its expert, Professor Harris, attempt to explain away these omissions by referring to Feldman's conduct as a "salami slicing fraud" – where "no victim suffers much." Harris Rpt. ¶ 200. But he pointed to no evidence of any victim who suffered *at all*.

This absence of evidence is a symptom of a more significant deficiency – the fraud claim is frivolous. Again, as reported by Dr. Saha, the data and trading records made available to and analyzed by the Division confirm that the counterparties to Feldman's trading all received their stock in a timely manner under Reg. SHO. *See* Saha Rpt. at 29-32. As the Division is well aware, Feldman's trading deceived no purchaser. And none of the 30 witnesses the Division apparently intends to call at the hearing – including Professor Harris – can plausibly testify to the contrary.

C. The Division Cannot Prove That optionsXpress Acted With the Requisite Scienter.

To prove the claim that optionsXpress aided and abetted fraud, the Division also bears the burden of proving by a preponderance of the evidence that the firm acted with the requisite scienter – i.e., that "optionsXpress caused and *willfully* aided and abetted Feldman's" purported fraud. OIP ¶ 165 (emphasis added); *see also* 15 U.S.C. § 78u-2(a)(2). Although "willful" implies conscious wrongdoing, the D.C. Circuit has held that a showing of "extreme recklessness" may satisfy this scienter requirement:

> "Extreme recklessness" – or as many courts of appeals put it, "severe recklessness" – may be found if the alleged aider and abettor encountered "red flags," or "suspicious events creating reasons for doubt" that should have alerted him to the improper conduct of the primary violator, or if there was "a danger ...

> so obvious that the actor must have been aware of" the danger. It is not enough that the accused aider and abettor's action or omission is "derived from inexcusable neglect." *"Extreme recklessness" is neither ordinary negligence nor "merely a heightened form of ordinary negligence."*

Howard v. S.E.C., 376 F.3d 1136, 1143 (D.C. Cir. 2004) (citations and footnotes omitted) (emphasis added); *see also In the Matter of Trautman Wasserman & Co., Inc., et al.*, 92 S.E.C. Docket 1156 (Jan. 14, 2008) (Murray, Chief ALJ) (same).

This Court need not reach the issue of scienter unless it finds a scheme to defraud based on a Reg. SHO violation, because such a violation is necessary to constitute the predicate for the Division's fraud claim. And, as discussed, there was no such violation, thus defeating the fraud claim entirely. But even if this Court were to find that the buy-write trading violated Reg. SHO – again, *an issue of first impression* – and Feldman committed fraud, the Division still could not satisfy the scienter requirement. First, as a matter of law, optionsXpress could not have acted with "extreme recklessness" when construing unsettled law, even if its interpretation were later deemed incorrect. Second, the evidence will confirm that optionsXpress did not act with extreme recklessness when executing trades by its self-directed Customers. Indeed, the firm made multiple attempts to seek regulatory guidance on the issue, no regulator told it that the trading was prohibited, and there is evidence that at the time even some regulators expressed the opinion that the trading was not violative.

1. As A Matter Of Law, optionsXpress Did Not Act With Extreme Recklessness When Construing Unsettled Law.

The Division alleges that optionsXpress knew or was reckless in not knowing that the buy-writes violated Reg. SHO. But that allegation fails as a matter of law given the unsettled state of the law.

In *Howard*, the D.C. Circuit rejected the notion that the SEC can satisfy the extreme recklessness standard by showing the respondent "should have known . . . the legal

requirements" under a securities "rule whose language was silent on the subject." 376 F.3d at 1147-49. "At best this amounts to a finding of negligence; at worst it is liability without fault." *Id.* at 1149; *see also Dronsejko v. Thornton*, 632 F.3d 658, 667 (10th Cir. 2011) (affirming dismissal of complaint for failure to plead recklessness under PSLRA because the accounting principle that purportedly was violated contained "ambiguity and generality," leaving room for "controversy"); *In re Boston Scientific Corp. Sec. Litig.*, 708 F. Supp. 2d 110, 125 (D. Mass. Apr. 27, 2010) (granting summary judgment due to a lack of recklessness, because defendant "proceed[ed] cautiously on the assumption that further research remained to be conducted").

The *Howard* decision is on point. Under no set of facts can the Division show that the trading here "so obvious[ly]" violated the legal requirements that optionsXpress "must have been aware of" the purported violation. After all, the law does not address the trading at issue. The language of Reg. SHO does not bar either buy-writes or deep-in-the-money calls. *See* 17 C.F.R. § 242.204. And there was (and still is) no secondary authority or case law directly on point. Even footnote 82 does not directly address the trading here. As a matter of law, the Division cannot claim that optionsXpress *willfully* aided and abetted a fraud by taking a non-frivolous (indeed, a very reasonable) position on an unsettled legal standard. The fraud claim should be rejected for this reason alone as a matter of law.

2. The Record Will Confirm That optionsXpress Did Not Act With Extreme Recklessness.

Even putting aside the law, the Division cannot meet its burden of showing that optionsXpress acted with extreme recklessness. The evidence will show that the information available to optionsXpress at the time – including the trading strategy, the assignment rates, and the regulatory advice – are all consistent with the position that the firm had no reason to believe a fraud was occurring, and no incentive to aid and abet any such fraud. Moreover, even the

regulators disputed internally whether the conduct here violated Reg. SHO – thus further emphasizing how optionsXpress's conduct was not reckless.

(a) optionsXpress Reasonably Relied On Regulator Statements To Allow The Trading.

The evidence will show that optionsXpress carefully reviewed the trading and reasonably relied on statements by the regulators themselves to allow the trading to continue. As discussed above and summarized below, optionsXpress has worked directly with its regulators in good faith to determine whether the trading at issue violated Reg. SHO. For example, representative samples of this cooperation and correspondence with regulators are summarized below:

- September 19, 2008: CBOE "confirm[ed]" that optionsXpress traders "do not need to close out a position if [they] are concerned about assignment risk" as long as the company "meet[s] [its] delivery obligation." OX 70.
- September 23, 2009 – CBOE issues Letter of Caution to optionsXpress regarding Zelezny trades finding *no violation* of Reg. SHO. OX 89.
- September 24, 2009 – optionsXpress speaks to SEC. Stern recaps call in internal email: "*SEC said to keep doing what we are doing re: the Reg Sho and short selling*." OX 246 at 746-47. An internal FINRA report of this call confirms that Trading and Markets "told the firm that the activity would not be considered a violation of 204." DX 237.
- December 2, 2010 – CBOE notified optionsXpress that it had completed its inquiry of Reg. SHO during the relevant period and "determined that no violations of the Securities and Exchange Commission or Exchange rules were apparent with respect to the materials reviewed in conjunction with this inquiry." OX 151.

When, in March 2010, the Division first expressed its "discomfort" to optionsXpress with the trading at issue, the company revised its written supervisory procedures to no longer permit the use of buy-writes to close out fails-to-deliver. Such cooperation with regulators should be encouraged – not characterized as extreme recklessness.

(b) The Internal Regulator Files Confirm That A Reg. SHO Violation Was *Not* "So Obvious" As To Support A Finding Of Extreme Recklessness.

Internal regulatory communications belie the Division's theory that optionsXpress "must have been aware" that the buy-writes here violated Reg. SHO. The regulators themselves did not reach this conclusion. Indeed, the investigative file lifts the lid on a confused and conflicting state of affairs within different Divisions of the Commission, FINRA, and CBOE as to the breadth of Reg. SHO. As the former CBOE Department Head of Market Regulation, speaking about optionsXpress and Reg. SHO, bluntly put it: "I continue to be perplexed on how the SEC provides different guidance to different regulatory entities." OX 337.

Below are a representative sample of internal, regulatory documents that will be presented at the hearing to show that even the regulators expressed doubt as to whether the trading here violated Reg. SHO:

- May 20, 2009 – CBOE speaks with SEC (Trading and Markets), "during which Trading and Markets informed CBOE that Trading and Markets did not believe that OX violated Regulation SHO." OX 84.

- June 19, 2009: CBOE issues a report saying "the Zelezny's were appropriately maintain[ing] hedged position in multiple securities" and "[n]o fails ever occurred in any account maintained by Zelezny." The regulators thus "recommended that this matter be Filed without Action[.]" The report recapped the May 20, 2009, conversation with SEC and confirmed: "the SEC felt that the Zelezny's were conducting and maintaining a hedge to their position appropriately." OX 129.

- August 6, 2009: CBOE Chief Investigator Daniel Overmyer emails Eric Ribelin of SEC: "[W]e have been talking to Victoria and Josephine [SEC Trading and Markets] and they do not think this is a REG-SHO violation." OX 136.

- February 1, 2010: Internal CBOE communication from Linda Gerdes recaps prior conversations where "Trading and Markets said there was no case" against the Zelinsky's. [*sic*] The email "[f]ast forward[s] to today" and says she "learned from an SEC lawyer [from the Enforcement Division], Jill Henderson . . . that they are looking to charge Reg Sho violations and fraud." The email concludes: "*I continue to be perplexed on how the SEC provides different guidance to different regulatory entities.*" OX 175.

- February 3, 2010: CBOE writes SEC. Letter recaps May 20, 2009 call and confirms, yet again, that CBOE "had been informed [by Trading and Markets] that there was not a Regulation SHO violation." OX 203.

- March 5, 2010: CBOE writes SEC: "CBOE had discussed the case facts with SEC Trading and Markets staff and was informed that the Reg SHO provisions do not apply to customer accounts, thus CBOE did not proceed to prosecute the potential Reg SHO violations associated with this case. *However, CBOE has recently come to understand that SEC Enforcement is proceeding to bring this case.*" OX 177 (emphasis added).

The record thus reflects a division at SEC: Trading and Markets found no Reg. SHO violation, but the *litigators* at the Enforcement Division chose to take action. David Fisher, CEO of optionsXpress Holdings, took notes of a November 10, 2010, meeting with two high-ranking CBOE officials. Fisher's notes reflect that the CBOE officials told him that "CBOE got two interps [*sic*] from SEC. CBOE on our [optionsXpress'] side. Firm didn't do anything wrong." OX 630. As Fisher testified, the "two interps" referenced in his notes refer to the fact that CBOE told him they had received two different interpretations of the legality of the trading from two different branches of the Commission. Trading and Markets advised CBOE that the trading activity was in compliance with Reg. SHO, but the Division had a "different reaction."

The Division thus has the gumption to tell this Court that optionsXpress acted with "extreme recklessness" by adopting a view of the law that was in fact taken during the relevant period by Trading and Markets – which, unlike the Division of Enforcement, actually developed Reg. SHO. That position, we submit, is absurd.

V. CONCLUSION

For the foregoing reasons, optionsXpress respectfully urges this Court: (1) to rule that optionsXpress did not violate Rules 204 and 204T of Reg. SHO; (2) to further rule that optionsXpress did not cause or willfully aid and abet any violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, or Rules 10b-5 or 10b-21 thereunder; and (3) to dismiss this administrative proceeding.[3]

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Respectfully Submitted,

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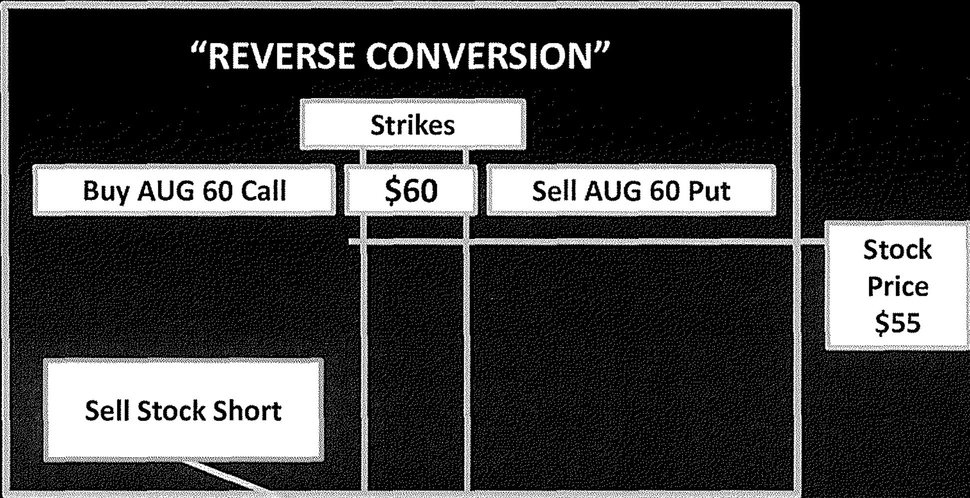
[3] optionsXpress incorporates by reference legal and factual arguments made by the other Respondents.



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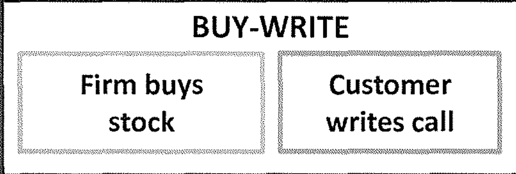

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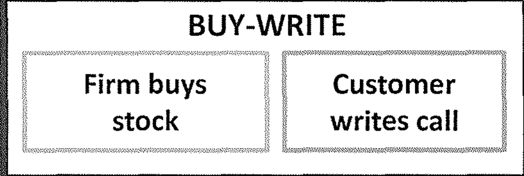

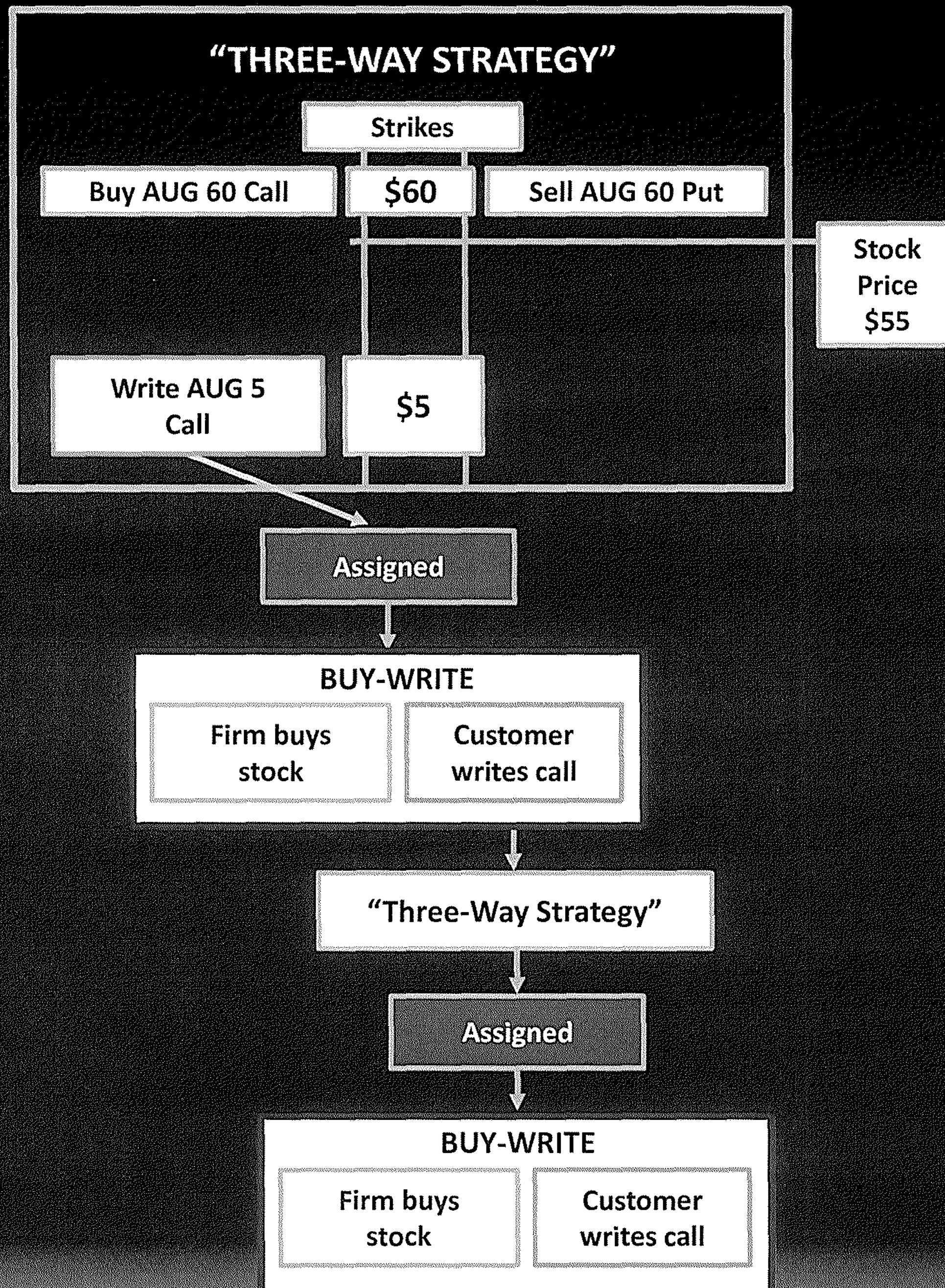

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