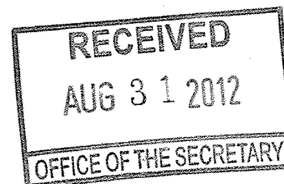
UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

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

Respondents.



DIVISION OF ENFORCEMENT'S
PREHEARING BRIEF

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The Division of Enforcement ("Division") respectfully submits this Pre-Hearing Brief.

INTRODUCTION

Despite its seeming complexity, this case is actually about a simple, old-fashioned kiting scheme. Respondent Jonathan I. Feldman took something that was not his using deception, and Respondents optionsXpress, Inc. and its former Chief Financial Officer and regulatory liaison Thomas E. Stern helped him do it. In the process, optionsXpress failed to deliver stock that Feldman sold, making it strictly liable for violating Reg. SHO.

To find that optionsXpress, Stern, and Feldman did nothing wrong, the Court would need to find that ***options*****Xpress** (a broker-dealer specializing in options) and Stern (one of its most senior officers) did not understand the basic principles of options pricing and trading. Further, the Court would need to find that Feldman, at the time a Senior Vice President at a regional savings bank, discovered an arbitrage opportunity that no professional traders in the market noticed. optionsXpress and Stern are not that naïve, and Feldman is not that ingenious.

In 2004, the Securities and Exchange Commission promulgated Reg. SHO in order to curb abusive naked short selling – that is, short selling without actually delivering the stock that was sold short. 69 Fed. Reg. 48008 (2004). In 2008, in order to further reduce failures to deliver, the Commission updated Reg. SHO by issuing Rule 204T, which imposed certain close-out obligations on broker-dealers, the gatekeepers of the settlement system. 73 Fed. Reg. 61706 (2008). The same year, the Commission also issued Rule 10b-21 for the same purpose, with particular focus on the conduct of the broker-dealer's customers. 73 Fed. Reg. 61666, 61667 (2008). Rule 10b-21 recognized that abusive naked short sales start with the short sellers themselves, emphasizing that they commit fraud by selling securities that they have no intention of delivering. 17 CFR § 240.10b-21. Thus, in combination, Rule 204T and Rule 10b-21 addressed short-selling misconduct by both broker-dealers and their customers. Rule 204T was made permanent by Rule 204 in 2009. 74 Fed. Reg. 38266 (2009).

Rule 204 and Rule 204T require broker-dealers like optionsXpress to deliver shares into the Continuous Net Settlement System (CNS) at the National Securities Clearing Corporation (NSCC), a subsidiary of the Depository Trust & Clearing Corporation (DTCC), no later than three days after the shares are sold. 17 C.F.R. § 242.204(a); 17 C.F.R. § 242.204T(a). Under the Rules, if shares are not delivered as required at the end of those three days, optionsXpress, as the clearing broker, must purchase or borrow the shares in a bona fide transaction no later than the beginning of regular trading hours the following day. *Id.*

optionsXpress blatantly and repeatedly failed to comply with Reg. SHO. Shares that were sold short by Feldman and optionsXpress' other customers were not delivered within three days. As a consequence, one or more purchasers failed to receive the shares that they had bought on the day that they expected delivery. optionsXpress compounded these failures to deliver by not purchasing or borrowing the shares at the beginning of regular trading on the subsequent day, as required by Reg. SHO. Instead, the firm helped Feldman and its other five customers (the "Customers") execute sham transactions which gave the appearance of purchasing shares but which did not actually result in any shares being delivered. The purchasers were again left holding an empty bag.

optionsXpress' failure to deliver, and thus the purchasers' failures to receive, continued for significant periods of time – indeed, optionsXpress had a failure to deliver in Sears Holding Corp. (SHLD) for 238 consecutive settlement days. optionsXpress would have you believe that this was not one long, continuous failure to deliver, but a series of new, unrelated failures *each and every day* from the *same six customers* after they executed their sham transactions. Commission rules requiring delivery are not so easily evaded. But even if optionsXpress' creative (yet completely unfounded) explanation for its persistent failures to deliver was accepted, it still violated Rules 204T and 204 of Reg. SHO because in two-thirds of the instances

where it failed to deliver it did not "purchase" or borrow shares at the ***beginning*** of regular trading hours on the subsequent day as required under the Rules.

optionsXpress' complete disregard of its responsibilities under Reg. SHO allowed its customer, Feldman, to perpetrate his fraud. Feldman's fraud centered on hard-to-borrow securities. Because short sellers do not own the securities they sell, they must either purchase them or borrow them in order to make delivery. The fee for borrowing hard-to-borrow securities is high because the demand by short sellers is higher than the supply of shares available for lending. It is expensive to short these securities because, if one follows the rules, one must deliver those shares to the purchaser. That high cost of borrowing hard-to-borrow securities is also priced into the options for those stocks. This is because sellers of options who wish to hedge their positions, such as market makers or individual traders like Feldman, must sell the securities to do so. If they sell these securities short, they must pay the high borrow fee. Consequently, options sellers incorporate this cost of selling hard-to-borrow securities into the price of options.

Feldman profited by not following the rules that everyone had to play by. He sold the highly priced options in hard-to-borrow stocks and hedged his resulting position by establishing short positions in the same stocks. When Feldman had to deliver the shares he had sold short (either directly or through options assignments), he would not borrow stock to make delivery on his short position (and consequently pay the borrow fee); instead, Feldman engaged in a fraudulent scheme comprised of sham transactions to avoid delivering the shares he sold. Specifically, Feldman simultaneously "bought" shares of stock and "sold" options that effectively canceled each other out and cost Feldman money every time they were executed. As a result, Feldman was able to sell his options at a higher price, as they reflected the hard-to-borrow fee, but he never had to pay that fee because he never delivered the shares. Because Feldman did not deliver the shares, the purchasers did not receive the shares they purchased and

thus could not lend them out and charge hard-to-borrow fees. Feldman's buy-writes were sham transactions by which he illegally "earned" the borrow fees rightly belonging to these purchasers. This is stock kiting. This is fraud.

Feldman does not (and cannot) dispute that his trading strategy was executed deliberately and intentionally and that optionsXpress executed the trades he requested. Given his substantial personal knowledge and exposure to numerous red flags, he knew or was reckless in not knowing that his trading was manipulative and deceiving to market participants. For example, Feldman was told on multiple occasions that the options he sold were just going to get assigned; "market-makers are ***always going to assign*** what you're short;" and "the market maker is ***usually always going to assign*** whatever call [it purchases] . . . normally ***you'll always going to get assigned.***" Feldman himself acknowledged, "you'd be stupid to say, oh, I'm going to write these and none them are going to get exercised." Feldman on multiple times acknowledged in writing that he was not going to make (or wanted to avoid making) delivery to settle his trades: ***"I don't settle the stock@all.";*** "So I could do a buy-write ***and then I wouldn't settle.***"; "So how many SHLD do I have to buy-in today (***to avoid settlement***)?" Feldman actually bragged about the market and regulatory concerns his trading was having on the trading volume of these stocks – telling a friend, "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. ***(Until someone notifies the SEC and they shut down the strategy!!)***" – and read a website that noted his "manipulative" activity was "consistent with the illegal 'reset' transaction" precluded by one of the Commission's recently-settled administrative proceedings.

As a result of the activity described above, optionsXpress violated Rules 204 and 204T on more than 1,200 occasions, thereby avoiding paying $7,214,977 in hard-to-borrow fees. optionsXpress' violations allowed Feldman to carry out his fraud in violation of Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rules 10b-5 and 10b-21 thereunder. Feldman's fraudulent

trading illegally transferred hard-to-borrow fees from true purchasers of stock to himself, enabling him to make illicit profits of $4,560,202. Stern aided and abetted optionsXpress' Reg. SHO violations and Feldman's fraudulent trading – he was aware of Reg SHO's requirements, was intimately familiar with Feldman's and other customers' trading activity, oversaw the implementation of the firm's buy-in procedures for their continuously naked, "perpetual" failures, and gave intentionally misleading and inaccurate information about the Customers' trading to the Commission's Division of Trading and Markets ("Trading & Markets").

BACKGROUND – TRADING OVERVIEW

During the relevant period, Feldman bought ***millions*** of dollars of call option contracts – giving him the right to buy stock at a certain price – on specific hard-to-borrow stocks. *See* Harris Report (Div. Ex. 310) at ¶ 52; Sheehy Report (Div. Ex. 375) at ¶ 18; Div. Ex. 75 (Feldman's Form 1099 from optionsXpress). At the same time, Feldman sold an identical quantity of put options in the same hard-to-borrow stock – giving a purchaser the right to make Feldman buy stock at the same price as the call option he had purchased. Purchasing the call and selling the put were the economic equivalent of buying shares of stock. Because it mimics owning a stock, this position is known as a "synthetic" long position. *See* Harris Report (Div. Ex. 310) at ¶ 101; Sheehy Report (Div. Ex. 375) at ¶ 24.[1] Feldman sought to profit from the difference in the prices of the purchased call and the sold put that made up the synthetic long. *See* Harris Report (Div. Ex. 310) at ¶ 137; Sheehy Report (Div. Ex. 375) at ¶ 46.

Because a synthetic long position exposed Feldman to potential losses if the stock price went down, just like owning a share of stock outright, Feldman would establish an offsetting short position, *i.e.,* he would "hedge" his synthetic long position. *See* Harris Report (Div. Ex. 310) at ¶¶ 17, 18, 111, 142; Sheehy Report (Div. Ex. 375) at ¶¶ 46, 49. Feldman's short "hedge"

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[1] "Div. Ex." refers to exhibits that the Division has marked for use at trial.

positions were established in one of two primary ways: (1) selling stock short; or (2) selling a deep-in-the-money call.[2] The sale of the short stock created a delivery obligation. The sale of the deep-in-the-money call options also created delivery obligations after those calls were exercised and assigned to Feldman. After the assignment of those calls,[3] Feldman had to sell the stock at the predetermined price which resulted in him having a short stock position. Because the call was deep-in-the-money, meaning the price at which the stock must be sold was well below the market price of the stock, the option was likely to be exercised and the obligation to sell triggered. In fact, the deep-in-the-money call options were regularly and promptly exercised, a scenario, as the Division's experts explain, one would expect of deep-in-the-money call options on hard-to-borrow stock. *See* Harris Report (Div. Ex. 310) at ¶¶ 23, 28, 74, Ex. 32; Sheehy Report (Div. Ex. 375) at ¶¶ 61-64.

Despite their delivery obligations, neither optionsXpress nor Feldman delivered the stock by settlement date (T+3) as required under Commission rules. *See* Harris Report (Div. Ex. 310) at Ex. 32. Instead, Feldman, assisted by optionsXpress, entered into "buy-write" transactions – matched orders that "buy" the amount of stock that he was required to deliver and simultaneously sell (i.e., "write") deep-in-the-money call options for the exact same quantity. *See* Harris Report (Div. Ex. 310) at ¶¶ 26, 158; Sheehy Report (Div. Ex. 375) at ¶ 8. To trade these buy-writes, Feldman had to actually ***pay money to*** the counterparty who was purportedly ***purchasing*** these options from him. *See* Harris Report (Div. Ex. 310) at Ex. 21; Sheehy Report (Div. Ex. 375) at ¶ 9(f). These deep-in-the-money call options Feldman sold as part of the buy-

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[2] The combination of a synthetic long and a short sale of stock is called a "reverse conversion." The combination of a synthetic long and the sale of a deep in the money call is called a "three-way" trade. At times, Feldman would also sell a put and buy a call.

[3] An assignment is notice received by an option writer stating that the option sold has been exercised by the purchaser of the option. When assigned, the option writer has an obligation to complete the requirements of the option contract. If the option was a call option, then the writer would have to sell the underlying security and deliver the shares being sold.

write were promptly exercised by the counterparty – resulting in the stock Feldman purportedly "bought" from the counterparty being promptly sold right back to the counterparty, at a net cost to Feldman – as one would expect when the counterparty is guaranteed money on every buy-write. *See* Harris Report (Div. Ex. 310) at Ex. 16; Sheehy Report (Div. Ex. 375) at ¶ 54(a). An example of this trading is set forth below:

- Start day: Feldman/optionsXpress owe delivery on 100 shares
- 11:00 a.m.: Feldman buys 100 shares, sells 1 deep-in-the-money call on 100 shares (Buy-Write Trade)
- 11:00 a.m.-4:30 p.m.: Deep-in-the-money call exercised
- 10:00 p.m.: Feldman gets assigned and sells 100 shares to satisfy assignment of 1 deep-in-the-money call
- End of Day: Feldman/optionsXpress are still short 100 shares

The buy-write trades that optionsXpress and Feldman executed were not bona fide purchases and had no legitimate economic purpose – rather, they only served to extend Feldman's "naked" short positions. Because of this "round-trip," neither optionsXpress nor Feldman actually delivered shares due at the beginning of the trading day – the "buy" portion of the transaction merely gave the impression that delivery was occurring when, in fact, the buy was coupled with the sale of a deep-in-the-money call option that was promptly exercised, thereby creating a new delivery obligation. Thus, at the end of the day, optionsXpress and Feldman were still obliged to deliver as many shares as they had been obliged to deliver at the beginning of the day. optionsXpress and Feldman repeated this buy-write process whenever Feldman's deep-in-the-money call options were exercised – as they were virtually certain to be from the outset– until the original put and call options expired or the entire position was unwound. *See* Harris Report (Div. Ex. 310) at ¶ 29; Sheehy Report (Div. Ex. 375) at ¶ 62.

The "buy" portion of the buy-writes did not satisfy optionsXpress' and Feldman's delivery obligations because the buying (of the stock) and selling (of the calls) occurred simultaneously and effectively cancelled each other out. *See* Harris Report (Div. Ex. 310) at ¶¶ 115, 116; Sheehy Report (Div. Ex. 375) at ¶ 61-64. That this was the intent and effect of the trades was apparent to both optionsXpress and Feldman; indeed, an optionsXpress trader explained to Feldman that his positions "are always short. By shorting options deep in the money, to get assigned, ***your trade date position stays constant, and the settled position never closes or goes long***." Div. Ex. 58 (emphasis added).

By entering into buy-writes, Feldman avoided paying substantial fees to borrow the hard-to-borrow stocks he was trading – as everyone else in the market was doing – and thereby deprived stock owners of borrowing fees they should have received. *See* Harris Report (Div. Ex. 310) at ¶¶ 141-145; Sheehy Report (Div. Ex. 375) at ¶¶ 9, 58-60. Feldman's "profit" came from the original reverse conversion or three-legged trade, and was the difference between the price *received* when selling the put options, less the price *paid* for the call options and any associated hedge. *See* Harris Report (Div. Ex. 310) at ¶¶ 137-139; Sheehy Report (Div. Ex. 375) at ¶ 46.

Despite the assertions by Respondents' experts, this price differential was not an arbitrage opportunity that Feldman (and optionsXpress' other retail customers) were the first and only people to recognize; rather, it was a price differential that anyone involved in options trading could readily see and understand. *See* Harris Report (Div. Ex. 310) at ¶ 16; Sheehy Report (Div. Ex. 375) at ¶¶ 37-39. But it was not one that could be realized because of the hard-to-borrow fees. True arbitrage opportunities in options trading exist for only a matter of moments, unlike the put/call price differential that can and does persist for months if not longer in hard-to-borrow stocks. *See* Sheehy Report (Div. Ex. 375) at ¶¶ 30-31. In true arbitrage opportunities (unlike this one), market makers and professional investors running sophisticated algorithms can capitalize on these opportunities quickly, making it virtually impossible for a

retail customer like Feldman to profit. *See* Div. Ex. 192 (optionsXpress website); Sheehy Report (Div. Ex. 375) at ¶ 30. Tellingly, optionsXpress' website notes the opportunity for retail investors to profit from reverse conversions is extremely limited: "Individual investors and most other off-the-floor traders don't have an opportunity to do conversions and reversals because price discrepancies ***typically only exist for a matter of moments***. Professional option traders, on the other hand, are constantly on the lookout for these opportunities. As a result, the market quickly returns to equilibrium." Div. Ex. 192 (emphasis added); *see also* Sheehy Report (Div. Ex. 375) at ¶ 31.

During the relevant period, Feldman and five other optionsXpress customer accounts routinely engaged in these transactions in at least 25 securities. *See* Harris Report (Div. Ex. 310) at ¶¶ 174-178. As a result, Feldman and optionsXpress' other customers had continuous failures to deliver in numerous securities that persisted for months. Feldman personally purchased at least $2.9 ***billion*** of securities and sold short at least $1.7 ***billion*** of options through optionsXpress in 2009 alone – making a profit over the entire relevant period of $4,560,202 – and optionsXpress' other five customer accounts purchased approximately $2.6 ***billion*** worth of securities and sold short approximately $2.3 ***billion*** of options. optionsXpress avoided paying $7,214,977 in hard-to-borrow fees over the relevant period. *See* Harris Report (Div. Ex. 310) at ¶¶ 41, 188, 199.

ARGUMENT

I. OPTIONSXPRESS VIOLATED THE CLOSE-OUT PROVISIONS OF RULES 204 AND 204T OF REG. SHO

A. Reg. SHO Was Designed To Reduce Failures-To-Deliver

Rules 204 and 204T of Reg. SHO are strict liability regulations designed to reduce failures to deliver and abusive "naked" short selling. Abusive naked short selling refers to selling short without having stock available for delivery – either in inventory or by borrowing it – and failing to deliver stock within the standard three-day settlement cycle. 73 Fed. Reg. 61667. The adopting release to Rule 204 makes clear that "[s]ellers sometimes intentionally fail to deliver securities as part of scheme to manipulate the price of a security, ***or possibly avoid borrowing costs associated with short sales, especially when the costs of borrowing are high.***" 74 Fed. Reg. at 38267 (emphasis added); *see also id.* at 61707-08.

In an effort to reduce failures to deliver and prevent abusive naked short selling, Rules 204 and 204T require optionsXpress and other participants of a registered clearing agency, to deliver equity securities to a registered clearing agency by settlement date, which is generally three days after the trade date ("T+3"). 73 Fed. Reg. at 61710, 61707 n.8. For short sales, if a participant like optionsXpress does not deliver securities by T+3 and thus has a failure-to-deliver position at the clearing agency, it must take affirmative action to purchase or borrow securities of like kind and quantity to close out the failure-to-deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date ("T+4"). 73 Fed. Reg. at 61710-11. Critically, however, where a participant like optionsXpress, that is subject to Reg. SHO's 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. 38266, 38272 n.82.

The Commission's concern about market participants using combined purchase-and-sale transactions to circumvent its rules was not new. In 2003, the SEC issued guidance to "disabuse traders of any notion" that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). As the Commission noted back then, "[e]ven viewed in the most favorable light, these married put transactions appear to be nothing more than temporary stock lending agreements designed to give the appearance of a 'long' position in order to effect sales of stock in a manner that would otherwise be prohibited." *Id.* "The Commission has previously indicated that where transactions involve no market risk and serve no purpose other than rendering a person an owner of a security in order to accomplish indirectly what was prohibited directly, the activity may violate the federal securities laws." *Id.*

In July 2007, the American Stock Exchange fined several entities and individuals for violating Reg. SHO Rule 203 (which also imposed close-out obligations) based on trading activity similar to what the Customers did here. *In the Matter of Scott H. Arenstein and SBA Trading, LLC (July 20, 2007); In the Matter of Brian A. Arenstein and ALA Trading, LLC (July 20, 2007).* In the *Arenstein* cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation of Rule 203. Following the release of the *Arenstein* cases, the Chicago Board Options Exchange ("CBOE") sent a regulatory circular to its members, including optionsXpress, "strongly cautioning" its members that transactions "pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement." CBOE Regulatory Circular RG07-87 (Aug. 9, 2007). "Short sales of threshold securities (that

result in fails to deliver) paired with one or more short-term option transactions, for example, including, but not limited to, ***reverse conversions and deep in-the-money long call/short stock,*** are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase." *Id.* (emphasis added). CBOE proceeded to explain that while its examples involved market-makers, "the same analysis would apply to similar arrangements between any market participants." *Id.*

The following year, CBOE reiterated its caution: "When accompanied by certain option transactions, stock purchases that are intended to effect close-outs of fail to deliver positions may bring into question whether a bona-fide purchase has occurred." CBOE Regulatory Circular RG08-63.[4] These CBOE regulatory circulars were reviewed by optionsXpress' compliance officers in connection with the trading. This guidance was again reinforced when the SEC adopted Rule 204T on October 14, 2008, explaining that "the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO's close-out requirement." 73 Fed. Reg. at 61715 n.78. In July 2009, Rule 204T became permanent with the adoption Rule 204 and the Commission stated:

> [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.

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[4] The Circular also noted that while it was permissible to re-establish a short stock position the business day following a close-out, "if the underlying stock purchase was not bona-fide or did not completely satisfy any close-out requirement, a pre-borrow of stock is required for the subsequent establishment of the new short stock position on the following business day until the close-out is satisfied."

Less than a month later, the SEC brought settled enforcement actions against several entities and individuals for violations of Rule 203 based on similar options trading as the Customers did here. *In the Matter of Hazan Capital Management, LLC and Steven M. Hazan*, Exchange Act Release. No. 34-60441 (Aug. 5, 2009); *In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke*, Exchange Act Release No. 34-60440 (Aug. 5, 2009). In the *Hazan* and *TJM* cases, the respondents engaged in a series of sham reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203.[5]

B. optionsXpress' Uncured Failures-To-Deliver Violated Reg. SHO

1. The Customers' Buy-Writes Were Sham Transactions

It is undisputed that the records of the Continuous Net Settlement ("CNS") system demonstrate that optionsXpress had failures to deliver in at least 25 securities for significant periods of time between October 2008 and March 2010. On this basis alone, optionsXpress violated the strict liability close-out provisions of Rules 204T and 204. Indeed, with respect to Sears (SHLD) stock, optionsXpress had a failure-to-deliver position for at least 238 continuous settlement days during the 2009-2010 period. *See* Div. Ex. 18 (Sears CNS Account Summaries); Harris Report (Div. Ex. 310) at Exhibit 32. During this time, optionsXpress' failures to deliver at CNS dwarfed any other clearing firm's failures to deliver. *See* Div. Ex. 18 (Sears CNS Account Summaries); Harris Report (Div. Ex. 310) at ¶¶ 191-195.

At the hearing, optionsXpress will ask this Court to find that these failures to deliver are somehow unrelated. Put another way, optionsXpress will ask that this Court find each of these

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[5] Three months later, the SEC brought settled enforcement actions against several other entities regarding similar trading and violations of Reg. SHO. *In the Matter of Rhino Trading, Fat Squirrel Trading Group, Damon Rein, and Steven Peter,* Exchange Act Release No. 34-60941 (Nov. 4, 2009).

continuous failures was actually a new failure each day – *from the same six customers executing the same buy-write transactions.* This argument places form over substance. The trading here is the epitome of a sham — optionsXpress' failures to deliver persisted at CNS because the buy-writes were sham transactions that allowed the Customers to never deliver securities they had purported to sell.

The buy-write trades that optionsXpress executed for Feldman and its other customers were not bona fide purchases to close out a failure-to-deliver position. Harris Report (Div. Ex. 310) at ¶ 30. In the same vein as the warnings of the Commission and CBOE and the violative trading in *Arenstein*, *Hazan*, and their progeny, the Customers' buy-writes were nothing more than a temporary stock lending arrangement that gave the appearance of a Reg. SHO close-out, but, as evidenced by the CNS reports, did nothing to clear the firm's fails. There is nothing in the confines of Rules 204T and 204 that supports optionsXpress' effort to distinguish these precedents. Rather, the Rules are broadly worded with the goal of reducing what optionsXpress and the Customers sought to perpetuate – failures to deliver. *See* 74 Fed. Reg. at 38266 ("These amendments are intended to help further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T."). There should be no doubt that the Customers' buy-writes are sham transactions.

Further, although the Division does not have to prove scienter for Reg. SHO violations, optionsXpress knew that the buy-writes were not resulting in actual delivery of shares. The firm knew that these Customers' buy-writes would not close-out a fail, but would result in another buy-in (and thus, another buy-write) the next day. In other words, optionsXpress knew that it maintained a continuous failure to deliver position in CNS in the securities traded by the Customers. In recognition of this, optionsXpress, on August 19, 2009, instituted new buy-in procedures that called for two categories of buy-ins: regular buy-ins and buy-ins where "the fail is continuously open due to customers being assigned in the money short calls," also known

internally as "perpetual," "chronic," or "rolling fails." These procedures were authorized by Stern. The new procedures, the implementation of which was overseen by Stern,[6] did nothing to alleviate the issue, but only institutionalized the violative conduct.

Moreover, the buy-ins for the "largest clients," like Feldman and the Customers, were treated differently (and more favorably) than the buy-ins for optionsXpress' other regular customers. The "big name" Customers like Feldman were given prior notice of a buy-in to afford those Customers the opportunity to place a buy-write.[7] That same opportunity was not afforded to optionsXpress' other customers, even those who engaged in a similar trading strategy.[8] Tellingly, optionsXpress chose to follow Reg. SHO for some of its less important customers but allowed Feldman and others to skirt their delivery obligations by executing their buy-write transactions.

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[6] Through this process, Stern became intimately familiar with the Customers' trading. Indeed, in 2009 alone, he requested information from an optionsXpress trader concerning Feldman's buy-write activities in Sears on more than 15 occasions. *See* Div. Ex. 160 (Payne) at 114:20-116:6.

[7] As explained by one of the optionsXpress traders: "For list #1, [a trader] will take care of contacting the big names: [including Feldman and the other Customers]. If any other names are on list #1 that are not above, go ahead and place market orders to cover at 8:25 a.m. and send the normal email notification to the customers." Div. Ex. 61.

[8] Notably, when optionsXpress received complaints from these other customers whose buy-ins were executed without prior notice, optionsXpress responded that its hands were tied by Reg. SHO. *See, e.g.*, Div. Ex. 62 ("I again apologize for this inconvenience, but we are following the SEC regulations regarding short selling."); Div. Ex. 205 ("The rule clearly states on page 6, section B, that any short position that cannot be delivered, must be closed out 'immediately.'"); Div. Ex. 107 ("I understand your frustration over this buy in, but even though you held the security for six months, we couldn't continuously locate the shares to hold against your position. I will be happy to credit back your commission, but the loss will not be reinstated by optionsXpress. This is a risk of shorting stocks.").

2. The Buy-Writes Had No Legitimate Economic Purpose

Respondents claim that the buy-writes had a legitimate economic purpose – the "buy" satisfied the delivery obligations and the "write" re-established the hedge against the original synthetic long. This is simply wrong because no delivery was ever made as a result of the alleged "buy" because the buy and the write were executed simultaneously and cancelled each other out. *See* Harris Report (Div. Ex. 310) at ¶.30. Moreover, Respondents' argument rests on an assumption that just because the trades had an economic purpose, it must have been legitimate. This is not so. A bank robber has an economic purpose for robbing a bank, however, that purpose is not legitimate – it is illegal. A person who kites checks has an economic reason for doing so – that too is illegal. Here it is undisputed that Feldman wanted to do the buy-writes in order to retain the profits he had made initiating the reverse conversions and three-way trades. However, the only way to keep those initial premiums was to not deliver shares that he had sold to legitimate purchasers, thereby converting the value (borrow fees) of these shares from these purchasers to himself. This economic purpose is the exact same economic purpose that the traders in *Hazan, TJM, Rhino* and *Arenstein* had – a purpose that was rejected as illegitimate. In short, Feldman's economic purpose was fraud and fraud is not a legitimate economic purpose.[9]

3. optionsXpress Violated Reg. SHO When the Buy-Writes Were Not Executed at Market Open

Even if this Court were to somehow conclude that the buy-write transactions were not shams, optionsXpress still violated Reg. SHO by not closing out its failures to deliver at market open. Reg. SHO requires a participant like optionsXpress, when it has failure-to-deliver positions, to close out each failure-to-deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date ("T+4"). 73 Fed. Reg. at 61710-11. In the

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[9] Furthermore, these buy-writes were a guaranteed cost to Feldman, further evidencing their illegitimacy. Sheehy Report (Div. Ex. 375) at ¶ 59. In other words, Feldman paid the counterparty to sell his own shares back to him.

present case, optionsXpress failed to execute the Customers' buy-writes at or near market open on at least sixty-six percent (66%) of the days on which buy-ins were required. Harris Report (Div. Ex. 310) at ¶ 106. Thus, even if the Court were to decide that optionsXpress is correct that the buy-writes were legitimate, optionsXpress still violated Reg. SHO.

While optionsXpress is strictly liable for violating Reg. SHO because it is not a scienter based regulation, there is ample evidence that optionsXpress knew the buy-writes that purported to cure the failures to deliver were not being executed at market open. In late October 2008, the Clearing Department and traders raised concerns to the Compliance Department that the stock was not being bought in at market open. The Compliance Department replied: "According to the rules, they need to be closed out at the opening. The industry is pushing back on this, and requesting the [whole] day, but as it is now, we need to cover at the open." Div. Ex. 202. Nonetheless, *for another ten months*, optionsXpress continued to allow the Customers until the end of the day to "buy" in with a buy-write and even when the firm changed its procedures in an attempt to get them executed by the market open, it was all in vain – the buy-writes continued to be executed later in the day, contrary to Reg. SHO. Harris Report (Div. Ex. 310) at ¶ 186.

C. optionsXpress Cannot Avoid Liability By Claiming It Relied On Regulators

optionsXpress believes it can exculpate itself from strict liability by arguing that it relied on guidance from regulators – including CBOE, FINRA, and the SEC – that the buy-writes it executed for Feldman and the other Customers were permissible trades that satisfied optionsXpress' close-out obligations under Reg. SHO. This argument is of no moment, because "the case law is consistent . . . that persons in the securities industry cannot blame [regulators] for their failure to carry out their responsibilities." *In the Matter of Gualario & Co., LLC*, AP File No. 3-14340, 2012 WL 627198, *14 (Feb. 14, 2012); *see also In the Matter of Stephen J. Horning*, AP File No. 3-12156, 2006 WL 2682464, *22 (Sept. 19, 2006) (Murray, A.L.J.) (holding that "persons in the securities industry cannot blame the Commission for their failure to

carry out their responsibilities"), *aff'd Horning v. SEC*, 570 F.3d 337 (D.C. Cir. 2009); *In the Matter of Certain Broker-Dealers Who Failed to File All or Part of Form BD-Y2K*, AP File No. 3-9759, 1999 WL 557616, *12 (Aug. 2, 1999) (Murray, A.L.J.) ("It is established that a broker-dealer cannot shift its responsibilities for compliance with applicable requirements to the...Commission.").[10] Putting the legal unavailability of this defense to the side, this argument strains credulity on the facts of this case. Not only did optionsXpress recognize, but choose to ignore, numerous red flags that the trading was problematic, it also misled regulators about the nature and extent of the Customers' trading. And more importantly, the regulators never gave the "comfort" that optionsXpress purportedly sought.

In mid-November 2008, a senior officer at optionsXpress sent an email to the Clearing Department about a *Wall Street Journal* article describing the trading in the *Arenstein* case and noting that FINRA had several ongoing cases involving this activity: "There is an article in the WSJ about how short sellers in [Sears] are using options to circumvent the SEC cover rule. I think we need to review this." The Clearing Department emailed back: "[The Customers are] definitely doing this." Div. Ex. 255 (email exchange); *see also* Div. Ex. 256 (*WSJ* article). Nonetheless, and as the series of events described below show, the firm remained undeterred in its execution of the Customers' buy-writes – even in the face of regulatory scrutiny.

Also in November 2008, CBOE began asking optionsXpress for information related to its Reg. SHO compliance. On February 26, 2009, CBOE notified optionsXpress that it was investigating the trading to determine whether SEC Rule 204T had been violated. Stern, who

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[10] *See also, e.g.*, *In the Matter of the Application of Ronald Pellegrino*, AP File No. 3-12941, 2008 WL 5328765, *14 (Dec. 19, 2008) (holding that a "regulatory authority's failure to take early action [does not cure] a violation"); *In the Matter of Newbridge Sec. Corp.*, AP File No. 3-13099, 2009 WL 1684744, *55 (June 9, 2009) (Kelly, A.L.J.) (holding that "it is well settled that respondents cannot shift responsibility for compliance to the NASD or the Commission"); *In the Matter of Quest Capital Strategies, Inc.*, AP File No. 3-8966, 2001 WL 1230619, *8 (Oct. 15, 2001) ("We have repeatedly pointed out that a broker-dealer cannot shift its responsibility for compliance with applicable requirements to...us.").

functioned as optionsXpress' primary regulatory liaison, was involved in the response to CBOE's investigation and reviewed the Customers' trading. *See* Div. Ex. 162 (Stern) at 426:13-427:13. In May 2009, FINRA initiated its first investigation into the Customers' trading.

On September 23, 2009, optionsXpress received a letter of caution from CBOE concerning the way the firm processed buy-ins for the Customers. Div. Ex. 193. On September 24, 2009, prompted by concerns raised by the traders who executed the Customers' buy-writes right after those traders had read *Hazan*,[11] optionsXpress' in-house counsel, Stern (who was aware of *Hazan*), and two compliance officers called FINRA, purportedly for guidance about the Customers' trading. FINRA said it would not discuss the issue because of its ongoing investigation. Div. Ex. 230 (FINRA Notes). The same day, the same optionsXpress individuals called Trading & Markets. optionsXpress claims that, based on facts provided by the firm on the call, representatives of Trading & Markets told optionsXpress to "keep doing what you're doing—keep closing out," and that Trading & Markets would get back to them on whether it had a best execution obligation to combine, as buy-writes, the Customers' buy-in orders with sales of calls.

However, optionsXpress failed to convey complete and accurate information on the call with Trading & Markets. Stern intentionally provided a misleading fact pattern on the call to "show the fact that the buy-in was not linked specifically to the amount of the assignment," despite his knowledge of the Customers' trading.[12] Div. Ex. 162 (Stern) at 326:11-327:15.

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[11] After reading the *Hazan* case, the primary trader who executed the Customers' buy-writes told his supervisor on September 23, 2009 that he "would not be placing any [buy-write] orders today." Div. Ex. 149.

[12] Specifically, to give the impression that the firm's failures were decreasing, Stern told Trading & Markets that the Customers sold *less* calls than the amount of their buy-ins, which is impossible given that the Customers' were trading buy-writes – which are by definition trades involving an *equivalent* number of shares purchased and calls sold – for their buy-ins.

Moreover, upon further investigation, Trading & Markets learned additional facts that optionsXpress did not disclose on the call, including that FINRA had an open investigation and that the Customers appeared to be using deep-in the-money calls to circumvent Reg. SHO and "re-establish their failing short positions...." Div. Ex. 210. In other words, optionsXpress' call to Trading & Markets was nothing but a set up to gain "regulatory cover" so that the Customers' buy-writes – and the commissions earned from them by the firm – could continue.

Upon learning the true story about optionsXpress and the Customers from FINRA, Trading & Markets called optionsXpress on October 2, 2009, and spoke to its in-house counsel and Stern telling them that the SEC could provide optionsXpress with "no comfort." *See* Div. Exs. 208, 209, 210. Right after the October 2, 2009, call with Trading & Markets, optionsXpress' in-house counsel, Stern, and two compliance officers again called FINRA. optionsXpress told FINRA that it had received a call from the SEC, was at a loss about what to do and was seeking guidance on the activity. *See* Div. Exs. 234, 235 (FINRA Notes). FINRA told optionsXpress that if it wanted guidance, it should send a request in writing to FINRA's general counsel or the SEC – optionsXpress chose to do neither. Instead, optionsXpress continued executing the Customers' buy-writes and the Customers (and the firm) continued avoiding their hard-to-borrow fees. Two weeks after the October 2 call, the Compliance Department recognized that the firm was "already under heavy scrutiny from regulators on our short sale practices . . . .", Div. Ex. 359, yet it was buy-writes as usual at optionsXpress.[13]

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[13] On December 15, 2009, optionsXpress also received a letter of caution from FINRA for violating Rule 204T by failing to timely close out a failure-to-deliver position in October 2008. FINRA noted in the letter that it had decided to provide a Cautionary Action Letter as a "compliance aid to assist the Firm in ensuring that it is in compliance with SEC Rule 204T;" however, "any subsequent violations of SEC Rule 204T may result in disciplinary action." Div. Ex. 111. optionsXpress did not change its procedures following the receipt of this letter and the buy-writes continued.

On January 14, 2010, Stern, optionsXpress' in-house counsel, and two compliance officers had a call with FINRA staff. During the call, FINRA staff expressed specific concern that the buy-ins did not result in a net flat or long position at the end of the day. Nevertheless, optionsXpress continued to allow the buy-writes until March 2010, a month after it received its first subpoena from the Commission.[14]

II. FELDMAN VIOLATED THE ANTI-FRAUD PROVISIONS OF THE SECURITIES LAWS

Feldman's scheme to profit by not delivering shares he sold is fraud. Indeed, the kind of deceptive conduct that Feldman engaged in has long been illegal under the federal securities laws. Nevertheless, to escape liability Feldman would have one believe that he is a naïve retail trader who did not understand the system, but yet devised a complex trading scheme to identify and profit off of perceived "arbitrage" opportunities that no professional trader noticed or traded upon. In reality, Feldman was neither a completely naïve trader nor the world's smartest trader — he was a sophisticated trader who understood the system and profited solely because he fraudulently manipulated it to his advantage by failing to follow the rules that others did.

[14] In January 2010, after the Division made a request for information, optionsXpress told Feldman that it was going to keep in place a commission increase that it imposed following Feldman's return from another broker-dealer, and by February 2010 began charging other Customers the increased commission as well. optionsXpress told Feldman that the reasons for the increase included regulatory concerns and increased compliance costs: "We have had discussions with the regulators about these strategies. It seems several market-makers have been complaining to the regulators about them. We continue to ask the regulators for guidance on these trades. . . . it continues to be a drain on our compliance staff." Div. Ex. 49. Several days later, optionsXpress told Feldman that "[r]egulators continue to ask questions, we provide answers and ask for guidance." *Id.*

A. The Securities Laws Prohibit Feldman's Scheme

1. Feldman's Conduct Violated the General Anti-Fraud Provisions of the Federal Securities Laws

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit (a) employing any device, scheme or artifice to defraud; . . . or (c) engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person.[15] Section 10b-5 does not require that there be a specific oral or written statement; "conduct itself can be deceptive." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008). Trading is a classic form of conduct that can be deceptive.

The scienter required for a Section 10(b) or Rule 10b-5 is "a mental state embracing the intent to deceive, manipulate or defraud." *Id.; Ernst & Ernst v. Hochfielder,* 425 U.S. 185, 193 n.12 (1976). Scienter may be established by showing either (a) knowing conduct or (b) "an extreme departure from the standards of ordinary care . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."[16] *Dolphin & Bradbury v. SEC,* 512 F.3d 634, 639 (D.C. Cir. 2008).

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[15] The Commission has also charged Feldman with violating Section 17(a)(1) and (3) of the Securities Act of 1933. For purposes of this case, the elements necessary to prove a Section 17(a) violation are essentially the same as a Section 10(b) violation, except that the Commission need only prove negligence with respect to Section 17(a)(3) violations. *SEC v. Monarch Funding Corp.,* 192 F.3d 295, 308 (2d Cir. 1999). Because the evidence establishing Feldman's knowing or reckless misconduct with respect to his Section 10(b) violations applies with equal (if not greater force) to his Section 17(a) violations, the Commission intends its Section 10(b) presentation to set forth evidence supporting its Section 17(a) allegations and, for the Court's convenience, will provide no further analysis of this claim at this time.

[16] With respect to direct violations, a willful violation of the securities laws means merely "that the person charged with the duty knows what he is doing." *Wonsover v. SEC,* 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC,* 174 F.2d 969, 977 (D.C. Cir. 1949)). "[K]nowledge of one's actions and their consequences is all the law requires; a demonstration of a subjective belief that those actions are illegal is unnecessary" for purposes of scienter. *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 79 n.32 (D.C. Cir. 1980).

In *Ernst & Ernst v. Hochfelder,* the Supreme Court stated that Section 10(b) reflected "overall congressional intent to prevent 'manipulative and deceptive practices which . . . fulfill no useful function." 425 U.S. 185, 206 (1976). The Supreme Court noted the significance of indirect legislative history that referred to Section 10(b) as "a catch-all clause to prevent manipulative devices" designed "to enable the Commission 'to deal with new manipulative (or cunning) devices.'" *Hochfelder*, 425 U.S. at 202-03 (quoting Thomas G. Corcoran, a spokesman for the drafters, during hearings prior to the enactment of the Exchange Act). It is for this reason that the securities laws and rules must be read broadly and flexibly and not "technically and restrictively." *SEC* v. *Zandford*, 535 U.S. 813, 819 (2002). These laws are enacted for the purpose of protecting against fraud and are designed to prevent "all the ingenious variations of security fraud that arise." *United States v. Jensen*, 608 F.2d 1349, 1354 (10th Cir. 1979). Feldman's scheme is just another variation of securities fraud.

In fact, Feldman's scheme — the sale of option contracts with no intention of fulfilling the terms of those contracts — is a type of conduct that courts have already found to be fraudulent. In *The Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, the Supreme Court held that selling an option while secretly intending not to fulfill one's obligations under the options contract is securities fraud. 532 U.S. 588, 596-97 (2001). "To sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith." *Id.; see also Walling v. Beverly Enter.*, 476 F.2d 393 (9th Cir. 1973) (entering "into a contract of sale with the secret reservation not to fully perform it is fraud cognizable under § 10(b)").

While the use of a buy-write in some circumstances is an entirely appropriate investment tool, Feldman's use of the buy-write here simply allowed him not to deliver stock to other market participants. Put another way, Feldman's use of a buy-write was a matched order that was set up to avoid his delivery obligations. Such manipulative devices have long been prohibited by the anti-fraud provisions of the securities laws. *Hochfelder*, 425 U.S. at 206 & 205

n.25 (1976) (holding that matched orders as "orders for the purchase [and] sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security."); *cf. Superintendent of Ins. of State of N.Y. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971) ("practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the regulatory agency have been found practically essential.").[17]

2. Feldman Violated Rule 10b-21 of the Exchange Act

Under Rule 10b-21, it is a manipulative or deceptive device or contrivance 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 to deliver the security on or before the settlement date, and such person fails to deliver the security on or before the settlement date." 17 C.F.R. § 240.10b-21. To prove a violation of Rule 10b-21, the Commission must show (1) scienter; (2) that an order was submitted to sell an equity security;

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[17] Feldman cited *United States. v. Finnerty*, 533 F.3d 143 (2d Cir. 2008), for the proposition that "[b]road as the concept of 'deception' may be, it irreducibly entails some act that gives the victim a false impression." Feldman Motion for Summary Disposition at 20. Feldman's reliance on *Finnerty* is misplaced. First, the facts of *Finnerty* are inapposite. In *Finnerty*, the Second Circuit overturned a criminal conviction where Finnerty had surreptitiously interposed his trades between the buyers and sellers of publicly-traded stock to conduct otherwise arms-length stock transactions and profit from both transactions. The court found that the purchasers and sellers of the stock received the benefit of their bargain. *Finnerty,* 533 F.3d at 145. As the court in *SEC v. Simpson Capital Mgmt., Inc.,* 586 F. Supp. 2d 196, 204 (S.D.N.Y 2008) noted in distinguishing *Finnerty:* "[A]ll that Finnerty did was to execute trades at disclosed terms...[H]e...did not deceive either the buyer or the seller with respect to the terms of their trades. Each side of the trade knew what it got—the shares purchased or sold and at what price." *Id.* at 204. Here, unlike in *Finnerty*, the purchasers of Feldman's sales did not receive the benefit of their bargain — they were deceived as to the terms of their trades. Harris Report (Div. Ex. 310) at ¶¶15, 49, 85. Second, the Second Circuit has given *Chevron* deference to the Commission's post-*Finnerty* adjudicatory decision finding Finnerty's conduct to be deceptive, which the Second Circuit has held "'trumps' our prior interpretation in *Finnerty*." *See Van Cook v. SEC,* 653 F.3d 130, 141 (2d Cir. 2011) (citing *David A. Finnerty,* Exchange Act Release No. 59998, 95 SEC Docket No. 2534, 2009 WL 1490212, at *3 (May 28, 2009)).

(3) the seller deceived a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security; and (4) the seller failed to deliver the security.

The scienter required for a violation of 10b-21 is the same as for a violation of 10b-5: "a mental state embracing the intent to deceive, manipulate or defraud." *Id.; Ernst & Ernst v. Hochfielder*, 425 U.S. 185, 193 n.12 (1976). When determining whether a failure to deliver has occurred under Rule 10b-21, the question is not whether there is a failure to deliver in the CNS system as it is for violations of Reg. SHO, but rather whether there is a failure to deliver ***by the seller***. 73 Fed. Reg. at 61672. "[S]ellers should promptly deliver the securities they have sold and purchasers have the right to the timely receipt of securities that they have purchased." *Id.* Rule 10b-21 targets the misconduct of sellers, specifically, individual sellers who fail to deliver securities that they sold. *Id.* at 61674.

Feldman violated Rule 10b-21 when he submitted orders to sell options, which are equity securities, knowing that (1) the options would be assigned, (2) he would thus have to deliver shares, and (3) he did not intend to, and did not, deliver the shares by settlement date. In doing this, he deceived clearing brokers and the ultimate purchasers (or recipients) of the stock about his intention to deliver the shares and, in fact, failed to deliver the shares on the settlement day.

B. Feldman Knowingly Or Recklessly Conducted A Fraudulent Scheme

Feldman knew or was reckless in not knowing that his trading was manipulative and deceiving to market participants. Feldman does not (and cannot) dispute that his options trading strategy was executed deliberately and intentionally and that optionsXpress executed the trading he requested. As part of his strategy, Feldman sold deep-in-the-money call options knowing that they were likely to be exercised and assigned (or was recklessly indifferent to that probability). As a result of the assignments, Feldman was required to deliver these shares by the standard settlement date. However, he did not do so. Instead, of delivering shares, Feldman entered into

buy-write transactions to give the appearance of delivery. Feldman had substantial personal knowledge and numerous red flags that this trading was deceptive.

1. Feldman Knew His Call Options Would be Assigned

Despite his current argument to the contrary, Feldman was well aware that the call options he sold would be assigned and result in the requirement to deliver stock. On numerous occasions, Feldman stated or was told that his options were being assigned on a regular basis. For example, a broker at another broker-dealer told Feldman "***market-makers are always going to assign what you're short.***" Div. Ex. 218 (emphasis added). Feldman had a similar conversation with a trader at optionsXpress who explained: "***the market maker is usually always going to assign*** whatever call [it purchases] . . . ***normally you'll always going to get assigned.***" Div. Ex. 221 (emphasis added). Indeed, according to Feldman himself: "[Y]ou'd be stupid to say, oh, I'm going to write these and none them are going to get exercised." Div. Ex. 181 (Feldman) at 196:24–197:1.

2. Feldman Knew His Stock Was Not Being Delivered

There is ample evidence that Feldman knew that the stock he had sold short was not being delivered. Examples include Feldman's conversations with a broker at another firm in which Feldman explained: "***I don't settle the stock@all***". Div. Ex. 245 (emphasis added). Similarly, Feldman told the other broker: "So I could do a buy-write ***and then I wouldn't settle.***" Div. Ex. 217 (emphasis added). Feldman also asked the broker: "So how many SHLD do I have to buy-in today (***to avoid settlement***)?" Div. Ex. 27 (emphasis added)

3. Feldman Knew that His Trading Was Raising Regulatory Concerns

Feldman was well aware that his trading was raising regulatory concern. For instance, Feldman told a friend, who was engaged in the same trading at optionsXpress: "I read the latest thread on the SHLD 'volume spikes'. Very entertaining. ***(Until someone notifies the SEC and they shut down the strategy!!).***" Div. Ex. 29 (emphasis added). Feldman also read another

website which noted that Feldman's "manipulative" activity was "consistent with the illegal 'reset' transaction" described in *Hazan,* which Feldman had also read. Div. Ex. 191; *see also* Div. Ex. 181 (Feldman) at 130:7-130:16, 132:8-132:22.

Feldman was also told about delivery requirements by optionsXpress. optionsXpress sent Feldman copies of Reg. SHO on several occasions and a compliance officer explained to Feldman that "when an assignment results in a short sale in a security we are already failing to deliver, we have to take action to clean up the entire fail immediately." Div. Ex. 28. Feldman responded by asking if there were other ways he could "***restart the clock.***" *Id.* (emphasis added). Later, another optionsXpress senior officer explained to Feldman that "several market-makers have been complaining to the regulators about [the trading]." Div. Ex. 49.

Another broker-dealer also told Feldman that there were regulatory issues with his trading. In fact, within two weeks of Feldman transferring part of his positions to that broker-dealer, the new broker-dealer told Feldman that he would be required to pay hard-to-borrow fees if he wanted to continue the trading.[18] Instead, Feldman fled back to optionsXpress, the only broker that would take him. As Feldman told a friend: "Millions of $$ inc [sic] comissions[sic],,,,yet treat me/us like criminals. . . . But, in the big picture...***it's still quite the gig...where can you get such mkt-bating [sic] retuens [sic] consistently***? So, as disgusting as [optionsXpress] are [sic], have to bend over and get raped, and take the punishment[.]" Div. Ex. 249.

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[18] While at the other broker-dealer, Feldman was told: "[The clearing broker] finally had a CNS fail, not net flat outside of Reg. SHO where they said their compliance told them that they had to go out and buy this stock no matter what." Div. Ex. 222. The broker further advised that regulators were concerned about this type of activity: "I don't think [optionsXpress is] going to take you because the CBOE regulators are starting to get heavy on this activity, that's why [the clearing broker] is getting more than likely skittish." *Id.*

4. Feldman Knew His Trading Created a False Market Impression

Feldman's sham reset transactions created the false appearance of a higher volume of trading in the market for some of the securities being traded. Harris Report (Div. Ex. 310) at ¶¶ 39, 179-185; Sheehy Report (Div. Ex. 375) at ¶ 63. Financial message boards reviewed by Feldman discussed daily "mystery trades," "illusory trades," and "faux trades" in Sears, including possible manipulation of its daily trading volume and violations of Reg. SHO. Div. Ex. 190 (Yahoo! Message Board Entries). In fact, in late December 2009, a friend of Feldman, who was engaged in the same trading at optionsXpress, told Feldman that the participants in the message boards "think Sears is buying back shares. . . . they have no idea." Div. Ex. 370; *see also* Div. 181 (Feldman) at 130:18-131:4. Feldman himself admitted that "everybody was out there just like getting worked up in a tizzy." Div. 181 (Feldman) at 235:7-236:1.

III. OPTIONSXPRESS CAUSED AND WILLFULLY AIDED AND ABETTED FELDMAN'S VIOLATIONS OF THE SECURITIES LAWS

To establish aiding and abetting liability, it is necessary to show (1) a securities law violation by a primary wrongdoer; (2) "substantial assistance" to the primary violator; and (3) that the accused provided the requisite assistance with knowledge of the securities law violation. *See Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (holding that extreme recklessness is sufficient); *see also SEC v. Apuzzo*, --- F.3d ----, No. 11–696–cv, 2012 WL 3194303, at *7 (2d Cir. Aug. 8, 2012) (holding that to prove aiding and abetting liability the SEC must prove "that [the defendant] in some sort associate[d] himself with the venture, that [the defendant] participate[d] in it as in something that he wishe[d] to bring about, [and] that he [sought] by his action to make it succeed") (quoting *United States v. Peoni,* 100 F.2d 401, 402 (2d Cir.1938)). To establish causing liability, the Division must show that: (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew,

or should have known, that his or her conduct would contribute to the violation. *See In the Matter of Robert M. Fuller*, Securities Act Rel. No. 8273 (Aug. 25, 2003).

As explained in detail above, Feldman's trading activity violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rules 10b-5 and 10b-21, thereunder. Feldman's fraudulent trading activity would not have been possible without the knowing and substantial assistance of optionsXpress; indeed, Feldman was precluded from perpetuating his scheme when he briefly moved his account to another broker. As outlined above, optionsXpress was fully aware of Rules 204 and 204T of Reg. SHO, and rather than follow the rules to prevent Feldman's fraudulent conduct, optionsXpress took every opportunity to find ways to avoid its regulatory obligations so that Feldman's trading (and the firm's resulting commissions) could continue. optionsXpress' conduct is the epitome of aiding and abetting fraudulent behavior and the Court should find it liable.

IV. STERN CAUSED AND WILLFULLY AIDED AND ABETTED OPTIONSXPRESS' AND FELDMAN'S SECURITIES LAW VIOLATIONS

A. Stern Caused optionsXpress' Violations Of Rules 204T And 204 Of Reg. SHO

Section 21C of the Exchange Act provides in pertinent part that the Commission may order any person who "is, was, or would be a cause" of a violation of the Exchange Act "to cease and desist from committing or causing such violation." To establish causing liability, the Division must show that: (1) a primary violation occurred; (2) an act or omission by the respondent contributed to the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. *See In the Matter of Robert M. Fuller*, Sec. Rel. 8273 (Aug. 25, 2003). Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *KPMG, LLP v. SEC,* 289 F.3d 109, 120 (D.C. Cir. 2002). Because Rules 204 and 204T do not contain a scienter element, a causing violation of those rules can be based on negligence.

As set forth above, optionsXpress violated Reg. SHO. Stern's conduct, as optionsXpress' CFO and primary regulatory liaison, contributed to and caused optionsXpress' violations. Stern was closely involved in the approval and implementation of optionsXpress' "perpetual fail" policy, a buy-in policy which institutionalized optionsXpress' Reg. SHO-circumventing conduct. Through that involvement, Stern became intimately familiar with the Customers' trading. Yet Stern, who knew about *Hazan*, and was aware of Reg. SHO's close-out requirements "on a pretty much daily basis," Div. Ex. 162 (Stern) at 56:19-20, intentionally provided misleading and inaccurate information about that trading to Trading & Markets in an attempt to justify the conduct. As the one optionsXpress individual, along with the firm's in-house counsel, who was on every call with the regulators, Stern also knew that these regulators – far from providing any comfort – had in fact raised concerns about the trading. Nevertheless, Stern allowed the Customers' trading to continue, contributing to optionsXpress' violations. And even when optionsXpress' Compliance Department determined that the buy-writes had to stop, Stern was part of the firm's decision to keep doing what it was doing – that is, violating Reg. SHO with the daily buy-writes. The Court should find that Stern's conduct makes him liable for causing optionsXpress' Reg. SHO violations.

B. Stern Willfully Aided And Abetted optionsXpress' Violations Of Reg. SHO

To establish aiding and abetting liability, it is necessary to show (1) a securities law violation by a primary wrongdoer; (2) "substantial assistance" to the primary violator; and (3) that the accused provided the requisite assistance with knowledge of the securities law violation. *See Howard*, 376 F.3d at 1143 (holding that extreme recklessness is sufficient). As set forth above, optionsXpress violated Reg. SHO and Stern provided knowing and substantial assistance to the company's violations for which the Court should hold him liable. This is evidenced by his: (a) knowledge of the close-out requirements of Reg. SHO, the Customers' trading activities, and the *Hazan* case; (b) approval and implementation of optionsXpress' "perpetual fail" buy-in

policy; (c) intentional misleading of Trading & Markets; and (d) decision to allow the Customers' trading despite concerns from regulators and his own Compliance Department.

C. Stern Caused And Willfully Aided And Abetted Feldman's Fraud

Stern's misconduct in causing and aiding and abetting optionsXpress' violation of Reg. SHO also caused and aided and abetted Feldman's violations of the fraud provisions of the Securities Act and Exchange Act.[19] Stern's role in institutionalizing the firm's "perpetual fail" policy, overruling his Compliance Department, providing misinformation to regulators, and ignoring those same regulators' concerns enabled Feldman – whose trading activities Stern was intimately familiar – to perpetrate his fraud. This is a classic example of causing and aiding and abetting behavior, for which the Court should find Stern liable.

V. THE COURT SHOULD ORDER DISGORGEMENT, PENALTIES, AND OTHER EQUITABLE RELIEF

A. optionsXpress Should Disgorge $7,214,977 Plus Pre-Judgment Interest

By willfully and repeatedly failing to comply with its obligations under Reg. SHO, optionsXpress avoided paying $7,214,977 of hard-to-borrow fees. Harris Report (Div. Ex. 310) at ¶¶ 41, 188, 199. Section 8A of the Securities Act and Section 21C of the Exchange Act authorize the Commission to require an accounting and disgorgement, including reasonable interest. 15 U.S.C. § 77h-1(e); 15 U.S.C. § 78u-3(e). It is well-established that disgorgement of losses avoided is an appropriate means of disgorgement. *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995); *SEC v. Pentagon Capital Mgmt PLC,* 844 F. Supp. 2d 377, 425 (S.D.N.Y. 2012). Based on its willful misconduct, disregard of its responsibilities as a broker-dealer, and aiding and

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[19] Because Section 10(b) and Rules 10b-5 and 10b-21 have a scienter element, the standard for causing these violations is essentially the same as an aiding and abetting charge.

abetting of Feldman's fraud, optionsXpress should be ordered to pay $7,214,977 plus pre-judgment interest.[20]

B. Feldman Should Disgorge $4,560,202 Plus Pre-Judgment Interest

Through perpetrating his fraud, Feldman earned illicit "profits" of $4,560,202. Harris Report (Div. Ex. 310) at ¶ 33. As Courts have long recognized, wrongdoers should not be allowed to profit from their misconduct. *SEC v. First Jersey Sec., Inc.,*101 F.3d 1450, 1474 (2d Cir. 1996) ("The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws."). This principal is incorporated into the federal securities laws which provide that those who violate the federal securities laws, including the anti-fraud provisions, should disgorge their ill-gotten gain. 15 U.S.C. § 77h-1(e); 15 U.S.C. § 78u-3(e). Thus, Feldman should disgorge the entirety of the profits from his illicit scheme – $4,560,202 – plus any prejudgment interest.

C. The Respondents Should Be Ordered To Pay Civil Money Penalties

Exchange Act Section 21B(a) authorizes the Commission to assess a civil money penalty where a respondent has willfully violated the Exchange Act or rules and regulations thereunder. A willful violation of the securities laws means the intentional commission of an act that constitutes the violation. Put another way, there is no requirement that the actor "must also be aware that he is violating one of the Rules or Acts." *Wonsover*, 205 F.3d at 414 (internal quotations marks and citation omitted).

The Exchange Act has a three-tier system identifying the maximum amount of penalty. For each "act or omission" by a natural person, the maximum amount of a penalty is $7,500 in the first tier, $75,000 in the second tier, and $150,000 in the third tier. *See* 17 C.F.R. § 201.1003,

[20] optionsXpress also directly earned $1,908,744 in commissions related to its violations of Reg. SHO. Harris Report (Div. Ex. 310) at ¶ 42. At a minimum, the Court should order optionsXpress to disgorge this amount plus pre-judgment interest.

Subpt. E, Table IV. For an entity like optionsXpress, the tiers are $75,000; $375,000 and $725,000. *Id.* To determine whether to issue a penalty, courts consider the following six statutory factors: (1) fraud; (2) harm to others; (3) unjust enrichment; (4) prior violations; (5) need for deterrence; and (6) such other matters as justice requires. *See* Exchange Act Section 21B(c) ("Determination of Public Interest").

The conduct of optionsXpress and Feldman harmed market participants and undermined market integrity. optionsXpress and Feldman greatly profited from the scheme. *See* Harris Report (Div. Ex. 310) at ¶¶ 83-88. A third-tier penalty is warranted against both optionsXpress and Feldman for each of their multiple violations, in order to deter other market participants from engaging in similar conduct.[21] Because Stern did not personally profit from his actions, the Division requests a second-tier civil money penalty of $75,000 against him.

D. The Respondents Should Be Ordered To Cease-And-Desist

Exchange Act Section 21C authorizes the Commission to enter a cease-and-desist order against any person who is "is violating, has violated, or is about to violate" any provision of the Exchange Act or rule or regulation thereunder. 15 U.S.C. § 78u-3. In considering whether a cease-and-desist order is appropriate, the Court looks to see whether there is some risk of future violations. *KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1185 (2001). The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction. *Id.* at 1191. In fact, a single violation can be sufficient to indicate some risk of future violation. *In the Matter of Ofirfan Mohammed Amanat*, Exchange Act Rel. No. 54708, 2006 WL 3199181 at *12 n. 64 (Nov. 3, 2006). The Commission has indicated that other factors may demonstrate the need for a cease-and-desist order such as the seriousness of the violation, the degree of harm to investors or the marketplace resulting from the violation, the sincerity of

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[21] The penalties in Section 21B are based on "each act or omission." 15 U.S.C. § 78u-2. optionsXpress violated Reg. SHO in 25 securities on at least 1,200 occasions. Feldman committed fraud in connection with 13 securities over 20 different periods.

assurances against future violations, the opportunity to commit future violations and the remedial function to be served by the cease-and-desist order in the context of other sanctions sought in the proceeding. *Id.* at *12. In this case, each of the Respondents should be ordered to cease-and-desist from violating the securities laws.

1. optionsXpress Violated Multiple Provisions of the Securities Laws

optionsXpress should be ordered to cease-and-desist from violating Rules 204 and 204T of Reg. SHO and from aiding and abetting violations of Section 10(b), Rule 10b-5 and Rule 10b-21 of the Exchange Act as well as Section 17(a) of the Securities Act. optionsXpress engaged in multiple acts that caused it to fail to deliver thousands of securities in a timely fashion. By doing this, optionsXpress avoided paying over $7 million of hard-to-borrow fees that should have been paid to other market participants. If optionsXpress had followed the mandates of Rules 204T and 204, Feldman would not have been able to carry out his fraud. optionsXpress is still a registered broker dealer and thus has the opportunity to commit future violations. As a result, optionsXpress poses a substantial, continuing risk of harm to investors and the marketplace. In sum, a cease-and-desist order is in the public interest.

2. Feldman Poses a Future Risk to Investors and the Marketplace

Feldman traded billions of dollars of options contracts. He placed numerous trades with no intention of delivering shares. This conduct greatly undermines market integrity. Harris Report (Div. Ex. 310) at ¶¶ 83-88. Feldman's conduct was at least reckless. He encountered numerous red flags that put him on notice that his trading was problematic yet he continues to trade in the marketplace. In short, he poses a substantial, continuing risk of harm to investors and the marketplace and a cease-and-desist order should issue.

3. Stern Poses a Future Risk to Investors and the Marketplace

While Stern no longer works at optionsXpress, he has given no assurances against future violations. Stern has refused to acknowledge that his conduct violated the securities laws. He

misled regulators and had a cavalier attitude regarding regulatory requirements. Stern poses a substantial, continuing risk of harm to investors and the marketplace. Accordingly, a cease-and-desist order should issue because it is in the public interest.

E. Stern Should Be Barred

Exchange Act Section 15(b)(6) authorizes the Commission to bar a person associated with a broker-dealer if he has willfully violated the federal securities laws and such sanction is in the public interest. In determining whether an industry bar is in the public interest, courts consider the factors identified in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979). Those factors include: (1) the degree of scienter involved; (2) the isolated or recurrent nature of the violations; (3) the sincerity of assurances against future violations; (4) and the likelihood that a respondent's occupation will present opportunities for future violations. *Id.*

Stern aided and abetted violations of the antifraud provisions of the securities laws as well as the close-out requirements of Regulation SHO. Stern's actions helped optionsXpress avoid paying over $7 million in hard-to-borrow fees. This caused harm to other market participants. Stern misled regulators and continued to allow the customers to engage in the trading in question despite numerous red flags. Stern has offered no assurances against future violations. He has been involved in the financial industry for decades. Without an industry bar, Stern will have the opportunity to commit more violations of the securities laws.

The Division asks that Stern be permanently barred from associating with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized rating organization. Stern should also be barred from acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter. Finally, Stern should be barred from participating in any offering of a penny stock, including: acting as a promoter, finder,

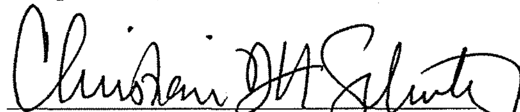
consultant, agent or other person who engages in activities with a broker, dealer or issuer for purposes of the issuance of trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock.

CONCLUSION

As the foregoing demonstrates, Feldman's trading was a manipulative and deceptive scheme that violated Section 10(b) of the Exchange Act, and Rules 10b-5 and 10b-21 thereunder, as well as Section 17(a) of the Securities Act. optionsXpress caused and willfully aided and abetted Feldman's and other Customers' abusive naked short selling, and in the process violated its delivery obligations under Reg. SHO. Finally, Stern's active role as optionsXpress' primary regulatory liaison and in setting optionsXpress' policies and procedures for handling the improper trading aided and abetted both optionsXpress' violations of Reg. SHO and Feldman's violations of the securities laws. The Court should order disgorgement from optionsXpress and Feldman, enter cease and desist orders regarding their conduct, permanently bar Stern from activity in the securities markets, and impose substantial civil penalties.

Dated: August 31, 2012

Respectfully submitted,



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