UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10125 / August 18, 2016

SECURITIES EXCHANGE ACT OF 1934
Release No. 78621 / August 18, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

OPTIONSXPRESS, INC. and
JONATHAN I. FELDMAN

OPINION OF THE COMMISSION

CEASE-AND-DESIST PROCEEDING

Grounds for Remedial Action

Close-out Obligations

A registered broker-dealer violated its close-out obligations under Rule 204 of Regulation SHO with respect to large and continuing fail to deliver positions that arose from trading activity by its retail customers. *Held*, it is in the public interest to issue a cease-and-desist order, to order disgorgement of ill-gotten gains, and to impose a third-tier civil monetary penalty against optionsXpress and to dismiss the proceedings as to a retail customer.

APPEARANCES:

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optionsXpress, Inc., a registered broker-dealer ("optionsXpress"), and Jonathan I. Feldman ("Feldman"), an optionsXpress customer, appeal from an administrative law judge's initial decision.[1] The law judge found that optionsXpress willfully violated Rules 204 and 204T of Regulation SHO of the Securities Exchange Act of 1934[2] by failing to close out certain fail to deliver positions and that Feldman violated Section 17(a) of the Securities Act of 1933,[3] Exchange Act Section 10(b),[4] and Exchange Act Rules 10b-5 and 10b-21[5] by writing call options with the intent not to make delivery of securities when those options were exercised. For these violations, the law judge issued a cease-and-desist order, an order to disgorge ill-gotten gains, and third-tier civil monetary penalties. We find that optionsXpress violated Rules 204 and 204T. But we find that the Division of Enforcement has not met its burden to show that Feldman committed fraud. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

I. Summary

This matter centers on the concept of "delivery" of securities and the different meanings that term has for clearing broker-dealers (like optionsXpress) and their customers (like Feldman). Rule 204 of Regulation SHO requires participants in a registered clearing agency to deliver securities to the clearing agency within three settlement days of a long or short sale transaction in an equity security (*i.e.*, T+3).[6]

For purposes of Rule 204, a "fail to deliver" occurs when the participant broker or dealer does not have enough shares in its securities-depository account to satisfy its delivery obligation to the clearing agency. When a fail to deliver occurs, Rule 204 requires the broker or dealer to, "by no later than the beginning of regular trading hours" on the next settlement day (*i.e.*, T+4), "immediately close out its fail to deliver position by borrowing or purchasing securities" of like kind and quantity. Rule 204 applies to participants in registered clearing agencies, and does not

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[1] *optionsXpress, Inc.*, Initial Decision Release No. 490, 2013 WL 2471113 (June 7, 2013).

[2] 17 C.F.R. §§ 242.204, 242.204T.

[3] 15 U.S.C. § 77q(a).

[4] *Id.* § 78j(b).

[5] 17 C.F.R. §§ 240.10b-5, 240.10b-21.

[6] 17 C.F.R. § 242.204. Rule 204 became effective on July 31, 2009 and made permanent the requirements of temporary Rule 204T. No party argues that there are material differences between Rules 204 and 204T, and we treat them interchangeably; references to Rule 204 include both the permanent rule and the temporary rule unless the context indicates otherwise.

apply to such participants' retail customers.[7] The delivery obligations of customers like Feldman instead arise from their contractual arrangements with their brokers and any representations they may have made, whether explicitly or by course of conduct, in connection with their trades. Ultimately, participants are required to comply with their own delivery obligations, regardless of whether a customer satisfies his or hers.

optionsXpress was a participant in the National Securities Clearing Corporation ("NSCC"), a registered clearing agency. Feldman and other retail customers of optionsXpress (the "Customers") employed an options trading strategy that contributed to the firm having large and continuing fail to deliver positions in about two dozen securities between October 2008 and March 2010 (the "OIP Securities"). The Division claims that optionsXpress violated its obligations under Rules 204T and 204 when it relied upon buy-writes placed by the Customers to address the firm's fail to deliver positions; the buy-writes, the Division claims, did not timely close out the firm's fails. It also claims that Feldman violated the antifraud provisions by allegedly not making delivery when the call options he wrote were exercised. We agree with the first claim, but find that the record does not support the second.

II. Overview of the trading activity

This matter involves paired stock and options transactions (*i.e.*, buy-writes) repeatedly executed by optionsXpress at the behest of certain of its retail customers, including respondent Feldman, between October 2008 and March 2010. Before turning to our analysis of the violations alleged in the OIP, we provide an overview of the trading activity and the impact that the transactions had on each respondent's distinct delivery obligations.

A. The Customers' trading strategy

Call and put options are contracts that give their holders the right, but not the obligation, to buy (a call option) or sell (a put option) a fixed number of shares of the underlying security at a specific price—called the strike or exercise price—until the expiration date. An option "series" consists of all the put options or call options on the same underlying security with the same strike price and the same expiration date.

The Customers' trading strategy took advantage of a disparity between the price of the underlying security and the price of options on that security in the OIP Securities. The OIP Securities were all "hard to borrow," which means that it was more expensive to borrow them because they were in high demand by short sellers relative to number of shares that were available for lending. In hard to borrow securities, puts will appear overpriced in comparison to

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[7] Rule 204 contains provisions governing situations when a participant allocatesa fail to deliver position to a broker-dealer customer "for which its clears trades or from which it receives trades for settlement." 17 C.F.R. § 242.204(d).

calls with the same strike price and expiration date because the higher borrowing costs are factored into the price of the put.

The Customers sought to profit from this apparent disparity by selling (or writing) puts and buying calls in identical quantities for the same security. When done together, with the same expiration date and strike price, these trades created a "synthetic long" position that mimicked owning the stock through the expiration date of the options. Standing alone, such a position would expose the Customers to the risk that the underlying security would decline in price. Thus, at the same time, the Customers would establish a hedge by either selling the stock short (which, when coupled with a synthetic long, is called a "reverse conversion") or writing deep-in-the-money call options (which, when coupled with a synthetic long, is called a "three-way trade").[8]

Once the Customers executed these initial trades, optionsXpress's books would reflect that they had a short stock position in their accounts with the firm. When they employed a reverse conversion, this short position was recorded immediately. When they employed a three-way trade, the deep-in the-money calls were typically exercised right away and then assigned to optionsXpress (which in turn would allocate the assignment to a customer). Once that happened, a short position would be recorded in the Customers' accounts, exactly as if they sold the stock short from the outset.

Either way, when optionsXpress had a fail to deliver position in the security, optionsXpress would then issue "buy-in" notices, which directed the Customers to "cover" their short positions with the firm.[9] The Customers might have responded by simply purchasing the stock and doing nothing else; in this case, they would have exposed themselves to directional risk in the underlying security until the synthetic long expired. The Customers also might have responded by purchasing the stock and also unwinding the synthetic long prior to expiration. But this would have eliminated any potential for profit as well. The issue in this case is that when optionsXpress allowed the Customers to place buy-writes—that is, an order to purchase the stock and write deep-in-the-money call options for the same number of shares—in response to its buy-

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[8] Whether the Customers initially proceeded by way of a reverse conversion or a three-way trade had no effect on the economics of the trading strategy from the Customers' perspective (or, as we explain below, on the delivery obligations incurred by optionsXpress). The Customers' maximum potential profit for any such position was fixed at the outset: It was, at most, the net premiums received for the synthetic long, less transaction costs, the cost of purchasing the security upon expiration of the synthetic long, and the ongoing costs to holding the position until expiration discussed in the next paragraph.

[9] The timing of when optionsXpress issued these buy-in notices is discussed *infra* Section III.B. Generally, optionsXpress would issue them when the firm had a fail to deliver and the customer had a short position with the firm.

in notices, optionsXpress itself relied upon the buy-writes to satisfy the firm's delivery obligations.[10] These buy-writes enabled the Customers to keep a hedge in place, and thus hold the synthetic long position open until expiration while remaining insulated from movements in the price of the underlying security. Yet each buy-write that the Customers placed cost them a penny or two per share of stock and thus cut into their profits.

We offer an example based on the three-way trade that Feldman employed in September and October 2009 in Sears Holdings Corp. (SHLD):

- On September 16, 2009, Feldman established a synthetic long position. He bought October 2009 SHLD calls with an expiration date of October 16, 2009 and a strike price of $70; the premium was $1.44/share. He also wrote October 2009 SHLD puts with the same strike price; the premium was $6.62/share. On the same day, he completed the three-way trade by selling deep-in-the-money September 2009 SHLD calls with a strike price of $10, for which he received a premium of $55.75/share. As a result of these transactions, Feldman received an up-front premium of $60.94/share (*i.e.*, $55.75 + $6.62 - $1.44).

- On almost every trading day between September 22 and October 16, optionsXpress had fails to deliver that were perpetuated by assignment of deep-in-the-money calls and issued Feldman buy-in notices. On each occasion, Feldman placed a buy-write at a cost of between $0.01 and $0.02/share, which optionsXpress executed and relied upon to address its own obligations under Regulation SHO.

- On October 16, the options comprising the synthetic long expired. Because the market price of SHLD was $70.08 (and thus above the $70 strike price of the October 2009 SHLD puts), their holders allowed them to expire unexercised. The holders of the deep-in-the money calls exercised the options, and Feldman was required to sell them SHLD for $10/share. Finally, Feldman exercised his October 2009 SHLD calls and was able to buy SHLD for $70/share. Feldman thus incurred a loss of $60/share.[11]

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[10] On average, the strike prices of the calls that Feldman wrote were 57% lower than the closing prices of the underlying securities on the day of the sale.

[11] If SHLD market price had been below the $70 strike price, the expected loss would have been the same, with the holders of the October 2009 puts exercising their options; the holders of the deep-in-the money calls doing the same; and Feldman's calls expiring worthless.

In summary, Feldman's overall expected profit from this series of trades was $0.94/share (*i.e.*, the up-front premium of $60.94/share minus the locked-in $60/share loss upon the expiration of the synthetic long), less the cost for the buy-writes and other transaction costs, such as fees and commissions.

B. The continuing cycle of buy-writes resulting from assignments

The calls written by the Customers were, on an ongoing basis, exercised, assigned to optionsXpress, and then allocated by optionsXpress to the accounts of its retail customers by its issuance of buy-in notices. The Customers therefore continued to have a short stock position in their accounts with optionsXpress. On each successive day, optionsXpress would issue another buy-in notice, which the firm allowed Customers to respond to by placing yet another buy-write, thus perpetuating the cycle until the synthetic long finally expired.

Although it was not certain that every call would be exercised and assigned right away, that was the case for the majority of the buy-write calls because they were written deep in the money. As Dr. Atanu Saha, optionsXpress's expert, acknowledged, the "deeper the call is in-the-money, the more likely it is to be assigned." Reviewing Feldman's trades in the OIP Securities, the Division's expert, Professor Lawrence Harris, determined that assignments to the buy-write calls very often occurred on the same day that they were sold. For example, on 94% of the 395 trading days on which *either* Feldman sold a call or an assignment was made to that series of options, *both* a sale of a new buy-write call and an assignment took place. Also, the size of the assignments correlated closely with the number of options being written on the same and immediately preceding days.

The Division's expert also determined that, on average, Feldman would execute a buy-write in the same security every 1.02 trading days. Stated another way, 98% of the time that Feldman executed a buy-write, he would execute another buy-write in the same security exactly one trading day later. The longest string of consecutive days in which Feldman used buy-writes in the same security, Sears Holdings Corp. (SHLD), was 50, and the average for all the OIP Securities was 12 consecutive trading days. Overall, Feldman executed 390 such buy-writes during the relevant period, and those buy-writes occurred on 386 (or 98%) of the 395 total trading days during the relevant period.

In short, Professor Harris's analysis demonstrated that many of the deep-in-the-money buy-write calls in the OIP Securities were being exercised as they were being written, and that Feldman would respond by placing yet another buy-write.[12]

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[12] As a further indication of the close relationship between calls sold as part of the buy-writes and subsequent assignments, Professor Harris found that, on a last-in-first-out basis, 92% of the buy-write call volume that was ultimately closed by assignment was assigned on the same day

(continued…)

Because Feldman traded in such large volumes, some of Feldman's buy-writes were also quite large. On December 31, 2009, for example, Feldman entered into a buy-write for 516,600 shares of Sears, and a corresponding number of call options, to maintain his hedged position in Sears. The notional value of the stock purchase was $43 million, and it represented 32% of the 1,603,300 total Sears shares (including those comprising the buy-write) that traded in the United States on that date.

Respondents contend that the Division's data does not tell the whole story, noting that, for trading involving securities not at issue here (and certain other periods of trading), assignments were often more sporadic or delayed. Their experts also noted that no two OIP Securities had the same likelihood of assignment and that the precise figure varied over time. This may be true, but for the OIP Securities during the periods identified in the OIP, there was a high likelihood that the calls would be immediately assigned (and that a buy-write would subsequently be placed).

Both optionsXpress and Feldman were aware of these facts at the time of the trades in question. For example, Feldman sent an instant message to a floor broker, writing, "See how it happens? Same trade every day. Get assigned stock [sic] + sell options." He similarly emailed optionsXpress that responding to its buy-in notices with a buy-write was "part of [his] daily routine. Brush teeth, get coffee, res[e]t C [Citigroup, Inc.], cover buyin on C." On another occasion, emailing optionsXpress, Feldman similarly wrote, "Gmorning. Can do the same today re [Sears] as yest[erday] re buy writes. Same applies tomorrow (Fri) too. Thx." Another floor broker who spoke with Feldman about his trades testified that "Feldman had made it aware to myself that he would be doing these buy-writes almost daily."

As Feldman admitted at the hearing, the "buy-writes were, as we all know, repetitious, and did happen frequently." He acknowledged this in his briefing as well, noting that "high-volume trading and frequent same-day exercise of the written calls" was evident to the marketplace.

C. optionsXpress's large and persistent fail to deliver positions

Although optionsXpress contractually required Feldman and the other Customers to respond to its buy-in notices (and permitted them to do so by placing buy-writes), the firm did not require them to actually locate and deliver shares to optionsXpress (or to anyone else). The firm's director of clearing operations, Ronald Molnar, admitted that optionsXpress never directed Feldman to deliver shares to the firm, whether to cure his short positions with the firm,

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(…continued)

that it traded and 97% was assigned on the day of the trade or the first trading day afterwards. The corresponding figures on a first-in-first-out basis were only slightly lower.

in response to the firm's buy-in notices, or otherwise. Molnar further testified that Feldman never made any representations about his ability or intention to do so and that, even if Feldman had made such a representation, the firm "wouldn't have accepted it."

The Customers' obligations to optionsXpress are distinct from the firm's own delivery obligations to the clearing agency under Regulation SHO.[13] In broad terms, Rule 204 of Regulation SHO requires participants of a registered clearing agency (such as optionsXpress) to deliver equity securities to a registered clearing agency (here, NSCC) by the designated settlement date—typically three days after the trade date, or T+3.[14] Put another way, Rule 204 required optionsXpress to deliver securities to NSCC within three days of executing a short sale order or being assigned on a call option. If optionsXpress did not have enough shares on hand to satisfy its aggregate delivery obligations, the firm would have a fail to deliver position reflected in NSCC's Continuous Net Settlement ("CNS") system. When this happened, Rule 204 required optionsXpress, by no later than market open the following day (*i.e.*, T+4), to "immediately close out" its CNS fail to deliver position "by borrowing or purchasing securities of like kind and quantity."

optionsXpress made no attempt to borrow the OIP Securities.[15] Nor did it simply purchase the stock at market open. It instead relied on the Customers' buy-writes to satisfy its obligations under Rule 204. It is clear, based on trading and CNS records, that optionsXpress's execution of the Customers' buy-writes did not close out the CNS fails. Instead, optionsXpress allowed those fails to persist for weeks—even months—on end. For example, between April 8, 2009 and March 18, 2010, optionsXpress had a fail to deliver position in Sears for 238 consecutive settlement days, during which the market value of the fail position averaged $25 million. By comparison, the next highest number of consecutive days of fails to deliver for Sears for another broker was *two*. And between June 19, 2009 and July 24, 2009, optionsXpress had a fail to deliver position in Citibank for 45 consecutive settlement days, during which the market value of the position averaged $9 million. These were not isolated occurrences. There were 27 periods in which optionsXpress had a fail to deliver position in one of the OIP Securities that exceeded a dozen consecutive settlement days. The Division's expert also showed that the volume of buy-writes placed by the Customers in a particular OIP Security was closely linked to

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[13] Our discussion pertains to only retail customers. Nothing in this opinion is intended to address the allocation of fail to deliver positions to the broker-dealer customers of participants in registered clearing agencies or any other issue regarding broker-dealer customers of clearing firms. *Cf.* 17 C.F.R. § 242.204(d).

[14] 17 C.F.R. § 242.204.

[15] If optionsXpress borrowed the stock, it would have had to pay the high stock loan fees associated with hard-to-borrow securities. Further, if it passed these fees along to Feldman, they would have more than offset the potential profits from establishing the synthetic long positions. Reverse conversions and three-way trades typically are not profitable for that reason.

the size of optionsXpress's fail to deliver position in that security in the surrounding days—with an average weighted correlation coefficient of 78%—showing that the buy-writes were associated with the ongoing fails.

D. An example series of transactions

To illustrate the trading activity and its effect on the Customers' accounts with the firm and optionsXpress's CNS positions, consider Feldman's trades in The Talbots Inc. (TLB) in February and March 2010. In the days before February 9, optionsXpress had a flat or slightly negative (*i.e.*, in the low hundreds) CNS position. Beginning on February 9, Feldman entered into a series of three-way trades consisting of paired synthetic long positions and deep-in-the-money call options representing about 330,000 shares of TLB. By the end of February 22, because of these trades and the trades of other customers, optionsXpress had a fail to deliver position of 336,200 shares (and thus owed that number of shares to NSCC).[16] At the same time, Feldman had a short stock position in his optionsXpress account because of the exercise and assignment of some of the options that he had previously written. On February 23, the following trades took place:

- **Beginning of the day:** Feldman was short shares in his optionsXpress account; optionsXpress owed (*i.e.*, had a fail to deliver of) 336,200 shares to NSCC

- **Morning:** optionsXpress issued a buy-in notice to Feldman, who bought 335,900 shares and wrote 3,359 deep-in-the-money call options representing 335,900 shares (the buy-write)

- **During the day:** Deep-in-the-money call options were exercised

- **Evening:** optionsXpress received assignment on 3,329 calls and in turn allocated it to Feldman

- **End of the day:** Feldman still was short 332,900 shares to optionsXpress; optionsXpress still had a fail to deliver of 336,000 shares to NSCC

Similarly, on the next day, February 24:

- **Morning:** optionsXpress issued another buy-in notice to Feldman, who bought 332,900 shares and wrote 3,329 deep-in-the-money call options (the buy-write)

- **During the day:** Deep-in-the-money call options were exercised

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[16] The numbers do not sum exactly because of a handful of much smaller trades by other optionsXpress customers.

- **Evening:** optionsXpress received assignment on 3,359 calls and in turn allocated it to Feldman

- **End of the day:** Feldman still was short 335,900 shares to optionsXpress; optionsXpress still had a fail to deliver of 336,000 shares to NSCC

And again on February 25:

- **Morning:** optionsXpress issued another buy-in notice to Feldman, who bought 335,900 shares and wrote 3,359 deep-in-the-money call options (the buy-write)

- **During the day:** Deep-in-the-money call options were exercised

- **Evening:** optionsXpress received assignment on 3,359 calls and in turn allocated it to Feldman

- **End of the day:** Feldman still was short 335,900 shares to optionsXpress; optionsXpress still had a fail to deliver of 335,861 shares to NSCC

And again on February 26:

- **Morning:** optionsXpress issued another buy-in notice to Feldman, who bought 335,900 shares and wrote 3,359 deep-in-the-money call options (the buy-write)

- **During the day:** Deep-in-the-money call options were exercised

- **Evening:** optionsXpress received assignment on 3,359 calls and in turn allocated it to Feldman

- **End of the day:** Feldman still was short 335,900 to optionsXpress; optionsXpress still had a fail to deliver of 330,820 shares to NSCC

This pattern repeated itself for the next several weeks, with optionsXpress immediately being assigned on the calls and Feldman repeatedly receiving a buy-in notice from optionsXpress and then placing a deep-in-the-money buy-write in response. optionsXpress's fail to deliver position likewise remained open throughout, hovering around 333,000 until March 15 and then decreasing slowly as the synthetic long unwound. Only on March 18 did this cycle of assignments and buy-writes end and optionsXpress's fail was finally closed out. Feldman placed a buy-write on all of the trading days during the period February 16 to March 18. On 17 of those 23 days, there was a less than 10% difference between the assigned call size and the sold call size in the buy-write, with an overall correlation for the period of over 0.9. The close relationship between assignments and buy-writes is confirmed by the analysis of Feldman's expert witness, who found with respect to TLB that 77% of the calls in the buy-writes were assigned in full and 100% were assigned at least in part on the same day they were written.

III. OptionsXpress Background

optionsXpress's reliance upon the buy-writes to satisfy its delivery and close-out obligations was, under these circumstances, improper. The buy-writes did not result in optionsXpress delivering shares to NSCC and thus did not "close out its fail to deliver position" as required by Rule 204(a). Moreover, apart from the fact that the buy-writes did not close out the fails, the firm did not ensure that the trades were placed at or before market open and therefore also violated Rule 204(a)'s proviso that firms act to address fails "by no later than the beginning of regular trading hours." Here, we provide more background specific to the Rule 204 violations.

A. How securities are cleared, settled, and delivered

A precise description of a broker's delivery obligations to NSCC, how those obligations are tracked and reflected by the CNS system, and what it means for a broker to have a fail to deliver position at CNS is relevant to our finding that optionsXpress violated Rule 204. As we detail below, the CNS system nets together a firm's trading activity on the same day—including activity from stock purchases and call option assignments—before computing end-of-day delivery instructions. When, as here, buy-write calls are regularly and immediately exercised and assigned, the buys and writes will effectively offset each other without the firm making delivery of securities to NSCC; intraday movement of shares does not occur.

1. *Delivery of securities following a stock transaction*

Most stock transactions involving publicly traded U.S. companies, including all trades at issue here, are centrally cleared through NSCC's Continuous Net Settlement system. The process works as follows:[17] On the settlement day after the trade date (*i.e.*, T+1), NSCC becomes the counterparty to the broker-dealers on each side of each trade.[18] NSCC assumes the buying member's obligation to pay the selling member and the selling member's obligation to deliver securities to the buying member.[19] At the same time, each member assigns to NSCC its

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[17] We draw from the parties' respective expert reports as well as the clearing agencies' rules and procedures, of which we take official notice. *See* 17 C.F.R. § 201.323; *see, e.g.*, *Capece v. The Depository Trust & Clearing Corp.*, No. 05-80498 CIV RYSKAMP, 2005 WL 4050118, at *5 (Oct. 11, 2005) ("[T]he NSCC Rules and Procedures are subject to judicial notice . . .").

[18] *NSCC Rules and Procedures* Rule 11 § 1(c), Addendum K § I(2)(a); *NSCC Rules and Procedures* Procedure VII § A, C(1).

[19] *NSCC Rules and Procedures* Rule 11 § 1(b).

respective rights to receive securities and payment, which "places the [NSCC] between the [buying] Member and the [selling] Member."[20]

The CNS system nets purchases and sales of each security on a daily basis, so that each member is required to deliver to NSCC (or becomes entitled to receive from NSCC) only the difference between the number of shares that it and its customers collectively bought and the number that they collectively sold.[21] Settlement occurs three days after the trade date (*i.e.*, T+3). Every evening, the CNS system computes a net settlement obligation (or entitlement) for each member in each security. This has two parts: (1) the contribution from trades settling that day (*i.e.*, those taking place three settlement days ago) and (2) the member's "closing position" in the CNS system from the previous day.[22] In other words, on day T+3, the total number of shares collectively purchased or sold by the member's customers on day T is added to the member's CNS position carried over from day T+2.

A member that owes NSCC securities has a short, or negative, CNS position; a member that is entitled to receive securities from NSCC has a long, or positive, CNS position; and a member that is neither obligated to deliver nor entitled to receive securities has a flat CNS position.[23] "Short position" in this context means that the member has an obligation to deliver securities to NSCC; that position did not necessarily result from the member or its customers selling the stock short in the market.

The CNS system tracks a firm's delivery obligations to and right to receive shares from NSCC. CNS positions do not reflect beneficial ownership, which instead is reflected in the books and records of the Depository Trust Company ("DTC"), the registered holder of record. Every NSCC member, as well as NSCC itself, has an account at DTC. "Delivery" of securities to NSCC occurs when, after the close of business on settlement date, NSCC instructs DTC to move shares from the accounts of members with a short CNS position to NSCC's own DTC account.[24] NSCC then directs DTC to move shares from NSCC's account to the DTC accounts of members with long CNS positions.

When a member does not have enough shares in its DTC account to satisfy its full delivery obligation to NSCC, a "fail to deliver" occurs. In that event, NSCC instructs DTC to remove securities from the member's account to the extent possible and any deficit is reflected in that member having a short CNS closing position, which is carried forward to the next settlement

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20 *NSCC Rules and Procedures* Rule 11 § 1(a).

21 *NSCC Rules and Procedures* Procedure VII § C.

22 *NSCC Rules and Procedures* Procedure VII §§ A, C(1).

23 *NSCC Rules and Procedures* Rule 11 § 3, Procedure VII § C(1), C(3).

24 *NSCC Rules and Procedures* Rule 11 §§ 3-4; Procedure VII § C.

day.[25] Until the member delivers securities to NSCC in sufficient quantity to make its CNS position flat or long, a fail will remain open.

Put another way, there must be a transfer of shares from the member's DTC account to NSCC's DTC account for a CNS fail to be cured. But because transactions settling the same day are netted together in the CNS system's "evening cycle"—before NSCC communicates delivery instructions to DTC—same-day stock purchases and sales (or, as discussed in the next section, stock purchases and assignments of a call option) for the same amount of a given security net each other out and will not result in the broker delivering shares to NSCC.[26] As a result, offsetting intraday transactions do not change the member's CNS position or close out a fail to deliver.

Because CNS operates on a net basis, the total number of shares that NSCC owes to members necessarily equals the total number of shares that are owed to NSCC by its members. When a member has a fail to deliver, NSCC will not have enough shares available to satisfy all of its members to whom it owes shares.[27] A member that does not receive all of the shares to which it is entitled is said to have a "fail to receive" and will end the day with a long CNS position.

A member that does not receive securities has two options. First, it may do nothing and wait for delivery to be made as securities are delivered to NSCC. The CNS system allocates incoming shares to the members by prioritizing deliveries to firms with the oldest long positions.[28] Therefore, even when the same firm has continuing fails to *deliver*, any specific member's fail to *receive* is likely to resolve itself in a relatively short period of time (as other firms deliver shares to NSCC). Second, if the member with the fail to receive desires shares sooner, it may file a Notice of Intention to Buy-in with NSCC, which gives the member still

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[25] *NSCC Rules and Procedures* Procedure VII §§ C(3), D.

[26] *NSCC Rules and Procedures* Rule 12 §§ 2(a), 4 (defining "effective time" of a delivery), Procedure VII § C. To be precise, each evening, that day's "Settling Trades [*i.e.*, those taking place three days ago]. . . are netted with the Closing Positions which have been carried forward from the previous day." Procedure VII § C(1). "*After* the procedures described in paragraph 1 have been completed," each "[m]ember's positions are passed to" DTC. *Id.* § C(3) (emphasis added). "Securities are transferred from the Member's [DTC] account to satisfy its short positions" to NSCC's DTC account and NSCC "*then* provides instructions to deliver those securities from its account at [DTC] to the [DTC] accounts of those Members which have long positions." *Id.* (emphasis added).

[27] *NSCC Rules and Procedures* Procedure VII § E.

[28] *NSCC Rules and Procedures* Procedure VII § E(4).

higher allocation priority in the CNS system.[29] Most fails to receive will resolve within a few days without the need for further action.

If NSCC nevertheless remains unable to deliver shares to the member, NSCC will issue CNS Retransmittal Notices to members with the oldest unsettled short positions.[30] Colloquially, these NSCC-issued notices are called "buy-in notices," but they are unrelated to the buy-in notices that a broker might issue to its retail customers; to avoid confusion, we will refer to the former only as CNS Retransmittal Notices. Two days after it submits a Notice of Intention to Buy-in, the member with the fail to receive can instruct NSCC to purchase the remainder of the position that it still has not received.[31] The firms that receive the CNS Retransmittal Notices are liable for any financial loss incurred in the purchase. Whether NSCC issues a CNS Retransmittal Notice is irrelevant to Rule 204 compliance.

2. *Delivery of securities following assignment of an option*

Besides the delivery obligations resulting from stock transactions, the CNS system also processes those resulting from options assignments. The options at issue in this proceeding are traded on the Chicago Board Options Exchange ("CBOE") and conform to CBOE's standardized specifications. Each contract in a given series, which represents 100 shares of the underlying security, is fungible with every other contract in that series, because all of them are issued and guaranteed by the Options Clearing Corporation ("OCC").

Retail customers generally hold options indirectly through their brokers, who are members of OCC. There is no direct contractual relationship between the purchaser and the writer of an option (or, for that matter, their respective brokers). Trades are reported by brokers to OCC and then "accepted" by OCC.[32] At that point, OCC becomes the buyer to the broker representing the writer and the seller to the broker representing the purchaser. In its books and records, OCC credits the account of the purchasing member with the number of contracts purchased in that series and debits the account of the writing member with the same number.[33] A member will have a short position in an option series—and thus be subject to assignment—if its customers collectively have written more options in that series than they have purchased.

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[29] *NSCC Rules and Procedures* Rule 11 § 7, Procedure VII § J.

[30] *NSCC Rules and Procedures* Rule 11 § 7(b), Procedure VII § J(1).

[31] *NSCC Rules and Procedures* Procedure X § A(1).

[32] *OCC Rules* Rule 401; *OCC By Laws* Art. I ¶ 22, Art. VI § 5.

[33] *OCC By Laws* Art. VI §§ 5-6.

Because OCC is the central counterparty, all rights run against OCC and all obligations run to OCC.[34] The holder of a call option has the right to exercise the option and thus to receive from OCC the specified number of shares of the underlying security upon payment of the exercise price.[35] A retail customer exercising a call option notifies his or her broker, which in turn notifies OCC. At the end of the day, OCC randomly allocates exercise notices among its members that have a short position in that option series.[36] OCC reduces the long positions of those members that have exercised options and reduces the short positions of those members that have been assigned.[37] All this occurs on a net basis, and the exercising member does not know (or care) who the assigned member is.

A member receiving an assignment of a call option is required to deliver the number of shares of the underlying security represented by the option.[38] For options in the OIP Securities, delivery occurs through the CNS system.[39] The "obligations among [OCC] Clearing Members resulting from the exercise of Options calling for the delivery of stocks are . . . discharged through" NSCC.[40] OCC automatically reports settlement instructions reflecting exercise and assignment to NSCC.[41] By arrangement with NSCC, the "date of the exercise at OCC is recorded as the trade date" in CNS (*i.e.*, T).[42] "Exercised calls . . . appear [in CNS] as purchases" of the security by the member, while "assigned calls appear as sells."[43] These

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[34] *Id.* §§ 5-6, 9 & Interp. 6.01. As far as OCC (or NSCC or the CNS system) is concerned, it is the responsibility of the member representing the option writer to ensure that the member delivers shares to NSCC. How the member goes on to allocate the assignment among its customers who have written an option in that series and whether that customer discharges his or her delivery obligation to the member is immaterial to the member's obligation to deliver shares to NSCC. Although a customer that writes an option is contractually bound to his or her broker to perform in accordance with the terms of the option, brokers are required to perform their own obligations regardless of whether their customers perform.

[35] *OCC Rules* Rule 801; *OCC By Laws* Art. VI § 9(a).

[36] *OCC Rules* Rules 802-803.

[37] *OCC By Laws* Art. VI §§ 12(b), 13(b).

[38] *Id.* § 9(a).

[39] *OCC Rules* Rule 901(a).

[40] Form S-20, Registration Statement, The Options Clearing Corporation at p. 4 (Mar. 18, 2002).

[41] *OCC Rules* Rule 901(b)-(c). Broadly speaking, OCC's delivery obligations are at an end once this step is completed. *OCC Rules* Rule 901(c), (h).

[42] *NSCC Rules and Procedures* Procedure III § D; see also *OCC Rules* Rule 803.

[43] *Id.*

"purchases" and "sells" settle at CNS three days after the exercise date (*i.e.*, T+3)—that is, the same settlement timeframe as a stock transaction taking place on the exercise date.

Thus, from the perspective of the CNS system, exercises of call options look just like stock purchases and assignments look just like stock sales. All such transactions occurring on day T are netted together to determine the number of shares that the member will be obliged to deliver or entitled to receive on day T+3. When a member is assigned on day T, this creates a duty to deliver to NSCC on day T+3 that is indistinguishable from the obligation it would owe NSCC if it had simply sold on T the same number of shares of the security represented by the option. Dr. Erik Sirri, Feldman's expert witness, explained: "Stock trades that result from the assignment of options are . . . cleared through CNS on a T+3 basis . . . [O]ption assignment trades are included in the batch of trades that is netted together to determine the number of shares the Clearing Member will deliver or receive on T+3."

As with all trades settled through CNS, there is no intraday delivery of shares when a stock purchase occurs the same day as an option exercise or assignment. Consequently, as Dr. Sirri explained, if the "written call [leg of a buy-write] is exercised and assigned on the same day the buy-write was executed, the settlement of the option assignment would occur on the same day as that of the stock purchase, the two components would offset each other, and the stock purchase would not change the Clearing Member's net delivery position at CNS."

3. *CNS Accounting Summaries*

The CNS system generates reports that notify participants of their delivery obligations and settlement activity. On the evening of every settlement day, NSCC issues a CNS Accounting Summary to each participant; retail customers do not have access to this information. For each security, that summary presents, *inter alia*, the "Member's opening Long or Short Position [*i.e.*, that carried over in the CNS system from the previous day], the Member's activity in such CNS Securities for that day, the transactions into and out of its Qualified Securities Depository [*i.e.*., DTC] account . . . , [and] the Closing Position for that day." In particular:

- The OPEN POSITION (or OPENING POSITION) column shows the member's closing position carried over from the previous day. If this is negative, the member owes that many shares to NSCC; if this is positive, the member is owed that many shares by NSCC.

- Activity (*i.e.*, changes in the net obligation that the member owes to NSCC or is owed by NSCC) is divided into two categories. The SETT TRADES (or SETTLING TRADES) column shows activity from stock transactions or options assignments settling on that day. The MISC/DIVID (or STOCK DIV/MISC. ACTIV) column captures miscellaneous activity, such as stock splits or stock dividends.

- The ALLOC/RCYC (or RECEIPTS/DELIVERY) column shows transfers into or out of the member's DTC account during that CNS evening cycle. If this is negative, the member received that many shares from NSCC; if this is positive, the member delivered that many shares to NSCC. If the number is zero, then the member neither received nor delivered stock to NSCC.

- The CLOSING POS or (CLOSING POSITION) column shows the member's closing position, which is the net of its opening position, activity settling during the day, and any receipts or delivery.

Based on the CNS Accounting Summary, a participant knows how many shares it owes to NSCC, how many shares it actually delivered to NSCC, and whether it has a fail to deliver position. It also knows the age of a fail, as reflected in the number of consecutive days that the open position column was negative in past accounting summaries.

B. optionsXpress's procedures for sending buy-in notices to Customers

The basic purpose of optionsXpress's buy-in procedures was to distribute its fail to deliver position at CNS among its retail customers whose transactions contributed to the firm's fail and to inform the responsible customers of the need to take action via buy-in notices. A participant's delivery and close-out obligations under Rule 204 are distinct from its customers' obligations to the firm under the firm's internal buy-in procedures: In all events, the firm is the entity responsible for compliance with Rule 204(a)'s requirement that securities be "borrow[ed] or purchas[ed]" at or before market open in sufficient quantity to "close out its fail to deliver position." In the following sections, we describe how optionsXpress determined which of its retail customers were issued buy-in notices (and for what number of shares), as well as how the firm's buy-in procedures changed over time.

1. *Overview of optionsXpress's process*

optionsXpress used a three-step process for identifying the customers who would be issued buy-in notices. In the first step, which took place after the close of trading, optionsXpress allocated the assignments that it received from OCC among its retail customers. It randomly selected customers who wrote options in that series to be responsible for the assignment. If the customer's account did not have enough shares to cover the assignment, then optionsXpress recorded a short position in the customer's account.

In the second step, optionsXpress determined whether it had a fail to deliver position at CNS in the security. Using the CNS Accounting Summaries, optionsXpress's information technology group prepared a report listing all securities "with [a] fail at CNS." This meant, as Scott Tortorella, a manager in optionsXpress's Clearing Department acknowledged, any security "that reaches T+3 or higher." If optionsXpress did not have a CNS fail in a security, then it did not issue any buy-in notices and allowed the customers who were short in that security to remain

so without taking any further action. If optionsXpress did have a fail, optionsXpress's Clearing Department was notified the next day (*i.e.*, T+4).

Unless the security was readily and cheaply available for borrowing, optionsXpress moved on to the third and final step.[44] The OIP Securities all were hard to borrow and had high stock loan fees, so optionsXpress did not borrow them. It distributed its total CNS fail amount among the customers who were short and determined "how much each one of those accounts . . . should be required to buy-in." If the customer covered the short on his or her own initiative (*i.e.*, by purchasing the shares in a transaction that has not yet settled), no further action was required. Otherwise, when customers' short positions remained outstanding, the Clearing Department sent an email to the Trading Desk (also called the Execution Desk) listing the security, the responsible accounts, and the number of shares that the customer would be directed to buy-in.

Most customers of optionsXpress were notified of buy-ins only *after* the Trading Desk had purchased the stock on their behalf. The Customers, on the other hand, were given notice *before* the firm executed a purchase order at market open. This advance notice allowed them to place a buy-write in response to the buy-in notices (instead of having the stock purchased on their behalf by the firm).[45] Throughout the period at issue, a "special rep" at optionsXpress's Trading Desk, trading specialist Jeremy Coronado, assisted the Customers in "build[ing]" buy-writes.

2. *Procedures from September 2008 to August 2009*

In September and October 2008, optionsXpress gave the Customers "throughout the day" on T+4 to respond to its buy-in notices. Only when a Customer failed to take action would August Payne—the Trading Desk employee responsible for monitoring fails and making sure they were covered—place a "market on close" order to purchase the stock. Payne did not recall being told that buy-ins had to be accomplished by market open for the firm to rely on those trades to satisfy its obligation under Rule 204T to act "by no later than the beginning of regular trading hours." The Clearing Department also lacked procedures for timely sending the buy-in list to the Trading Desk. Every morning, Tortorella, a manager in the department, had to manually "sort[] out what . . . shares were in T+4" and which customers should be directed to

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[44] When optionsXpress borrowed stock, it allowed its customers to remain short. The firm was willing to absorb modest borrowing costs and did not pass them along to customers. Its policy in this regard was not unusual. As a vice president at E*TRADE explained, "[w]e don't have the mechanics or the facility to pass along those charges."

[45] An optionsXpress employee denied that the Customers got more favorable treatment, testifying that the firm would have been "more than happy to call" other customers and give them notice of a buy-in if they "wanted to receive" notice. But he conceded that he had no idea how these customers would have known to ask.

buy in. As a result, there were a number of days that the Clearing Department did not even send the buy-in list to the Trading Desk until after market open.

Towards the end of October 2008, some optionsXpress employees began expressing concerns about the timing of this process in light of Rule 204T, which was issued on September 17, 2008. On October 27, Payne sent an email to Tortorella, copied to Ronald Molnar (who was Tortorella's supervisor), inquiring about the proper "timeline" since he had been "letting [customers] close-out by the end of the day." Molnar in turn asked Kevin Strine, optionsXpress's vice president of compliance, by "when we need to cover our CNS fails": "Is it by the opening, or anytime today as long as the position is covered?" Strine replied (correctly) that this needed to be done "at the opening."

Notwithstanding Strine's recognition that Rule 204T required the firm to take action to address fails by market open, optionsXpress did not implement procedures to ensure that the requisite purchases or borrows took place then. Instead, it permitted the Customers to place buy-writes well after market open.[46] One reason for this was that the Clearing Department continued to have difficulties delivering the buy-in list to the Trading Desk. On a number of occasions—*e.g.*, July 31, 2009 and August 10, 2009—Tortorella did not send the Trading Desk the buy-in list until half an hour or more after the open. This did not go unnoticed by Payne, who wrote on August 10 that the Trading Desk was "still getting the buy-in report pretty late in the morning"—on that day, 10:10 am ET. Molnar, too, stressed that the department "need[ed] to get better" and "need[ed] to get the list out to prevent the SEC . . . to come in and fine us because of a tardy buy-in." Moreover, at the hearing, Tortorella and another optionsXpress employee, Jay Risley, admitted that buy-in lists were not being provided in a timely fashion.

Even when the list of buy-ins was being sent to the Trading Desk before market open, Payne and others continued to notify the Customers (to enable them to place buy-writes) instead of immediately purchasing stock on their behalf. For example, on June 29, 2009, Payne informed Feldman that optionsXpress's "current practices" gave him the entire "day of for buy-ins." Two days later, a trader sent a mid-afternoon email stating that the buy-ins were "covered," prompting Tortorella to say: "Surely it's 'opening of business' somewhere."

We find persuasive the analysis of optionsXpress's trading records performed by the Division's expert, Professor Harris, which showed that optionsXpress executed 97% percent (*i.e.*, 1173 out of 1205) of the Customers' buy-writes in the period between September 30, 2008 and August 20, 2009 (when optionsXpress changed its buy-in procedures) after 10:00 am ET on T+4. On average, buy-writes were executed 2 hours and 40 minutes after market open on T+4.

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[46] To be clear, Rule 204T did not by itself require optionsXpress to ensure that the buy-writes were executed by a certain time (or, for that matter, that optionsXpress take any other action with respect to its retail customers). But here, the firm was relying on its execution of the Customers' buy-writes to satisfy its own obligations under Rule 204T.

3. *Procedures after August 2009*

August 2009 brought a shift in how optionsXpress handled buy-ins for the Customers. According to optionsXpress, these changes were prompted by the Commission's promulgation of Rule 204, which made permanent the delivery and close-out requirements of Rule 204T and became effective on July 31, 2009.[47] Around the same time, on August 5, 2009, the Commission instituted and settled actions in *Hazan Capital Management, LLC*, and *TJM Proprietary Trading, LLC*, which involved violations by broker-dealers of the analogous delivery and close-out requirements of Rule 203 of Regulation SHO and are described more below. In response to these developments, optionsXpress made two principal changes. First, it established special procedures for hard-to-borrow securities that always appeared on the Clearing Department's buy-in lists in large amounts, including many of the OIP Securities. Second, it changed how it processed the Customers' buy-writes.

a. *The "perpetual fail" list*

On August 19, 2009, optionsXpress's Compliance Department instituted new procedures effective the next day. The decision to implement these procedures was made by a group that included Thomas Stern, optionsXpress's CFO and primary regulatory liaison.[48] These procedures called for the Clearing Department to send the Trading Desk two buy-in lists.

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[47] On August 6, 2009, Payne informed Feldman that buy-ins would have to be completed "immediately," instead of "by the end of the trading day." Payne stated that the Commission's promulgation of Rule 204 changed the buy-in deadline. He asserted that the Commission "did not approve the buy-ins to be covered by the end of the trading day." In a subsequent email, Payne asserted the Commission "actually voted . . . and still decided it must be done at the open." Payne's implication that Rule 204 changed the deadline was inaccurate: Both Rule 204T and Rule 204 require participants to close out fails "no later than the beginning of regular trading hours" on T+4. But his email to Feldman nonetheless confirms that optionsXpress perceived the need to *change* its buy-in procedures precisely because, prior to August 2009, it understood that it had *not* even been requiring customers to execute buy-ins at market open.

[48] The OIP alleged, and the law judge found, that Stern caused and aided and abetted the other respondents' violations in this case. The law judge imposed a cease-and-desist order, directed that Stern pay a civil penalty of $75,000, and barred him from the securities industry. Although Stern sought Commission review of the initial decision, he later agreed to withdraw his petition for review as a condition of settling another administrative proceeding involving him, optionsXpress, and OX Trading, LLC, an optionsXpress affiliate. The initial decision in this proceeding has become final as to Stern. *optionsXpress, Inc.*, Securities Exchange Act Release No. 71354, 2014 WL 217060 (Jan. 17, 2014); *see also OX Trading, LLC*, Exchange Act Release No. 70739, 2013 WL 5740457 (Oct. 22, 2013) (accepting offer of settlement); *OX Trading, LLC*, Exchange Act Release No. 70740, 2013 WL 5740458 (Oct. 22, 2013) (same). The other settled administrative proceeding involved violations of Section 15(a) and 15(b)(6) of the Exchange Act

(continued…)

The first list, which Tortorella aimed to send Payne shortly before market open, identified securities (and customer accounts that had short positions in those securities) that were "appearing on the [buy-in] list pretty much day after day" because "the fail is continuously open due to customers being assigned in the money short calls." These were considered "perpetual buy-ins" because the Customers were "[a]lways short, cover[] [their] buys by buying [sic] short options deep in the money, so they get assigned" and, as a result, their "settled position never closes or goes long." When the list was instituted, it covered four of the OIP Securities, American International Group, Inc. (AIG); Chipotle Mexican Grill, Inc. (CMG); Sears Holdings Corp. (SHLD); and Shanda Interactive Entertainment Limited (SNDA); others were later added. This first list was called the "chronic" list, the "rolling fail" list, or the "perpetual failure list." Feldman and four other Customers were the accounts that appeared most frequently on it. The second list, which Tortorella aimed to send shortly after market open, addressed all other securities and customer accounts. On several occasions—*e.g.*, August 31, 2009 and September 14, 2009—the second list was sent a half hour or more after the beginning of trading.

As before, Payne provided advance notice to the Customers when they appeared on either list. optionsXpress wanted to give them "time to formulate a strategy before calling the execution desk." For "any other" customer, optionsXpress continued to go "ahead and place market orders to cover" the buy-in at market open—*i.e.*, execute stock purchase orders that were "filled immediately"—and notified them only afterwards.

Special procedures applied to the "perpetual failure" list. Instead of running a lottery to distribute optionsXpress's fail to deliver position proportionately among the customers, optionsXpress would issue a buy-in notice for the entire amount of each customers' short position, including whatever additional shares they owed from option assignments the previous day. For example, if optionsXpress's CNS fail to deliver position was 250 shares, and there were three customers whose accounts were 200, 300, and 400 shares short, respectively, every customer would still be required to buy-in 100% of his or her short position, for a total of 900 shares. As a result, buy-in notices were often issued for a number of shares that in the aggregate exceeded optionsXpress's total CNS fail to deliver position.

b. *Pre-building the buy-writes*

Around the same time, optionsXpress also made cosmetic changes to how it accepted buy-writes from the Customers. In essence, the Trading Desk would enter stock purchase orders in the Customers' accounts before market open, but purposely delay their execution to allow the

(…continued)

and arose from events unrelated to those at issue here. The factual findings in these settled orders are not binding on respondents and we do not consider them.

Customers to place the call component of the buy-write. Only then would the Trading Desk send the stock and options trades for execution as a single order.

On August 20, 2009, Payne asked Strine and Phillip Hoeh, optionsXpress's Chief Compliance Officer, whether the Customers could still respond to the buy-in notices by placing buy-writes "as one order." Strine, who had reviewed the *Hazan* and *TJM* settled actions finding violations of Regulation SHO, replied "absolutely not." He worried that if optionsXpress "process[ed] the buy-write, regulators could consider the buy-ins as sham transactions."[49] Hoeh was also emphatic, explaining his view that optionsXpress "has to begin the buy-in process at the open . . . [and] must execute the buy-in on the open for the specified amount to cover the fail."

Despite this apparent recognition by compliance personnel that relying on the buy-writes to satisfy its obligations under Rule 204 could raise regulatory concerns, optionsXpress continued to permit the Customers to place them in response to its buy-in notices.[50] At a later meeting among Hoeh, Coronado, and Peter Bottini, who was in charge of trading and customer service for optionsXpress, they decided that buy-writes had to be formally *entered* in each customer's account as two separate orders. Thus, the Trading Desk would prepare a stock purchase order, "the customer would put in an order to sell to open calls and then . . . [the firm] would bundle those orders and send them as a buy-write" for execution.[51]

Accordingly, Payne instructed the other traders:

> Compliance is telling us that buy-writes can no longer be used . . . [W]e can place them another way. Execution will put in market orders to cover the shares at the open. All we require the customer to do is call in and place a not held option order . . . . *The outcome will basically be the same*, but two separate orders will be in [the] customers['] account, which the SEC wants to see.

Afterwards, the Trading Desk generally "built" a stock purchase order in the Customers' accounts before or around market open, but marked that order as "do not send to exchange,"

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[49] Strine later elaborated: "I believe that if we do the buy-write for them, auditors will consider them sham transactions as the SEC did with the two fined prop trading institutions," *i.e.*, the respondents in the *Hazan* and *TJM* cases discussed *infra*.

[50] As discussed above, we focus on the buy-writes because optionsXpress was using those trades to address its Rule 204(a) obligations. *See supra* note 46. We do not suggest that optionsXpress was required under all circumstances to prohibit the Customers from placing the buy-writes or making any other trades.

[51] Bottini stated that he believed that optionsXpress's "best execution" obligation required the bundling of the buy and the write, because if they were executed separately, the price of the underlying security might change in the meantime.

meaning that the order would not immediately be executed. Instead, the Trading Desk would wait until after the customers phoned in a "not held" order for the call component of the buy-write (which could happen after market open).[52] A "not held" order gave optionsXpress discretion on the price of execution and allowed the Trading Desk to match up the price of the stock with the option contract. Otherwise, the customer risked "paying a lot more" to transact the buy-write if the prices diverged.

After waiting to pair the orders, the Trading Desk would transmit the buy-write as a single package to PrecISE, an electronic trading platform, or to On Point Executions LLC, a floor (or "two-dollar") broker. In both cases, the buy-write was placed and executed as a single order; indeed, neither PrecISE nor On Point, operating on options exchanges and accepting stock orders only as part of a complex order, would have accepted a standalone stock purchase. Because optionsXpress placed the buy-writes on a "very price sensitive" basis—*i.e.*, as limit orders rather than as market orders—it took additional time to arrange for execution of the buy-writes.[53] optionsXpress never informed On Point that the buy-writes had to be executed at market open and, with a single exception, never expressed any concern about the timing of execution. To the contrary, Coronado told On Point to "take [its] time" and that he "underst[ood]" there would be delays.

As Professor Harris's analysis of optionsXpress's trading records demonstrated, the firm still was not executing buy-writes at or near market open. True, after August 20, 2009, optionsXpress did *input* buy-writes much earlier because it pre-built them in the Customers' accounts. But because optionsXpress did not *send* the buy-writes immediately to the exchange for execution, and instead waited for the Customers to phone in the option order, 51% (*i.e.*, 1105 out of 2186) of the buy-writes were not actually *executed* until after 10:00 am ET. On average, the buy-writes were executed 58 minutes after market open.

IV. optionsXpress analysis

We conclude that optionsXpress violated Rule 204(a)'s close-out requirement (and the identical provision of Rule 204T) by relying upon the buy-writes to address to its CNS fail to deliver positions when those transactions did not result in the firm making delivery to NSCC and thus did not close out its fails. We also find that optionsXpress violated Rules 204 and 204T for

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[52] The Trading Desk did not always follow this procedure. Sometimes, Coronado would allow Feldman to place a "standing order" for the buy-write on the expectation that he would want to execute the same or similar trades on subsequent days. On at least one occasion, Coronado even placed a buy-write without hearing from Feldman at all. On January 19, 2010, Coronado told Feldman that he "put [the buy-write] up" already even though he "didn't hear from [Feldman] on it" because he had to "get these things in the morning."

[53] Because of the frequency of the buy-writes, other, unidentified market participants began to anticipate the trades and often had "resting orders" in place to take the other side.

the independent reason that the transactions it relied upon to address its fails, irrespective of whether or not they actually effected a close out, frequently were not executed at or before market open on T+4.

A. The purposes and objectives of Rule 204's close-out requirement

The Commission promulgated Rule 204 to address persistent fails to deliver by participant brokers or dealers and to curb certain abusive and manipulative "naked" short selling practices (such as selling stock short while intentionally failing to deliver or selling stock short and failing to deliver with the purpose of driving down the security's price).[54] On a number of prior occasions, we have recognized that sellers of securities should promptly deliver (or arrange for delivery of) securities and that buyers of securities have a right to expect prompt delivery of securities.[55] Fails to deliver have potential negative effects on investors and the marketplace. As Rule 204's adopting release explained, "[l]arge and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending."[56] "[I]ssuers and investors have repeatedly expressed concerns about fails to deliver in connection with manipulative 'naked' short selling," which "could be used as a tool to drive down a company's stock price," "undermine the confidence of investors," and cause "unwarranted reputational damage due to investors' negative perceptions regarding fails to deliver."[57]

optionsXpress contends that the concerns that prompted us to promulgate Rule 204 and its predecessors are largely speculative. It asserts that the Division did not present testimony from a "single 'victim'" of the fails to deliver or introduce a "single letter of complaint from a counterparty" or another entity that failed to receive shares on any particular occasion.[58] optionsXpress misses the point: Persistent fails to deliver undermine market integrity in concrete, tangible ways, even when the centralized system for clearing and settling securities

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[54] Final Rule, *Amendments to Regulation SHO*, 74 Fed. Reg. 38,266, 38,273 (July 31, 2009) ("Rule 204 Adopting Release"); Interim Final Temporary Rule, *Amendments to Regulation SHO*, 73 Fed. Reg. 61,706, 61,708 (Oct. 17, 2008) ("Rule 204T Adopting Release"). A "naked" short sale, in which the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard settlement period, is not itself improper.

[55] Rule 204 Adopting Release, 74 Fed. Reg. at 38,267 & n.18 (collecting citations).

[56] *Id.*

[57] *Id.* at 38,267-38,268.

[58] Of course, the Division is not required to prove actual harm to investors to establish liability. *See, e.g.*, *SEC v. Morgan Keegan & Co.*, 678 F.3d 1233, 1244 (11th Cir. 2012); *SEC v. Wolfson*, 539 F.3d 1249, 1256 (10th Cir. 2008); *Graham v. SEC*, 222 F.3d 994, 1001 n.15 (D.C. Cir. 2000); *SEC v. Blavin*, 760 F.2d 706, 711 (6th Cir.1985).

transactions may make it difficult to identify specific victims.[59] This was the premise of our decision to adopt Rule 204's requirements, and optionsXpress may not second-guess the Commission's policy judgments in the context of this enforcement proceeding.

Therefore, although the record contains relatively little evidence of harm to specific investors,[60] we reiterate that fails to deliver—particularly large and persistent ones—can and do have a "negative effect on the securities markets and investors."[61] As the adopting release explained, the "close-out requirements of Rule 204 help address these concerns by prohibiting the persistence of fails to deliver."[62] That "strict close-out requirement[]"[63] is integral to "advancing our goal of further reducing fails to deliver."[64] Rule 204(a) thus "protect[s] and enhance[s] the operation, integrity, and stability of the markets."[65]

B. optionsXpress violated Rules 204 and 204T because it did not close out its fail to deliver positions

Rule 204, which is entitled "[c]lose-out requirement," provides that a participant of a clearing agency, such as optionsXpress, must "deliver securities" to the clearing agency by the settlement date after a transaction, which under present practice takes place on T+3.[66] It is not by itself unlawful for a broker-dealer to have a fail to deliver. But when a firm does have such a fail to deliver position, Rule 204(a) requires it to, "by no later than the beginning of regular trading hours on the settlement day following the settlement date [*i.e.*, T+4], *immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity*."[67] The Division argues (and we agree) that optionsXpress violated this close-out requirement.

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[59] *See infra* Section V.C for additional discussion of how fails to deliver pose a substantial risk of systemic harm to market participants and market integrity.

[60] *See infra* note 142.

[61] Rule 204 Adopting Release, 74 Fed. Reg. at 38,289.

[62] *Id.* at 38,271.

[63] *Id.*

[64] *Id.* at 38,270.

[65] *Id.* at 38,269.

[66] 17 C.F.R. § 242.204(a). In all respects material here, Rule 204(a) is the same as temporary Rule 204T(a).

[67] *Id.* (emphasis added).

1. Rule 204(a) unambiguously required optionsXpress to "close out" fails to deliver, which the firm did not accomplish when it relied on its execution of the Customers' buy-writes to address its fails

optionsXpress had fail to deliver positions at CNS on T+3 (and later). The firm received CNS Accounting Summaries indicating that it had a negative "closing position"—*i.e.*, reflecting a T+3 or even older fail to deliver—in the 25 OIP Securities. These summaries showed that the firm's fails continued day after day, often for weeks and months; they dwarfed any other participant's failures to deliver. For instance, with respect to Sears Holding Corp. (SHLD), optionsXpress had a fail at CNS for 240 settlement days during the period at issue here. Finally, testimony and other documentary evidence demonstrated that optionsXpress employees were well aware throughout that the firm had T+3 fails that it was required to close out. As detailed above, they described the fails as "perpetual," "chronic," or "rolling," and characterized the firm as being caught in a "vicious cycle" of "open CNS fail[s]."

These T+3 failures to deliver triggered Rule 204(a)'s close-out requirement. When a participant has a fail to deliver position, Rule 204(a) requires it to take affirmative action "no later than the beginning of regular trading hours" on T+4 to "immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity."[68] It may not "offset the amount of its fail to deliver position with shares that the participant receives or will receive during the applicable close-out date."[69]

optionsXpress chose to rely upon its execution of the Customers' buy-writes to address its fails to deliver. But those transactions did not close out optionsXpress's fail to deliver position as required by Rule 204(a) and as demonstrated by its "perpetual" CNS fail positions. The CNS system nets together all trades settling the same day and there is no intraday delivery. When a stock purchase and a call assignment occurs on the same day, NSCC and OCC procedures specify that those transactions will be netted together *before* NSCC provides settlement and delivery instructions to DTC; there is no intraday delivery. Although not every buy-write call was immediately assigned, most were because the options were deep in the money and represented a large proportion of the open interest in that option series. We credit Professor Harris's analysis (*see supra* Section II.B) in finding that the buy-write calls were frequently being exercised as they were being written. That being the case, the "buy" component of the

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68 17 C.F.R. § 242.204(a).

69 Rule 204 Adopting Release, 74 Fed. Reg. at 38,272 n.81.

Customers' buy-writes was offset by the same-day exercise and assignment of their "write" component.[70]

The CNS Accounting Summaries confirm that, on account of the same-day assignments of buy-write calls, shares of the OIP Securities were not being transferred from optionsXpress's DTC account to NSCC's DTC account—that is, *delivered*[71]—in sufficient quantities to close out optionsXpress's failures to deliver. optionsXpress's decision to rely on the buy-write transactions perpetuated and maintained its original fail position. Often no delivery occurred at all, and even when the firm made delivery of *some* shares, it did not deliver enough: The ALLOC/RECYC column of the summaries in subsequent days was less than the quantity of optionsXpress's fail to deliver position, and often zero. As a result, optionsXpress's fail to deliver positions remained open for days, weeks, and often months on end, instead of being closed out by its transactions on T+4.[72] We conclude, therefore, that optionsXpress failed to satisfy Rule 204(a)'s close-out requirement.

We highlight two examples when optionsXpress attempted to address a fail to deliver position by executing buy-writes that did not result in the firm delivering shares to NSCC in sufficient quantities to close out the fail.[73]

The transactions in China Sky One Medical, Inc. (CSKI) in January 2010 and February 2010 are illustrative. Feldman initiated a three-way trade on Wednesday, January 6 by entering into a synthetic long representing 20,400 shares and writing 204 deep-in-the-money call contracts. That same day (*i.e.*, T), optionsXpress was assigned on 147 contracts, which it allocated to Feldman. optionsXpress's closing position on Monday, January 11 (*i.e.*, T+3) was a fail to deliver in the amount of 15,176 shares. At that point Rule 204(a) required optionsXpress to "immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity" by market open on T+4. optionsXpress responded instead by relying on its execution of a buy-write placed by Feldman, purchasing 14,700 shares and writing 147 call options. Feldman placed buy-writes on the subsequent days as well (corresponding to 13,700 shares and 137 contracts on January 13 through January 15 and 20,400 shares and 204 contracts

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[70] To the extent that the calls were not *fully* assigned, that meant that the stock purchases were not wholly cancelled out. When this happened, delivery of *some* shares may have occurred, but not *enough* shares to close out optionsXpress's fails.

[71] *See, e.g.*, *CFTC v. Hunter Wise Commodities, LLC*, 749 F.3d 967, 978 (11th Cir. 2014) (finding that the "ordinary meaning" of the word "delivery" is "a transfer of possession").

[72] Transactions taking place on T+4 do not settle until three settlement days later; therefore, we look to the firm's CNS activity and positions on T+7.

[73] *See also supra* Section II.D (discussing optionsXpress's reliance on Feldman's buy-writes to address its large and continuing fail to deliver position in Talbots Inc. (TLB)).

on January 19 through mid-February). In other words, virtually all of the call portion of Feldman's buy-writes in CSKI were exercised and assigned on an ongoing basis:

Jonathan I Feldman and Judith S Feldman [JTWROS] (Continued)
Underlying Security: CSKI

Trade Date	Weekday	Trade Day Sequence #	Trade Type	Put/Call/Stock	Side	Trade Size (100's)	Trade Value
06JAN10	Wednesday	320	Synthetic Long	Put & Call	B	204	$26,807
			Syn Long Hedge	Call	S	204	$271,312
			Assigned Call	Stock & Call	B	147	$338,982
11JAN10	Monday	323	Option Trade	Call	B	102	$0
			Assignment	Stock	S	102	$102,000
12JAN10	Tuesday	324	Buy-Write	Stock & Call	S	147	$316,491
			Assigned Call	Stock & Call	B	35	$75,355
13JAN10	Wednesday	325	Buy-Write	Stock & Call	S	137	$286,193
			Assigned Call	Stock & Call	B	137	$286,193
14JAN10	Thursday	326	Buy-Write	Stock & Call	S	137	$280,987
			Assigned Call	Stock & Call	B	137	$280,987
15JAN10	Friday	327	Buy-Write	Stock & Call	S	137	$276,740
			Assigned Call	Stock & Call	B	204	$412,080

19JAN10	Tuesday	328	Buy-Write	Stock & Call	S	204	$443,904
			Assigned Call	Stock & Call	B	204	$443,904
20JAN10	Wednesday	329	Buy-Write	Stock & Call	S	204	$424,524
			Assigned Call	Stock & Call	B	204	$424,524
21JAN10	Thursday	330	Buy-Write	Stock & Call	S	204	$399,636
			Assigned Call	Stock & Call	B	204	$399,636
22JAN10	Friday	331	Buy-Write	Stock & Call	S	204	$382,908
			Assigned Call	Stock & Call	B	204	$382,908
25JAN10	Monday	332	Buy-Write	Stock & Call	S	204	$390,252
			Assigned Call	Stock & Call	B	204	$390,252
26JAN10	Tuesday	333	Buy-Write	Stock & Call	S	204	$374,136
			Assigned Call	Stock & Call	B	204	$374,136
27JAN10	Wednesday	334	Buy-Write	Stock & Call	S	204	$384,744
			Assigned Call	Stock & Call	B	204	$384,744
28JAN10	Thursday	335	Buy-Write	Stock & Call	S	204	$373,320
			Busted Sell	Call	S	408	$320,076
			Assigned Call	Stock & Call	B	204	$373,320

The assignments of these calls offset the stock purchases in CNS. Consequently, in executing the buy-writes, optionsXpress did not deliver shares to NSCC and did not successfully close out its fails. The ALLOC/RCYC column of the CNS Accounting Summaries for CSKI, which shows optionsXpress's deliveries to NSCC, was 0 on January 11 through January 29 and hovered at most in the low hundreds thereafter. And the CLOSING POS column likewise stayed stubbornly negative, ranging from about negative thirteen thousand to negative twenty thousand, showing that optionsXpress continued to have a fail. Indeed, optionsXpress's fail to deliver position *increased* on January 21 to 20,641 shares and remained in that range until February 17, when Feldman's buy-writes in CSKI ceased. Only then was optionsXpress's original, January 11 fail eventually closed out.

The transactions in Under Armour, Inc. (UA) provide another example of how by relying on the Customers' buy-writes, optionsXpress did not close out its fail to deliver positions. On Tuesday, August 4, 2009, optionsXpress had a CNS fail of 7,255 shares for UA. It issued a buy-in notice to Feldman, who placed a buy-write for 7,200 shares and 72 calls. The options were exercised and assigned later that day. The CNS Accounting Summary for Friday, August 7, 2009—that is, the settlement day for the buy-write, as well as the options assignment—shows that optionsXpress did not deliver any shares to NSCC (the ALLOC/RCYC column was 0) and that optionsXpress continued to have a fail. Nor did optionsXpress deliver shares to NSCC on any intermediate day. It had fail to deliver positions for UA of 972 shares on August 5 and 5,572

shares on August 6, which corresponded almost exactly to Feldman's buy-writes on those days: He executed a buy-write for 1,000 shares and 10 calls on August 5 and for 5,600 shares and 56 calls on August 6.

To summarize, the CNS records unequivocally show that the buy-writes resulted in no (or an insufficient number of) shares being delivered to NSCC. Under these circumstances, optionsXpress could not rely on the buy-writes to close out its fail to deliver positions, as required by Rule 204(a).

2. The Commission's releases and other guidance issued by regulators confirm that participants cannot rely upon buy-writes that do not close out fails to satisfy Rule 204(a).

For the above reasons, we have concluded that optionsXpress's reliance on the buy-writes to satisfy its obligations under Rule 204(a) is violative of the plain text of that rule. That conclusion is consistent with published guidance that the Commission and other regulators have provided on previous occasions about the close-out requirements and its applicability to paired stock-and-option transactions.

a. *Guidance on fails and close outs before the adoption of Rule 204T*

The concept of closing out a fail to deliver existed in other Commission rules before our promulgation of Rule 204T in September 2008. Rule 203(b)(3) of Regulation SHO provided that a participant who has a fail to deliver position in a so-called "threshold" security for 13 consecutive settlement days is required to immediately "close out the fail to deliver position by purchasing securities of like kind and quantity."[74] In two cases from July 2007 (the *Arenstein* cases), the American Stock Exchange ("AMEX") fined several broker-dealers (and their managing members) because, among other things, the brokers had failed to close out fails in violation of Rule 203.[75] The broker-dealers in the *Arenstein* cases executed transactions that "*appeared* to close out their fail to deliver position by purchasing securities of like kind and quantity," but that in reality had only "reset[] the buy-in date." These transactions included buy-writes that paired a purchase of stock with the sale of one-day and two-day, deep-in-the money

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[74] 17 C.F.R. § 242.203(b)(3). A threshold security is one that has an aggregate (*i.e.*, summed across all brokers) fail-to-deliver position at a clearing agency exceeding a certain, specified limit. *Id.* § 242.203(c)(6).

[75] *In re: Scott H. Arenstein & SBA Trading, LLC*, Case No. 07-71 (July 20, 2007); *In re: Brian A. Arenstein & ALA Trading, LLC*, Case No. 07-174 (July 20, 2007).

FLEX call options.[76] By repeatedly engaging in transactions like these, the broker-dealers were able to maintain fails in threshold securities for extended periods.

Following the release of the *Arenstein* decisions, AMEX issued Circular Reg. 2007-35 in August 2007 to provide additional guidance regarding Regulation SHO's close-out requirement. The circular cautioned participants that a "purchase of stock paired with one or more short term option transactions such as, for example, a one-day in-the-money FLEX option, or a married put or buy write transaction," that "does not result in actual delivery of the shares in question may not satisfy the Regulation SHO close-out requirement and will invite regulatory scrutiny." It went on to explain that the use of a "one-day, deep-in-the-money FLEX option to nominally close out a fail to deliver position and then . . . reestablish or 'reset' the fail to deliver position is not the only means by which an aged fail can be reset. Other transactions that can result in an improper "'reset' of an aged fail include, but are not limited to . . . buy[-]writes, . . . or other delta[-]neutral short term strategies matching options with stock."

Around the same time, CBOE issued Regulatory Circular RG07-87 "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." The circular observed that "[e]ntering into a stock/option combination transaction that includes a very short-term option in connection with a mandatory Regulation SHO close-out obligation, as opposed to just buying the stock in the open market, brings such transactions under greater scrutiny." It also recognized that "transactions matching options with stock *may* be used as part of a legitimate hedging strategy," but not when they are "abusive" or "are used in a scheme to evade" regulatory requirements. CBOE reiterated this caution a year later, in May 2008, reminding participants that, "[w]hen 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."

optionsXpress management and compliance staff reviewed and discussed the *Arenstein* decisions and the CBOE circulars. For example, in a November 13, 2008 email, Bottini (who was in charge of trading and customer service) forwarded Risley (a supervisor in the Clearing Department) a *Wall Street Journal* article describing, in Bottini's words, how short sellers in Sears were using "options to circumvent the SEC cover rule"; the article mentioned AMEX's *Arenstein* settlements. Risley responded with the comment, "[t]hey're [*i.e.*, the Customers] definitely doing this." optionsXpress never sought guidance from any of the AMEX or CBOE

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[76] FLEX options are exchange-traded options with certain customizable parameters. They are cleared by OCC and subject to assignment in the same way as the standardized options used in the Customers' buy-writes.

employees listed in the circulars. It not only allowed the Customers' buy-writes to go on, but continued to rely on those trades to address the firm's CNS fails.[77]

b. *Settled enforcement actions in* Hazan *and* TJM

The AMEX and CBOE orders cautioned that buy-writes (and other transactions matching options with stock) were among the kinds of transactions that could be used to evade regulatory requirements by improperly resetting aged fails. We endorsed this view as consistent with our own interpretation of our regulations when we brought settled enforcement actions finding violations of Rule 203's analogous close-out requirement in August 2009.[78] In the *Hazan* and *TJM* cases, we found that the firms (which, like the respondents in the *Arenstein* cases, were trading for their own accounts) had engaged in a series of "reset" transactions to "create[] the illusion" that the firm "satisfied the close out obligation of Reg[.] SHO."[79] The firms used a reverse conversion strategy that coupled establishing a synthetic long position while selling short the underlying stock. When a fail resulted, the firms would respond by:

> buy[ing] shares of that security while simultaneously selling short-term, deep[-]in-the-money call options to . . . the counterparty to the share purchase. . . . [T]he shares that are apparently purchased in the reset transactions are never actually delivered to the purchaser because on the day after executing the reset, the option is . . . exercised . . . transferring the shares back to the party that apparently sold them the previous day.[80]

The *Hazan* settlement noted that some of the reset transactions took the form of buy-writes and that although the option component of the "reset transactions were usually established using 'FLEX' options," they could also be "created using standard options."[81]

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[77] *See supra* notes 46 and 50.

[78] *Hazan Capital Mgmt., LLC*, Exchange Act Release No. 60441, 2009 WL 2392842 (Aug. 5, 2009); *TJM Proprietary Trading, LLC*, Exchange Act Release No. 60440, 2009 WL 2392840 (Aug. 5, 2009).

[79] *Hazan Capital Mgmt., LLC*, 2009 WL 2392842, at *2; *see also TJM Proprietary Trading, LLC*, 2009 WL 2392840, at *3-4. For present purposes, the only material difference between Rule 203's and Rule 204's close-out requirement is that, under Rule 204, "clearing firms must close out fails-to-deliver on all securities (not just threshold securities) and must do so earlier than under Rule 203(b)(3)." *Hazan Capital Mgmt., LLC*, 2009 WL 2392842, at *6 n.11.

[80] *Hazan Capital Mgmt., LLC*, 2009 WL 2392842, at *2 (footnote omitted).

[81] *Id.* at *4 & n.9 (noting that certain of the respondents' reset transactions used "standard options to create the married puts and buy-writes" instead of FLEX options). Another settled

(continued…)

Strine, optionsXpress's Vice President of Compliance, read the *Hazan* and *TJM* decisions when they were issued. He discussed them with other compliance and business personnel at optionsXpress. On August 6, Strine wrote to Hillary Victor (an in-house lawyer) and others at optionsXpress noting that the similarities between the Customers' trading and the trades in *Hazan* and *TJM*:

> The troublesome part is that the SEC characterized, and found as a violation, the fail to deliver close-out process used by both firms as "sham reset transactions." In both cases, the firms would either use married-put or buy-write transactions to close-out their Regulation SHO fails-to-deliver. Our customers have been engaging in buy-write transactions, or simply selling deep-in-the-money calls after we process buy-ins in their accounts. *The end result in all situations is similar*: the shares are bought-in, but the subsequent exercise or assignment of the option that night results in a continuation of the fail.

(Emphasis added.) Strine's email concluded that, "[a]lthough troublesome," he believed that "the two cases can be distinguished from [optionsXpress's] customers' activity." Later, on August 20, when asked by traders if optionsXpress should continue to allow the customers to respond to its buy-in notices by placing buy-writes, Strine recalled the "sham transaction" concept from the *Hazan* and *TJM* cases and, in an email to the firm's Chief Compliance Officer, stated his "belie[f] that if [optionsXpress] d[id] the buy-write," the firm might be seen as having engaged in the same kind of violative transactions as those "two fined prop trading institutions."

On September 22, Strine and Stella, one of optionsXpress's traders, discussed the *Hazan* case. Strine told Stella that the trades in that case had similarities to what the Customers were doing. The following morning, on September 23, Stella emailed excerpts of the case—the material block-quoted above—to two others in the trading department, Coronado and Bottini, because he also saw similarities. A minute later, Coronado informed Bottini that he was "not placing any orders today" because he, too, was concerned after reading the *Hazan* case that the trading strategies were similar. Bottini nevertheless directed Coronado and Stella to "execute the buys and customer orders today." His email stated that the Compliance Department had reviewed *Hazan*, but was "not convinced" the case was applicable and had asked "our regulator

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case, *Rhino Trading, LLC*, Exchange Act Release No. 60941, 2009 WL 3652431 (Nov. 4, 2009), found similar reset transactions to be violative of Regulation SHO's close-out requirement. As in *Hazan*, the respondents principally used short-term FLEX options, although "occasionally" they used "standard in-the-money call" options as well. *Id.* at *3, 5. There is no evidence that optionsXpress personnel were aware of the *Rhino Trading* case.

for an opinion but had not received it." Later that day, Bottini and Hoeh confirmed to Stella and Coronado that they should continue processing the Customers' buy-writes.

c. *Guidance accompanying the adoption of Rules 204T and 204*

Our adopting releases for Rule 204T and Rule 204 made clear that participants cannot employ combined purchase-and-sale transactions to circumvent the requirements contained therein. The adopting release for Rule 204T explained 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."[82] Along similar lines, we stated in footnote 82 of Rule 204's adopting release that even when "a participant subject to the close-out requirement purchases or borrows securities" on a close-out day, if it *also* on that same date engages in transactions that can be used "to re-establish or otherwise extend the participant's fail," and for which the "participant is unable to demonstrate a legitimate economic purpose," it "will *not* be deemed to have satisfied the close-out requirement."[83]

* * *

The clarity of this guidance is evidenced by the fact that optionsXpress employees who reviewed these materials contemporaneously recognized that "they're [that is, the Customers] definitely doing this." They understood that the "end result" of the Customers' buy-writes was "similar" to the transactions found violative in prior cases and recognized these similarities as "troublesome." Its chief compliance officer recognized footnote 82 of the Rule 204 adopting release—addressing same-day transactions that re-establish or otherwise extend a fail—as a "very pertinent section" in response to an inquiry regarding the Customers' use of buy-writes. optionsXpress's efforts to distinguish these settled cases by identifying marginal factual

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[82] Rule 204T Adopting Release, 73 Fed. Reg. at 61,714 n.78.

[83] Rule 204 Adopting Release, 74 Fed. Reg. at 38,272 n.82 (emphasis added). We have found a violation of Rule 204(a)'s plain language, pursuant to which a firm must "*close out* its fail to deliver position." 17 C.F.R. § 242.204(a) (emphasis added). Therefore, we see no need to consider in this proceeding under what circumstances the absence of a "legitimate economic purpose" would present an independent basis for finding a violation of Rule 204. Although we do not need to determine whether the buy-writes that optionsXpress relied on to address its fail to deliver positions lacked a legitimate economic purpose, we do not believe that the firm has on this record sustained its burden of demonstrating that those transactions had such a purpose. We recognize that the Customers desired to place buy-writes because alternative courses of action would not have allowed them to profitably exploit the put/call disparity in the initial synthetic long. But an economic purpose—*e.g.*, making money by avoiding costs—is not a *legitimate* economic purpose when, as here, the profits can be exploited only because a regulatory requirement has been circumvented.

differences—*e.g.*, between FLEX options and standardized options—are unpersuasive. Our *Hazan* order, for instance, specifically observed that some of the violative transactions took the form of buy-writes and that the option component of these buy-writes could be "created using standard [call] options," as well as the short-term FLEX options that were principally employed by the respondents in that case.[84] Likewise, the fact that many of the previous settled cases involved broker-dealers trading for their own accounts, and not firms executing trades for retail customers, is immaterial for the point at issue here: That a firm's reliance on buy-writes to address its fails to deliver, however those trades come to be placed, raises serious concerns as to compliance with Rule 204(a)'s close-out requirement.

In short, Rule 204(a) is, as we stated earlier, clear on its face in imposing a close-out requirement in the event a firm has a fail to deliver position on T+3: Specifically, the firm must "borrow[] or purchas[e] securities of like kind and quantity" by market open on T+4 *and* its transactions on that date must "close out its fail to deliver position" at CNS. Yet even if that were not so, the regulatory guidance available to optionsXpress throughout the OIP Period consistently stated that relying on paired stock and option transactions to satisfy Rule 204(a)'s close-out requirement would be impermissible when, as here, the effect of those transaction is to maintain an open fail to deliver position.[85]

3. optionsXpress's arguments are unpersuasive

The various arguments that optionsXpress raises about the scope, interpretation, and application of Rule 204 are without merit. We also reject optionsXpress's arguments about the relevance of CNS data and its due process claim.

a. *The interpretation of Rule 204*

optionsXpress asserts that the Division has not established that Rule 204 "applies in the options context" and that the rule governs only the handling of fails arising from long or short sales.[86] It long has been clear that the assignment of a call option is, like an explicit short sale, subject to Regulation SHO and triggers an obligation to "deliver the security by settlement

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[84] *Hazan Capital Mgmt., LLC*, 2009 WL 2392842, at *4 & n.9.

[85] *Cf. Ass'n of Private Sector Colleges & Universities v. Duncan*, 681 F.3d 427, 442 (D.C. Cir. 2012) (explaining that an "agency's permissible interpretation of its own regulation normally 'must be given controlling weight unless it is plainly erroneous or inconsistent with the regulation'") (quoting *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994)). A contrary interpretation of Rule 204(a) would not accord with "advancing our goal of further reducing fails to deliver" and "prohibiting the persistence of fails to deliver." Rule 204 Adopting Release, 74 Fed. Reg. at 38,270-71.

[86] The Customers' reverse conversions—which coupled a synthetic long with a hedge created by selling stock short—involved an explicit, initial short sale of a stock.

date."[87] It would be anomalous to exclude such transactions from Rule 204 given that, under NSCC's and OCC's procedures, the CNS system treats call assignments indistinguishably from stock sales. Indeed, industry participants immediately recognized Rule 204's potential applicability to options transactions.[88] optionsXpress *itself* implemented procedures in response to Rule 204 and those procedures did not distinguish between fails arising from stock or option transactions

Next, optionsXpress argues that Rule 204's close-out requirement is applicable only when the participant has a fail to deliver on T+3, whereas its August 2009 adoption of a policy to require customers to place buy-writes on "T+1" for securities on the "perpetual fail" list eliminated aged fails. Put another way, optionsXpress contends that the Division has failed to prove that the closing positions listed on the CNS Accounting Summaries actually reflected T+3 fails in the "perpetual fail" securities.[89] According to optionsXpress, they instead were fails that had *already* been closed out by buy-writes that the firm executed on T+1 that had not yet settled.

optionsXpress's argument assumes that the buy-writes operated to close out its open fail to deliver positions. This assumption is flatly contradicted by the record—a fact evident in the "perpetual fail" procedures themselves, which applied only when the "fail is *continuously open* due" to the "assign[ment] [of] in the money short calls." (Emphasis added.) Just as before the policy was put into place, the buy-writes still involved a stock purchase order paired with the writing of a deep-in-the-money call option that was very likely to be assigned the same day. Because same-day stock purchases and options assignments are netted together, the firm did not

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[87] Division of Trading and Markets, *Guidance Regarding the Commission's Emergency Order Concerning Short Selling*, 2008 WL 2787961, at *2 (July 18, 2008) (explaining that a person who "sells short pursuant to the assignment of a call option . . . must deliver the security by settlement date"); *see also* Interim Final Temporary Rule, *Disclosure of Short Sales and Short Positions by Institutional Investment Managers*, 73 Fed. Reg. 61,678, 61,681 (Oct. 17, 2008) (explaining that, if a short sale is effected "as a result of assignment to it as a call writer," then "upon exercise, the resulting transaction is a short sale"); *see also Amendments to Emergency Order and Rule*, 73 Fed. Reg. 55,556, 55,556 (Sept. 25, 2008).

[88] *See* Rule 204 Adopting Release, 74 Fed. Reg. at 38,270 & nn.48, 53 (citing comments received from CBOE, OCC, Boston Options Exchange, and NASDAQ Options Market).

[89] Some of the OIP Securities were never on any perpetual fail list, and were always were governed by optionsXpress's pre-August 2009 policy. optionsXpress's witnesses acknowledged that buy-ins notices for such securities in the list continued to be issued "based on the T+4" position.

deliver shares to NSCC. Thus, in executing the buy-writes, the firm at no time—*i.e.*, whether three days later or on any other day—actually closed out the fail.[90]

Moreover, under the August 2009 policy, each of the Customers was issued a buy-in notice in the amount of the Customer's *entire* short position regardless of the size of the firm's fail to deliver at CNS. Therefore, the buy-writes would have quickly reduced optionsXpress's fails—because the firm's customers were nominally "purchasing" in the aggregate more shares than the amount of optionsXpress's fail to deliver—*if* they truly resulted in delivery to NSCC. In fact, optionsXpress's fails persisted well past August 2009 precisely because the calls were continually assigned and delivery did not occur. Instead, the fails remained open and their age crept steadily upwards. As a result, subsequent buy-writes occurred well after T+1 and also did not result in delivery to NSCC. In short, the buy-writes did not restart the fail to deliver clock and create new fails; the original fail remained open, and subsequent buy-writes were actually being executed on, for example, T+10 or T+55 or even later.

optionsXpress also argues that Rule 204 requires only that the participant place an order to "borrow or purchase securities," regardless of whether that trade ultimately results in shares being delivered to NSCC or the CNS fail being closed out. It urges that, because Rule 204 imposes strict liability, it must be applied in a "mechanical" and "literal" fashion.[91] Yet it is optionsXpress's reading of that rule that runs counter to ordinary principles of statutory interpretation. Rule 204(a) provides that the participant must "*immediately close out its fail to deliver position* by borrowing or purchasing securities."[92] optionsXpress's interpretation would

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[90] This argument fails for the additional reason that Rule 204(e) contains a specific provision relating to "pre-fail" close-outs—*i.e.*, close-outs that the firm places on T+1, T+2, or T+3—that optionsXpress does not invoke in either its petition for review or its briefs to the Commission.

[91] *See Gollust v. Mendell*, 501 U.S. 115, 122 (1991). Contrary to optionsXpress's suggestion, courts employ the usual tools of statutory interpretation when construing a strict liability provision. *E.g.*, *PCS Nitrogen Inc. v. Ashley II of Charleston LLC*, 714 F.3d 161, 185 (4th Cir. 2013) (Comprehensive Environmental Response, Compensation, and Liability Act); *Miller v. Javitch, Block & Rathbone*, 561 F.3d 588, 592 (6th Cir. 2009) (Fair Debt Collection Practices Act); *Wallace v. Korean Air*, 214 F.3d 293, 299 (2d Cir. 2000) (Warsaw Convention).

The initial decision found that the use of buy-writes constituted a "sham transaction" although it did not formally fall within Rule 204(f)'s prohibition of sham close outs because there was not a prior "arrangement" or collusion with a counterparty to avoid delivery. The Division argues only that optionsXpress violated Rule 204(a)'s close-out requirement when it relied on buy-writes that did not result in delivery to NSCC to satisfy that requirement; it does not assert that optionsXpress violated Rule 204(f) and we therefore do not discuss the sham transaction doctrine further.

[92] 17 C.F.R. § 242.204(a) (emphasis added).

render the italicized portion of the provision superfluous.[93] That interpretation also would leave Rule 204(a) ineffectual in accomplishing its purposes: If optionsXpress were correct that the mere placement of a stock purchase order was sufficient to achieve Rule 204(a) compliance, a participant could buy stock and then, an instant later, sell the same number of shares—*i.e.*, a wash sale. Because these transactions would cancel each other out, the firm would maintain its net short CNS position, and the fail to deliver position would be allowed to remain open indefinitely, confounding our "goal of reducing fails to deliver."[94]

In support of its interpretation, optionsXpress relies on the testimony of Dr. Erik Sirri, a former Director of the Division of Trading and Markets and Chief Economist of the Commission. Dr. Sirri initially asserted that Rule 204 was "not written" to "require the broker to make progress on [*i.e.*, close out] its CNS position." But we do not defer to expert testimony about the meaning of the law.[95] And the fact that Dr. Sirri used to work at the Commission does not mean that his understanding of the Commission's regulations are those of the Commission or bind the Commission.[96] Moreover, in the course of cross examination, Dr. Sirri ultimately disavowed "offering any opinions about whether optionsXpress complied with SHO" because he did not "have the information to do it even if [he] were to try."

optionsXpress also claims that reading Rule 204(a) to include a close-out requirement would have absurd consequences, such as "barring all buy-writes in response to fail to deliver positions" or requiring brokers to prohibit all further sales transactions on a close-out day. Although we do not address the applicability of Rule 204(a) to conduct that is not before us in this proceeding, optionsXpress's asserted fears are unfounded.[97] Feldman attempted to employ his trading strategy at a number of other brokers, and every such broker faced with a similar use

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[93] *See, e.g.*, *TRW Inc. v. Andres*, 534 U.S. 19, 31 (2001) (describing the "cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant") (internal quotation marks omitted).

[94] Rule 204 Adopting Release, 74 Fed. Reg. at 38,267.

[95] *See, e.g.*, *IMS/CPAS & Assocs.*, Exchange Act Release No. 45019, 2001 WL 1359521, at *10 n.45 (Nov. 5, 2001); *Robert D. Potts, CPA*, Exchange Act Release No. 39126, 1997 WL 690519, at *10 n.56 (Sept. 24, 1997).

[96] *See, e.g.*, *Sidell v. Comm'r*, 225 F.3d 103, 111 (1st Cir. 2000) ("[S]tatements by individual IRS employees cannot bind the Secretary [of the Treasury]."); *SEC v. Nat'l Student Mktg. Corp.*, 68 F.R.D. 157, 160 (D.D.C. 1975) (explaining that the views of individual Commission staff or an individual Commissioner do not "reflect the position of the agency as a whole").

[97] A clearing broker is free to execute legitimate transactions subject to Regulation SHO's requirements. Moreover, in this proceeding, we are not presented with the question of how uncoordinated or unrelated transactions effected by a firm's other customers later on a close-out day should be treated under Rule 204. We accordingly leave such questions for another day.

of buy-writes decided not to accommodate it.[98] Moreover, the size and persistence of optionsXpress's fails was truly extraordinary; a FINRA investigator recalled that they were among the longest fails that she had ever seen. optionsXpress was by itself responsible for 64% of all shares that all 273 clearing brokers failed to settle in the CNS system during the periods and in the stocks identified in the OIP. It ranked first among all clearing brokers for the largest fails in 26 of the 44 periods in the OIP and it was ranked among the top three clearing brokers in 38 of the periods.

b. *CNS data*

Another category of arguments raised by optionsXpress pertains to the relevance and meaning of CNS data. In large part, these arguments are premised upon optionsXpress's erroneous characterization of the CNS system and, in particular, its conflation of failures to *deliver* and failures to *receive*. For example, optionsXpress cites a portion of Professor Harris's expert report that discusses how long it took other firms to receive their shares. But the fact that other firms often received shares of the OIP Securities from CNS without great delay does not mean that optionsXpress timely (or ever) delivered a sufficient number of shares to CNS to close out its fail to deliver positions. For a given security, the right to receive shares from NSCC, and the priority among members with fails to receive, is independent of other members' obligations to deliver shares to NSCC. Accordingly, optionsXpress's argument is inapposite to the question whether it closed out its fail to deliver position.

optionsXpress also claims that the "age of fails cannot be determined by looking" at CNS data. To support this assertion, optionsXpress cites a statement on the Commission's Freedom of Information Act website that supplies the "total number of fails-to-deliver . . . recorded in the . . . CNS system *aggregated over all NSCC members*."[99] The data on the website is not tied to specific NSCC participants. Unlike the data on the Commission's website, the CNS Accounting Summaries introduced in this case break out the fail to deliver positions for each participant individually, including optionsXpress, and allow the age of each such fail to be determined.[100]

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[98] The other brokers borrowed securities in response to the fails, which resulted in them incurring high borrowing costs.

[99] *Frequently Requested FOIA Document: Fails-to-Deliver Data*, https://www.sec.gov/foia/docs/failsdata.htm (last visited August 17, 2016) (emphasis added).

[100] optionsXpress also posits that fails might persist on CNS Accounting Summaries for an extended period (*e.g.*, between T+4 and T+7 or perhaps later) "even when Rule 204(a) admittedly is satisfied" because of the three-day settlement cycle. Its expert sketched out an elaborate hypothetical in which multiple "trades occur in a Regulation SHO compliant way" and, because of delays in settlement, a CNS fail remains open for a number of consecutive days. This scenario, where one day's fails might be unrelated to any subsequent day's fails on account of transactions coincidentally "cancelling" and netting against each other, bears no resemblance to

(continued…)

Finally, optionsXpress claims that CNS data cannot measure compliance with Rule 204. optionsXpress contends that compliance is determined by looking at the participant's own books and records to determine whether the participant has a stock purchase transaction on the close out date. It purports to find support for this position in the Rule 204 adopting release, which it selectively quotes to omit the italicized language:

> *[A] participant must take affirmative action to close out a fail to deliver position by purchasing or borrowing securities . . . . In addition*, . . . to meet its close-out obligation a participant *also* must be able to demonstrate on its books and records that on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position and, therefore, that the participant has a net flat or net long position on its books and records.[101]

Thus, read in context, the adopting release actually makes clear the standalone requirement that "a participant . . . take affirmative action to close out a fail to deliver position by purchasing or borrowing securities."[102] The "close-out requirements of Rule 204 are based on a participant's fail to deliver position at a registered clearing agency"—that is, the firm's CNS fails.[103]

(…continued)

the facts established by the record in this case. Here, a small number of optionsXpress's customers employed an options trading strategy from which arose the firm's fail to deliver positions, which persisted in some cases for dozens of consecutive days. On a continuing basis, the firm relied on buy-writes placed by the Customers to address its fails, even though the calls were being immediately and repeatedly assigned to optionsXpress and thus no delivery and no close out resulted. Expert analysis of the customers' trading records and CNS data demonstrated that the buy-write volume was closely correlated with the size of optionsXpress's fail to deliver positions in surrounding days.

[101] Rule 204 Adopting Release, 74 Fed. Reg. at 38,272 (emphasis added).

[102] *Id.*

[103] *Id.*; *see also id.* at 38,272 n.81 (referencing a firm's "notification from NSCC regarding its securities delivery . . . obligations"). In any event, optionsXpress never produced its entire books and records, and thus we have no basis to determine whether optionsXpress's "books and records" contention is factually supported. Its expert, Dr. Atanu Saha, reviewed only the trades in the Customers' accounts. His report asserted that he conducted an "analysis of aggregate data across *all* its customers' accounts" showing that "optionsXpress complied with . . . Regulation SHO." But he conceded in his hearing testimony that his review was actually confined to the firm's "books and records for these six accounts"— *i.e.*, the Customers' accounts.

c. *Due process*

optionsXpress also claims that its due process rights were violated. We do not agree. It is settled that "[r]egulations satisfy due process as long as they are sufficiently specific that a regulated entity 'acting in good faith would be able to identify, with ascertainable certainty, the standards with which the agency expects' it to conform by 'reviewing the regulations and other public statements issued by the agency.'"[104] Rules 204T and 204 straightforwardly required participants to immediately close out their CNS failures to deliver. The requirements of those rules were apparent on their face and, standing alone, adequately placed optionsXpress on notice of the proscribed conduct.

Also, there was an abundance of regulatory guidance available—for example, the *Arenstein* and *Hazan* orders and the adopting releases for Rules 204T and 204 described *supra* Section IV.B.2—that informed optionsXpress that its reliance on the Customers' buy-writes to satisfy its obligations under Regulation SHO was not proper insofar as they did not result in delivery and thus did not close out its fails.[105] Indeed, the applicability of this guidance was so clear that, after reading reports of settled enforcement orders involving similar trading activity, one of optionsXpress's traders immediately recognized the potential peril: "I'm not placing any trades today." When nonetheless directed to "execute the buy ins and customer orders today," he felt the need to forward that response to his personal, Yahoo email account. Another trader who was copied on the email exchange did the same thing, explaining that it "[d]oesn't hurt" to have "some sort of documentation" that he raised the issue with his superiors.

For essentially the same reasons, we find that optionsXpress acted willfully and with deliberate and reckless disregard for the risk that its conduct violated Rule 204. optionsXpress knew that it was not closing out its fails by executing the buy-writes. It asserts that it received "green flags" from regulators about relying on buy-writes to satisfy its obligations under Rule

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[104] *WHX Corp.*, Exchange Act Release No. 47980, 2003 WL 21283081, at *12 n.63 (quoting *General Elec. Co. v. EPA*, 53 F.3d 1324, 1329 (D.C. Cir. 1995)); *see also Marrie v. SEC*, 374 F.3d 1196, 1204 (D.C. Cir. 2004) (relying on the "Commission's accompanying statement" for a rule); *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 127 (2d Cir. 2000) (relying on "footnote to the adopting release" in deferring to Commission's determination as to scope of rule).

[105] *See, e.g.*, *Howmet Corp. v. EPA*, 614 F.3d 544, 554 (D.C. Cir. 2010) ("This court has held published agency guidance may provide fair notice of an agency's interpretation of its own regulations."). Further, although optionsXpress correctly points out that settled cases are not precedent (and are not binding on non-parties to the settlement), that is beside the point. *E.g., Citizens Capital Corp.*, Exchange Act Release No. 67313, 2012 WL 2499350, at *5 n.27 (June 29, 2012). We "'may use an opinion issued in connection with a settlement to state views on the issues presented in that case that [we] would apply in other contexts.'" *S.W. Hatfield, CPA*, Exchange Act Release No. 73763, 2014 WL 6850921, at *6 n.28 (Dec. 5, 2014) (quoting *George J. Kolar*, Exchange Act Release No. 46127, 2002 WL 1393652, at *4 (June 26, 2002)).

204, but the record does not support that claim.[106] As detailed below, optionsXpress was not forthcoming in its discussions with CBOE, FINRA, and Commission staff.

i. Interactions with CBOE

Contrary to optionsXpress's contentions, an investigation by CBOE did not conclude that optionsXpress complied with Regulation SHO. On February 26, 2009, CBOE staff notified optionsXpress that it was investigating the repeated use of buy-writes by two customers in a hard-to-borrow stock in January and February of that year.

CBOE's lead investigator and his supervisor misunderstood the requirements of Regulation SHO.[107] For example, CBOE staff incorrectly believed that retail customers could violate Regulation SHO; the investigator testified that "anyone can violate Reg[.] SHO." As a result, CBOE's investigation focused on whether the customers—not optionsXpress—were violating Rule 204T. CBOE staff also incorrectly believed that a fail to deliver could not occur unless NSCC issued a CNS Retransmittal Notice. Therefore, although optionsXpress told CBOE staff in response to an April 2009 inquiry that its customers used buy-writes and provided CBOE with CNS accounting data, CBOE staff did not appreciate that optionsXpress had CNS fails during that period or that optionsXpress was relying on the buy-writes to close out those fails. Rather, they were puzzled as to "the purpose of doing buy-writes *if [the] fail has been closed*."

These misunderstandings are further evidenced by the conversations between CBOE staff and staff from the Commission's Division of Trading and Markets. CBOE staff inaccurately told Trading and Markets staff that optionsXpress did not have any fails to deliver. In response, Trading and Markets staff correctly advised CBOE of the "basic rule" that Rule 204T could not be violated without a CNS fail.[108] Another call between CBOE and Trading and Markets staff

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[106] *See Graham*, 222 F.3d at 1008 ("[W]hat we have in this case is nothing more than a series of investigations into [the defendant's] trades . . . Neither [the defendant] nor the [other respondents] can be said to have been cleared along the way.").

[107] Neither CBOE employee received formal training in Regulation SHO and their knowledge of Rule 204T was limited to reading the rule itself. Moreover, they were unaware of the *Arenstein* and *Hazan* settled cases or the related regulatory circulars. They admitted, among other things, that they did not know what a fail to deliver was, how the age of a fail could be determined from CNS Accounting Summaries, or when on T+4 a fail had to be closed out.

[108] According to notes by FINRA staff with whom the CBOE investigator discussed his investigation, Trading and Markets staff reminded CBOE staff that Rule 204T imposes obligations only on brokers, not retail customers. Thus, the CBOE investigator was correctly told that optionsXpress's customers could "not officially [be] violating" Rule 204.

covering similar ground took place in June 2009. CBOE staff reiterated their assumption that "due to [the] buy-writes, they [*i.e.*, optionsXpress] never had [a] fail."[109]

On neither the May 2009 call nor the June 2009 call did Trading and Markets staff opine that optionsXpress was in compliance with Regulation SHO or that its reliance on buy-writes was proper. One participant from Trading and Markets recalled that both calls were "incredibly confusing" and requested additional information in writing. In response, the CBOE investigator sent Trading and Markets staff a memo, which gave an example of the Zeleznys' "deep call buy-write strategy." Trading and Markets staff did not speak with either CBOE investigator again after receiving the June 16 memo. And CBOE staff never discussed their consultations with Trading and Markets staff with optionsXpress.

On June 19, the CBOE investigator recommended that his investigation be "Filed without Action" because, in his view, "[n]o fails ever occurred." In a follow-up email to his supervisor, he stated that his conclusion that there was no Regulation SHO violation was based on his assessment that there was no "fail[] on any security." On September 23, 2009, CBOE closed its investigation by issuing a Letter of Caution. The letter found a technical violation of optionsXpress's buy-in procedures unrelated to Regulation SHO. It did not mention Regulation SHO, Rule 204T, or Rule 204, or state that the buy-writes satisfied the firm's obligations thereunder. Nor did CBOE investigators otherwise assure optionsXpress that the buy-writes were appropriate or that optionsXpress should continue to rely on them to address its fail to deliver positions.

Some months later, in January 2010, CBOE opened unrelated, routine surveillance inquiries. These "short sale reviews" were limited in scope and triggered by automated "exceptions reports." CBOE requested that optionsXpress "[p]rovide any fail or buy-in [*i.e.*, CNS Retransmittal] notices" with respect to certain securities. The CBOE investigator in charge of the routine surveillance misunderstood Rule 204 as well. He was not a lawyer, received no formal training on Regulation SHO, never read any of the relevant CBOE circulars, and had only briefly perused the rules. He testified that these inquiries could be closed without further investigation if the firm did not receive any CNS Retransmittal Notices (which he called "buy-ins").

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[109] Another topic that was discussed was Rule 204(f)'s "sham transaction" exception, which provides that a "participant of a registered clearing agency shall not be deemed to have fulfilled" the delivery or close-out requirements when "the participant enters into an arrangement with another person to purchase or borrow securities" and "knows or has reason to know that the other person will not deliver securities." 17 C.F.R. § 242.204(f). Because a violation of Rule 204(f) is not advanced in this proceeding (*see supra* note 91), the guidance (if any) that Trading and Markets staff provided about its potential applicability is irrelevant.

In February 2010, optionsXpress informed the CBOE investigator that it "[d]id not receive buy-in notices from CNS" and attached CNS Accounting Summary excerpts. The investigator testified that he spent about a half hour checking to see whether the securities and trade dates listed "matched up" with those identified in the automated exceptions reports. He had never seen a CNS Accounting Summary before and he did not understand the connection between CNS data and fails to deliver. He consequently sent optionsXpress form letters in December 2010 stating that no violations were apparent with respect to the materials reviewed. The "sole basis" for this determination was, he acknowledged, optionsXpress' representation "that it did not receive any buy-in notifications from CNS."

ii. Interactions with FINRA and Commission staff

In the first half of 2009, FINRA opened an investigation of optionsXpress because of its extended fails to deliver in three securities, Greenhill & Co., Inc. (GHL); Jos. A. Bank Clothiers, Inc. (JOSB); and Sears Holdings Corp. (SHLD). The fails, which in one case persisted over 120 consecutive days, were among the longest ones that the FINRA investigator had ever seen. Over the next several months, optionsXpress provided FINRA staff with trade data showing that certain of its customers were using buy-writes.

1. September 23 and 24, 2009 calls between optionsXpress and FINRA staff: After receiving CBOE's Letter of Caution in September 2009, optionsXpress spoke with the FINRA investigator and her supervisor. optionsXpress represented that CBOE had investigated the same activity and found that it was not actionable under Regulation SHO. It is undisputed that FINRA staff did not tell optionsXpress that it was in compliance with Rule 204 or otherwise provide any guidance about Rule 204 because its investigation was still ongoing.

2. September 24 call between optionsXpress and Trading and Markets staff: Later on September 24, Stern, Victor, Hoeh, and Strine from optionsXpress spoke with Trading and Markets staff. Stern took the lead on the call and described the Customers' trading activity. According to the testimony of the optionsXpress witnesses, Trading and Markets staff told optionsXpress to "keep doing what you're doing—keep closing out." Victor's notes also state "we do not fall into the sham transaction → the customer may."

One of the Trading and Markets staff members testified at the hearing. Her recollection of the September 24 call was markedly different. She testified that optionsXpress told Trading and Markets staff that its customers were engaging in an "arbitrage strategy" that involved selling deep-in-the-money calls, getting assigned on those calls, and then selling more calls when the firm directed them to buy-in. She did not recall using the phrase "keep doing what you're doing," and emphasized that if she did say it, it was only in the context of stating the obvious—*i.e.*, that optionsXpress had to continue complying with Regulation SHO and closing out its CNS fail to deliver positions. She thought that it was improbable that she would have assured optionsXpress that it was complying with Regulation SHO because it was not the typical practice

of Trading and Markets staff to tell broker-dealers over the phone that a specific fact pattern did or did not violate the law.

We are not convinced that Trading and Markets staff advised optionsXpress on September 24 that the trading activity described by Stern would not violate Rule 204.[110] But we need not (and do not) rest our ultimate conclusions on this point because any guidance that hypothetically might have been given by Trading and Markets staff was premised on the materially inaccurate and incomplete information provided by optionsXpress. optionsXpress was not, therefore, entitled rely on it.

optionsXpress did not reveal that it was under investigation by FINRA—a consequential omission since Trading and Markets staff would have told optionsXpress that it could not give guidance in light of that pending investigation. In testimony that the law judge found credible, the staff member specifically denied that optionsXpress disclosed the FINRA investigation. Additionally, her testimony was corroborated by notes maintained by other Trading and Markets staff (which do not mention any FINRA investigation), Victor's own notes,[111] and subsequent emails to FINRA and individuals at the Commission describing the conversation.

optionsXpress also did not reveal that, at the time of the call, the firm had longstanding fails to deliver in the OIP Securities—for example, in the case of Sears, 120 consecutive settlement days. Moreover, optionsXpress repeatedly assured Trading and Markets staff that it was closing out fails to deliver as they arose. Trading and Markets staff understood this to mean that optionsXpress was purchasing or borrowing securities "in a bona fide" manner so as to "close[] out the amount that was failing" every morning.

Although optionsXpress may have mentioned the concept of "bundling" buy-writes in some general way, it did not reveal that it was relying on its execution of paired stock and options transactions placed by customers to close out its fails.[112] The Trading and Market staff member testified that the use of buy-writes to address fails would have raised a "red flag" for her given the *Hazan* and *TJM* settled cases.

optionsXpress also did not reveal that that it was not consistently executing transactions at market open. According to Victor's notes, optionsXpress instead told Trading and Markets

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[110] There was conflicting testimony on this issue, as well as ambiguous indications in the available documentary evidence.

[111] Victor's notes contain the phrase "we got okay from FINRA," which suggests that optionsXpress misled Trading and Markets staff about the status of the FINRA investigation.

[112] It is undisputed that Trading and Markets staff told optionsXpress that it was not in a position to give any advice on whether the firm could bundle the buy-writes to achieve "best execution."

staff that it bought in customers "at the open" and only "contact[ed] [the] customers [to] tell them [it] [was] buying in" after the stock purchases already had been executed.

Finally, optionsXpress did not reveal that the Customers were in practice selling calls corresponding to roughly the same number of shares that the firm specified in its buy-in notices. In the example that Stern gave Trading and Markets staff, optionsXpress was assigned on 100 calls (*i.e.*, corresponding to 10,000 shares). The next day, the firm issued the hypothetical customer a buy-in notice for 10,000 shares, in response to which the customer wrote options corresponding to a *different* number of shares—88 calls (*i.e.*, 8,800 shares). Moreover, in Stern's example, still *another* number of those options, 44, were assigned later that day. This example was purposely misleading in multiple respects. He admitted that his example was intended to give Trading and Markets staff the impression that the number of calls written for the "buy-in was *not* specifically linked to the amount of the assignment" on prior or subsequent days.[113] Victor's notes confirm that optionsXpress thought it was "important" to convey that "every new day is a 'different' number"—which was not in fact the case.

Stern further misled Trading and Markets staff by explaining that the Customers might want to sell fewer calls than the buy-in amount if they expected the stock to increase in price (and thus desired to establish a long position). In fact, Stern was well aware that the customers used buy-writes precisely because they wanted to hedge their synthetic long positions and maintain an overall directionally neutral position.

3. October 2 calls between Trading and Markets staff and FINRA staff and between Trading and Markets staff and optionsXpress: On October 2, Trading and Markets staff learned additional facts from FINRA staff that optionsXpress did not disclose during the September 24 call. Among other things, Trading and Markets staff learned that FINRA had an open investigation into the activity, that the calls were being written simultaneously with the stock purchase orders, and that FINRA suspected buy-writes were being used to circumvent the close-out requirement. Based on this new information, Trading and Markets staff stated that they would contact optionsXpress and tell the firm it would not provide an opinion given the "difference in the facts as they were presented." Shortly after getting off the phone with FINRA, Trading and Markets staff called optionsXpress and told Victor that staff could provide the firm with "no comfort" and that optionsXpress needed to discuss the matter with FINRA.

4. October 2 call between optionsXpress and FINRA staff: optionsXpress reported to FINRA that it was "at a loss about what it should be doing." FINRA staff did not provide any guidance about optionsXpress's compliance with Rule 204 on this call (or on any other

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[113] In fact, there was a close correlation between these numbers, as established by Professor Harris's analysis.

occasion). It advised optionsXpress to submit its request for guidance in writing to FINRA's Office of General Counsel, which optionsXpress never did.

5. January 14, 2010 call between optionsXpress and FINRA staff: In connection with FINRA's ongoing investigation, Stern, Victor, and others at optionsXpress had another call with FINRA staff, including a FINRA Senior Vice President who headed the Options Regulatory Team and co-authored AMEX's circular Reg. 2007-35. Before the call, the FINRA team reviewed the trading and determined that continued investigation was warranted. The January 14 call occurred because the team was concerned that optionsXpress's activity was similar to that in prior Regulation SHO cases that FINRA had brought involving the use of buy-writes. FINRA staff did not tell optionsXpress that its activity was consistent with Regulation SHO. Notwithstanding the call, the trading activity went on for another two months and optionsXpress continued to rely on the Customers' buy-writes to address the firm's fails to deliver and satisfy its obligations under Rule 204(a).

FINRA's investigation of optionsXpress continued. Eventually FINRA made an internal decision to defer further action because the Commission's own investigation was ongoing. In February 2010, optionsXpress received investigative subpoenas from the Commission. On March 9, optionsXpress halted the trading, but allowed Customers' options positions to remain open until their expiration later that month.

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In sum, we find that optionsXpress failed to fully describe the trading activity and provide essential context for how the buy-writes were being relied upon by the firm. Given this, we do not think that optionsXpress could reasonably have believed that any statements made by staff amounted to a reassurance that the firm's conduct complied with Rule 204(a). In any event, it is undisputed that, on October 2, 2009, FINRA and Trading and Markets staff specifically told optionsXpress that they could provide "no comfort." Yet optionsXpress changed nothing about how it addressed fail to deliver positions for almost another half year, which standing alone is flatly inconsistent with optionsXpress's protestations that it made good faith efforts to comply with the law.

C. optionsXpress also violated Rule 204 because the transactions it relied upon to comply with that rule were not executed at or before market open

We find that optionsXpress violated Rule 204 in a second respect. Rule 204(a) requires the firm to take affirmative action in response to a fail to deliver "by no later than the beginning of regular trading hours" on the applicable close-out day.[114] Therefore, regardless of whether or not the firm was *actually* complying with Rule 204(a)'s close-out requirement, optionsXpress

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[114] 17 C.F.R. § 242.204(a).

relied upon the buy-writes for that purpose, and that meant they had to be executed by market open on T+4.[115] As detailed above, optionsXpress frequently was not executing buy-writes at market open. Before August 2009, optionsXpress required its customers to respond to buy-in notices when the Clearing Department calculated a fail to deliver on T+4. The Clearing Department often did not even calculate the buy-in list until well after the market opened, and the Trading Desk allowed the Customers to place buy-writes throughout the day. For the 1,205 buy-writes executed before August 20, 2009, 97% were executed after 10:00 am. For the entire OIP Period, 67% of the buy-writes were executed after 10:00 am, and on average approximately an hour and a half after the market opened.

We therefore conclude that optionsXpress willfully violated Rule 204(a) by not taking affirmative action in response to its fails "no later than" the time required by the Rule.

V. optionsXpress Sanctions

The law judge issued a cease-and-desist order, an order to disgorge ill-gotten gains, and a third-tier civil monetary penalty of $2,000,000 against optionsXpress. We impose the same sanctions.

A. Cease-and-desist order

Securities Act Section 8A[116] and Exchange Act Section 21C[117] authorize the Commission to impose a cease-and-desist order on any person we find has violated or caused a violation of those acts or rules thereunder. In determining whether a cease-and-desist order is appropriate, we consider whether there is a reasonable likelihood of violations in the future, the seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind in committing violations, the respondent's recognition of the wrongful nature of his or her conduct, and how recent the violations are.[118] Absent evidence to the contrary, a single past violation

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[115] The parties agree that a close-out trade after 10:00 am ET on T+4 does not take place by the "beginning of regular trading hours" and have framed their arguments and analysis on this premise. We resolve this case based on the parties' shared premise, but in so doing, we emphasize that "regular trading hours" generally "means the time between 9:30 a.m. and 4:00 p.m. Eastern Time," and caution that a participant must not delay in placing a close-out trade. *See* Rule 204 Adopting Release, 74 Fed. Reg. at 38,269 & n.44.

[116] 15 U.S.C. § 77h-1.

[117] 15 U.S.C. § 78u-3.

[118] *Ronald S. Bloomfield*, Exchange Act Release No. 9553, 2014 WL 768828, at *19 (Feb. 27, 2014) (citing *KPMG Peat Marwick LLP*, 2001 WL 47245, at *23).

ordinarily suffices to establish a risk of future violations.[119] The risk of future violations required to support a cease-and-desist order is significantly less than that required for an injunction.[120]

We find that these factors weigh in favor of imposing a cease-and-desist order against optionsXpress. optionsXpress's violations were repeated and serious. Day after day, optionsXpress failed to close out fails to deliver with market values often individually exceeding a million dollars. In doing so, optionsXpress disregarded explicit guidance from the Commission and other regulators cautioning market participants against the use of paired stock/option transactions to give the appearance of satisfying Rule 204's close-out requirement. The firm essentially took the position that, until a regulator explicitly told it to stop, it would continue to rely on its execution of buy-writes for the Customers to satisfy its obligations. The firm also failed to act transparently with regulators when the firm's activities were under investigation, and it continues to insist that its conduct was lawful.

optionsXpress's arguments against imposing a cease-and-desist order do not outweigh these considerations. The firm notes, for example, that its violations are not recent, and it cites *WHX Corp. v. SEC* for the proposition that "automatic" cease-and-desist orders are improper.[121] But our decision to impose a cease-and-desist order is not automatic, and no one factor is dispositive.[122] Even though the violations occurred some time ago, we are still concerned about the risk that optionsXpress will commit future violations because of the seriousness and recurrent nature of optionsXpress's violations, the firm's failure to accept responsibility for its conduct, and its efforts to deflect responsibility onto regulators.[123] Nor are those concerns mollified by the optionsXpress's argument that it has subsequently been acquired by Schwab and that the managers who were most involved with the violations have since left the company.[124]

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[119] *Id.*

[120] *KPMG Peat Marwick LLP*, 2001 WL 47245, at *26.

[121] 362 F.3d 854 (D.C. Cir. 2004).

[122] *See, e.g.*, *Phlo Corp.*, Exchange Act Release No. 55562, 2007 WL 966943 2007 WL 966943, at *13 (Mar. 30, 2007) (stating that not all of factors for considering whether to impose a cease-and-desist order "need to be considered, and none of them, by itself, is dispositive").

[123] By comparison, the D.C. Circuit found that the respondent in *WHX* committed only "a single, isolated violation" that it voluntarily and immediately corrected upon notification by Commission staff, suggesting a minimal risk of recurrence. *WHX Corp.*, 362 F.3d at 861.

[124] *E.g.*, *vFinance Investments, Inc.*, Exchange Act Release No. 62448, 2010 WL 2674858, at *17 (July 2, 2010) (rejecting argument that cease-and-desist order against broker-dealer was unwarranted because the responsible employee was "no longer associated with [the firm] and . . . it is 'unlikely that the precise situation will arise again in the future'"); *City of Miami*, Exchange Act Release No. 47552, 2003 WL 1412636, at *11 (Mar. 21, 2003) (explaining that the "departures" of the city "officials involved with that [violative] conduct" did not provide "assurance that [the city] will not commit similar violations in the future").

optionsXpress continues to operate as a registered broker-dealer and will therefore continue to have the opportunity to commit future violations of Regulation SHO.[125] We thus find that a sufficient risk of future violations exists so as to order optionsXpress to cease and desist from violating Exchange Act Rule 204 of Regulation SHO.

B. Disgorgement

Securities Act Section 8A(e) and Exchange Act Section 21C(e) authorize us to impose disgorgement and reasonable interest.[126] "[D]isgorgement's underlying purpose is to make lawbreaking unprofitable for the law-breaker[.]"[127] Accordingly, "the amount of disgorgement should include all gains flowing from the illegal activities," but calculating the amount of disgorgement "requires only a reasonable approximation of profits causally connected to the violation."[128] Once the Division shows that its disgorgement figure is a reasonable approximation of the amount of unjust enrichment, the burden shifts to the respondent to demonstrate that the Division's estimate is not a reasonable approximation.[129]

Here, we find that an appropriate disgorgement amount is $1,574,599. This represents the commissions that optionsXpress earned by executing the buy-writes for the Customer accounts listed in the OIP. We find that this is a reasonable approximation for how much the firm profited from its decision to rely on its execution of those trades to satisfy its close-out

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[125] optionsXpress also subsequently altered its policies to forbid the use of buy-writes in similar circumstances, but our assessment of the "risk of future violations . . . arises not so much from the likelihood that [the firm] will again rely on the same [transactions], but that it will again provide the same inadequate level of scrutiny" to compliance issues relating to optionsXpress's obligations under Regulation SHO. *KPMG Peat Marwick LLP*, 2001 WL 47245, at *27 n.151.

[126] 15 U.S.C. §§ 77h-1(e), 78u-3(e), 80b-3(j) and (k)(5), and 80a-9(e).

[127] *SEC v. Contorinis*, 743 F.3d 296, 301 (2d Cir. 2014).

[128] *SEC v. JT Wallenbrock & Assocs.*, 440 F.3d 1109, 1114 (9th Cir. 2006) (quotations and citation omitted); *see also SEC v. First City Fin. Corp., Ltd.*, 890 F.2d 1215, 1231 (D.C. Cir. 1989) (noting that, when calculating disgorgement, "separating legal from illegal profits exactly may at times be a near-impossible task").

[129] *SEC v. Lorin*, 76 F.3d 458, 462 (2d Cir. 2006); *see also, e.g.*, *Zacharias v. SEC*, 569 F.3d 458, 472–73 (D.C. Cir. 2009) (noting that, where disgorgement cannot be exact, the "well-established principle" is that the burden of uncertainty in calculating ill-gotten gains falls on the wrongdoer whose illegal conduct created that uncertainty); *SEC v. Calvo*, 378 F.3d 1211, 1217 (11th Cir. 2004) ("Exactitude is not a requirement; so long as the measure of disgorgement is reasonable, any risk of uncertainty should fall on the wrongdoer whose illegal conduct created that uncertainty." (quotations omitted)).

obligations.[130] optionsXpress challenges this calculation by arguing that any disgorgement against the firm should reflect only its *net* profits (*i.e.*, the total amount of commissions less overhead and operating expenses) rather than its *gross* revenue (*i.e.*, the total amount of commissions). According to optionsXpress, the firm's overall profit margin was approximately 44% in 2010. However, because the "gross proceeds" that optionsXpress received are a "prima facie reasonable approximation of profits connected to the securities violation," the burden rests on optionsXpress to demonstrate why that is not a reasonable approximation of its ill-gotten gains.[131]

optionsXpress has not met this burden. Even if a respondent may in some circumstances be "entitled to a deduction for all *marginal* costs incurred in producing the revenues that are subject to disgorgement," it is not entitled "to deduct expenses (such as ordinary overhead) that would have been incurred in any event, if the result would be that [respondent's] wrongful activities—by defraying a portion of overall expenses—yield an increased profit from [respondent's] operations as a whole."[132] optionsXpress does not attempt to separate out these costs and, instead, points only to the firm's overall profit margin across all of its activities in 2010. The Commission and courts have repeatedly rejected this approach, finding that

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[130] The Commission has authority to require disgorgement of avoided losses. *See, e.g.*, *SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995) (insider trading); Restatement (Third) of Restitution § 51 cmt. e ("Profit results in some cases from the avoidance of an otherwise necessary expenditure."). But under the circumstances of this case, we decline to accept the Division's suggestion that the Commission should order disgorgement in the amount of the hard-to-borrow fees that optionsXpress would have paid if it had borrowed shares to close out the fails to deliver. Rule 204 does not require firms to borrow shares; the rule instead gives firms a choice of "borrowing or purchasing securities" to close out a fail. And a firm is not required to allow its customers to employ whatever trading strategies they may choose. Other brokers declined to accommodate Feldman's trading strategy precisely because they did not want to incur high borrowing costs. Thus, we do not believe that the borrow costs are "otherwise necessary expenditures": But for the misconduct, optionsXpress likely would have disallowed the trades altogether, rather than allow the trading to go on and absorb the borrow fees.

[131] *SEC v. Whittemore*, 659 F.3d 1, 7 (D.C. Cir. 2011); *see also SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1096 (9th Cir. 2010); *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1104–05 (2d Cir. 1972). Any risk of uncertainty in distinguishing between lawful and unlawful proceeds must "fall on the wrongdoer whose illegal conduct created the uncertainty." *First City Fin. Corp.*, 890 F.2d at 1232; *see also SEC v. Razmilovic*, 738 F.3d 14, 31 (2d Cir. 2013).

[132] Restatement (Third) of Restitution § 51 cmt. H; *see also id.* § 51(5)(c) (stating that a "defendant will ordinarily be denied any credit . . . for expenditures incurred directly in the commission of a wrong"); *JT Wallenbrock*, 440 F.3d at 1114 ("expenses in carrying out a fraudulent scheme . . . are hardly appropriate or legitimate deductions" (quotation marks omitted)).

wrongdoers are not entitled to an offset against the disgorgement amount for ordinary business expenses.[133] We therefore find it appropriate to order optionsXpress to disgorge $1,574,599, plus prejudgment interest.[134]

C. Third-tier civil penalties

Sections 8A(g) of the Securities Act and 21B(a) of the Exchange Act authorize us to impose civil monetary penalties for willful violations of these Acts.[135] In considering whether a civil penalty is in the public interest, we may consider (1) whether the act or omission involved fraud or deliberate or reckless disregard of a regulatory requirement; (2) whether the act or omission resulted in harm, or risk of harm, to others; (3) the extent to which any person was unjustly enriched, taking into account restitution made to injured persons; (4) whether the individual has committed previous violations; (5) the need to deter such person and others from committing violations; and (6) such other matters as justice may require.[136]

These public interest factors weigh in favor of imposing a substantial monetary sanction against optionsXpress. As discussed above, optionsXpress acted in deliberate and reckless disregard of its regulatory obligations over a prolonged period.[137] In repeatedly violating Rules 204 and 204T, optionsXpress ignored explicit guidance from the Commission and other regulators; took the position that, until a regulator explicitly told it to stop, it could continue to

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[133] *See, e.g.*, *Richmark Capital Corp.*, Exchange Act Release No. 48758, 2003 WL 22570712, at *10 n.35 (Nov. 7, 2003) (collecting cases); *Laurie Jones Canady*, Exchange Act Release No. 41250, 1999 WL 183600, at *10 & n.35 (Apr. 5, 1999) (collecting cases); *accord SEC v. Hedgelender* LLC, 786 F. Supp. 2d 1365, 1371-72 (S.D. Ohio 2011); *SEC v. Hughes Capital Corp.*, 917 F. Supp. 1080, 1086, 1087 (D.N.J. 1996) (refusing to offset disgorgement by "certain 'legitimate' business expenses" and noting that the "overwhelming weight of authority holds that securities law violators may not offset their disgorgement liability with business expenses"), *aff'd*, 124 F.3d 449 (3d Cir. 1997); *SEC v. World Gambling Corp.*, 555 F. Supp. 930, 935 (S.D.N.Y. 1983) (declining to reduce disgorgement by "overhead and income taxes"), *aff'd*, 742 F.2d 1440 (2d Cir. 1983) (table); Restatement (Third) of Restitution § 51 cmt. h. ("[T]he defendant will not be allowed to deduct expenses (such as ordinary overhead) that would have been incurred in any event . . . .").

[134] *See Terence Michael Coxon*, Exchange Act Release No. 48385, 2003 WL 21991359, at *14 (Aug. 21, 2003) ("[E]xcept in the most unique and compelling circumstances, prejudgment interest should be awarded on disgorgement, among other things, in order to deny a wrongdoer the equivalent of an interest free loan from the wrongdoer's victims."), *aff'd*, 137 F. App'x 975 (9th Cir. 2005).

[135] 15 U.S.C. §§ 77h-1, 78u-2.

[136] 15 U.S.C. § 78u-2(c).

[137] *See supra* Sections IV.B.2- IV.B.3.

use buy-writes to address its fail to deliver positions; and instead of proactively seeking guidance from regulators (as optionsXpress claims), the firm tried to keep them in the dark about the trading activity.

We find it proper to impose a sanction for every occasion that optionsXpress violated Rules 204 and 204T by failing to close out a fail to deliver position as required by Rule 204(a). The Division argues (and the law judge found) that these violations occurred on at least 1,200 occasions based on its expert's analysis of optionsXpress's CNS Accounting Summaries. We find that the record supports this finding and we accordingly accept it.[138] Moreover, the record also establishes that optionsXpress independently violated Rules 204 and 204T each time it executed the transactions it was relying on for Rule 204 compliance—*i.e.*, the buy-writes—after 10:00 am ET on T+4 (and thus well after market open). That was the case for 1,173 out of the 1,205 buy-writes placed by the Customers between September 30, 2008 and August 20, 2009, and additional buy-writes placed in the period after August 20. We accordingly find that a preponderance of the evidence establishes optionsXpress violated Rules 204 and 204T at least 1,200 times.

We further find that a third-tier penalty is appropriate because optionsXpress deliberately and recklessly disregarded regulatory requirements and its violations created a substantial risk of loss to investors.[139] In promulgating Regulation SHO, the Commission found that fails to deliver pose a substantial risk of systemic harm to market participants and market integrity.[140] As we explained, "[l]arge and persistent fails to deliver may have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending . . . .

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[138] Specifically, the Division's expert found that optionsXpress had a total of 1,271 consecutive days with fails to deliver for the securities and time periods listed in the OIP. The law judge relied on this evidence to find that optionsXpress violated Rule 204 on at least 1,200 occasions. optionsXpress does not challenge that figure in either its petition for review or its briefs to the Commission; optionsXpress instead argues only that there were *no* Regulation SHO violations (a position we reject).

[139] For each violative "act or omission," the Commission may impose one of three tiers of penalties, depending on the nature of the violation. From October 2008 to March 3, 2009, the Commission could impose first-tier penalties of up to $6,500 for violations of the securities laws; second-tier penalties of up to $65,000 for violations of the securities laws that "involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;" or third-tier penalties of up to $130,000 for violations that satisfy the requirement for a second-tier penalty and "resulted in substantial losses *or* created significant risk of substantial losses to other persons *or* resulted in substantial pecuniary gain." 15 U.S.C. § 78u-2(b)(3)(A)(B) (emphasis added). After March 3, 2009, the maximum amount of civil penalty for each act or omission at the second tier was $75,000 for a natural person, and at the third tier was $150,000 for a natural person and $725,000 for any other person.

[140] *See, e.g.*, 74 Fed. Reg. at 38,267; 72 Fed. Reg. at 45,544; 68 Fed. Reg. at 62,975.

Persistent fails to deliver in a security may also be perceived by potential investors negatively and may affect their investment decisions."[141]

optionsXpress argues that there is little evidence that its conduct *actually* undermined market integrity on any specific occasion—*e.g.*, there is no record of an identifiable counterparty suffering concrete harm because it did not timely receive shares.[142] But this is not unexpected, given NSCC's role as a central counterparty in clearing and settling transactions and the indirect means by which securities are held through DTC. Although harms from persistent fails to deliver by nature tend to be diffuse, a significant *risk* of substantial harm is all that is required to impose a third-tier penalty under the statutory scheme. We determined that such a risk exists when we promulgated Rule 204 and we adhere to that finding.

Specifically, when a broker has a fail to deliver position, it necessarily follows that another broker (or set of brokers) will have a fail to receive position because CNS functions on a net basis. When a broker has a fail to receive in a security, the number of shares in its DTC account for that security will be less than the total number of shares that have been purchased by its customers. In other words, the broker's books may reflect that its customers collectively hold more shares with the broker than the broker itself holds with DTC, with the difference being the broker's long CNS position. Because the rights associated with ownership—*e.g.*, the right to vote the stock, receive dividends, or lend the stock out in exchange for fees—pass through DTC to the member and then finally to the purchaser, the broker's failure to receive may impair the rights of its customers.

This indirect system of securities holdings is governed by Article 8 of the Uniform Commercial Code, which has been enacted by the legislatures of all 50 states. The central concept of Article 8 is that of a "security entitlement," which is a special kind of undertaking in which a securities intermediary (such as DTC or a broker) agrees to treat the entitlement holder as being entitled to exercise the economic benefits and governance rights that comprise the security.[143] Thus, instead of possessing rights directly against the issuer, the entitlement holder has rights only against its own securities intermediary—*i.e.*, against DTC in the case of a broker and against the broker in the case of a broker's customers.[144] The intermediary must pass

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[141] 74 Fed. Reg. at 38,281.

[142] There was evidence that other brokers submitted a number of Notices of Intention to Buy-in with CNS for the OIP Securities meaning that they had fails to receive that they desired to promptly resolve. There also was evidence that optionsXpress received CNS Retransmittal Notices from NSCC on several occasions, placing it on notice that it might be required to compulsorily purchase the securities and deliver them.

[143] *See generally* U.C.C. § 8-102(a)(17) & cmt. 17; § 8-501(a)-(b) & cmt. 1.

[144] *See generally* U.C.C. §§ 8-102 cmt. 17, 8-503 & cmt.2.

through the benefits and rights of ownership to the entitlement holder.[145] Importantly, though, a securities intermediary may credit its customers' accounts with a security entitlement even when the intermediary does not yet hold the security at DTC (or have enough securities entitlements with its own, upstream securities intermediary).[146]

A customer's contractual rights against *its broker* do not depend on whether the broker has sufficient holdings of the asset with DTC.[147] But that customer's security entitlement against his or her broker does not give him or her contractual rights against *anyone else*. Accordingly, when a broker has a fail to receive at CNS and thus a shortfall of shares in its DTC account, it may be unable to see to it that its customer receives the economic and corporate rights that comprise the financial asset.[148] For example, although customers are entitled to instruct their broker how to vote the shares in their accounts (and a broker is in turn obliged to direct DTC accordingly), the broker may cast only as many votes as it has shares in its account with DTC as of the record date. Therefore, as the Division's expert put it, a failure to receive may prevent the broker from "own[ing] the stock legally" and thus "hav[ing] the right to vote the shares."[149] Likewise, fails to receive may prevent purchasers from receiving the full economic benefit of dividend payments—*e.g.*, because payments in lieu of dividends credited by the CNS system may not be eligible for preferred tax treatment as qualified dividend income—or taking advantage of the opportunity to lend shares to others.

The risk of these systemic harms, which we previously identified in the Rule 204T and Rule 204 adopting releases, creates a substantial need to deter optionsXpress and others from committing similar Rule 204 violations in the future by imposing significant penalties. By earning more than $1 million in commissions, optionsXpress's violative conduct also resulted in a "substantial pecuniary gain," which itself exposes optionsXpress to third-tier civil penalties.

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[145] *See generally* U.C.C. §§ 8-505 to 8-508.

[146] U.C.C. § 8-501(c) & cmt. 3; *see also id.* §§ 8-504, 8-509(a); 17 C.F.R. § 240.15c6-1.

[147] U.C.C. § 8-501 cmt. 3.

[148] When brokers credit entitlements to their accounts before they receive the security via CNS, the total number of *entitlements* credited to all customer accounts across all brokers may exceed the total number of *shares* registered at the DTC. That latter figure is unaffected by fails to deliver or fails to receive at CNS, because only the issuer itself can create more shares.

[149] Put another way, the aggregate number of votes that potentially *could* be submitted by customers might exceed the number of shares that the broker is entitled to vote on their behalf. Whether a fail to receive impacts any particular customer's right to vote shares would depend on the number of votes actually cast and the broker's method for reconciling excess votes. "Neither our rules nor SRO rules currently mandate . . . the use of a particular reconciliation or allocation methodology." *Concept Release on the U.S. Proxy System*, Exchange Act Release No. 62495, 2010 WL 2779423, at *13 (July 14, 2010).

Considering these circumstances, we find that a total monetary penalty of $2 million is appropriate. This amount is well within the maximum amount allowed under the Securities Act and Exchange Act—indeed, that is so regardless of which of the three tiers of penalties is applicable to each of optionsXpress's violations. A $2 million civil penalty is comparable to the amount that optionsXpress was unjustly enriched by the violations (that is, the $1,574,599 in ill-gotten gains that we have ordered be disgorged).[150] Finally, a $2 million third-tier penalty serves the public interest of deterring optionsXpress and others in similar positions from committing future violations.[151]

VI. Feldman background

Although we find that optionsXpress violated Rule 204 by relying on Feldman's and other Customers' buy-writes to satisfy the firm's delivery obligations when those trades did not result in the firm closing out its fails, the record does not contain sufficient evidence for us to find that Feldman failed to fulfil his own, distinct delivery obligations or that he otherwise violated the anti-fraud provisions. We begin with a recitation of the relevant facts about Feldman's trading activity.

A. Feldman was open about his trading strategy

The allegations against Feldman arise from options trades that he executed through optionsXpress between October 2008 and March 18, 2010.[152] Feldman was notably transparent about those trades. The Division does not dispute that Feldman fully disclosed his trading strategy to optionsXpress and other brokers with which he placed trades. The Division also acknowledges that the public could determine that the calls written by Feldman (and other Customers similarly engaged in the repeated use of buy-writes) were likely to be exercised and

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150 *See, e.g.*, *Collins v. SEC*, 736 F.3d 521, 525 (D.C. Cir. 2013) (noting that, "in administrative proceedings before the SEC," civil penalties "ranging from roughly one-half of the disgorgement" to "about 25 times the disgorgement" have typically been observed).

151 optionsXpress argues that that the proceeding must be dismissed because it is time-barred under Section 4E(a) of the Exchange Act, which sets forth certain deadlines "for completing enforcement investigations." 15 U.S.C. § 78d-5. The D.C. Circuit recently rejected this argument, holding that Section 4E does "not impos[e] a jurisdictional bar" as to the Commission's authority to bring administrative proceedings regardless of whether those deadlines have been met. *Montford & Co., Inc. v. SEC*, 793 F.3d 76, 81 (D.C. Cir. 2015).

152 At the time of the trades, Feldman worked as a Senior Vice President at Eastern Savings Bank in Hunt Valley, Maryland. Feldman's options trading had no connection to that job, and Feldman had no formal securities training, held no securities licenses, and was not a compliance professional. Rather, Feldman traded options in his spare time.

assigned by looking at the "open interest" and volume of options in those series.[153] Feldman even posted a comment on a public Internet blog in June 2009 using his own name and describing his strategy, including the buy-in notices that he repeatedly received from optionsXpress:

> I have been in this Citi/Preferred Arb trade for 3 months now.[] While I some[how] am not paying the "cost to borrow" fees (don't ask me how), the risk of "buy[-]in" is huge. You've done a great job of using the analogy of the loan that does not renew. I went 2 months with zero buy-ins (miraculously), but the past 2-3 weeks the buy[-]ins have been fast and furious. However, when[e]ver I get a buy-in (I'm talking hund[re]ds of thousands of shares sometimes), I recreate the position by selling in-the-money calls, which of cou[r]se then get assigned, leaving me short again. It's a viscious [sic] cycle, [b]ut worth the [transaction costs] (and the .01-.02 loss per round turn) in order to make the .785/share profit (now closer to .50 as the gap narrowed yesterday).

The Division notes that, two days after Feldman last posted to this blog, someone posted a question asking Feldman "if you get assigned on the short call, you have to deliver stock. How do you do this?" The poster continued, "My understanding is that if you do nothing, you will get bought in (by your clearer) to make delivery on the assignment. Fascinated to hear if/how you get around this." The record contains no evidence that Feldman ever saw this post or responded to it.

B. optionsXpress changed its buy-in policy, but told Feldman it wanted to "keep his business"

In July 2009, optionsXpress notified Feldman that it had changed its procedures. optionsXpress previously gave Feldman the entire day to place buy-writes in response to its buy-in notices. Beginning in July 2009, the firm told Feldman that it would start requiring him to cover "immediately."[154] In notifying Feldman of this change, Payne assured Feldman in an email dated August 6, 2009, that "[t]his process has been a headache from the beginning, but I do appreciate you continuing to work with optionsXpress with your orders."

Responding to Payne's email, Feldman wrote that "[i]t is very distressing that I (and I assume other clients) learn the rules, adapt to them, base strategies on them, and play by them. Only to have them changed." Feldman then asked whether the change in policy would impact

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[153] Open interest refers to the total number of contracts in a particular series that are currently outstanding—*i.e.*, contracts that have been written, but not yet exercised.

[154] As discussed *supra* Section III.B.3, optionsXpress began pre-building the buy-writes before market open, but delayed executing them until the Customers placed an order.

his ability to continue doing buy-writes by noting that buy-writes were "crucial to maintain the neutral hedge" of his strategy and that "[s]eparating [the buy and the write into separate transactions] creates mkt (sic) risk for you and the client." Feldman also asked whether the change in policy was due to a Commission or internal optionsXpress rule, writing that he was "just trying to understand what the heck is behind this. People too often make up rules and forget they're in business to do business."

Payne wrote back that "[t]his is definitely an SEC regulation, and not one from our compliance department." He also attached a link to the adopting release for the amendments to Regulation SHO, asserting that the issue with Feldman's trades was that, "[b]y shorting options deep in the money, to get assigned, your trade date position stays constant, and the settled position never closes or goes long." Because of this, Payne wrote, the firm would have to require Feldman to respond to buy-in notices for those trades "at the open." Payne nevertheless assured Feldman that "[w]e definitely want to keep your business," and that an optionsXpress broker was "here to take any orders you wish to work." Payne also added, "we have to follow the rules." Payne did not tell Feldman that the trades ran afoul of any Commission rule. To the contrary, Payne's comments conveyed the impression that the timing of the buy-writes was changed to assist with regulatory compliance.

C. Feldman received assurances from optionsXpress

At some point, optionsXpress began limiting the size of Feldman's trades by charging an extra half cent per share when he executed buy-writes in response to certain large buy-in notices. Feldman testified that optionsXpress's VP of Trading/Customer Service, Peter Bottini ("Bottini"), explained to him that "the real reason why we are trying to limit your position . . . [i]s because the SEC had been looking at the trades . . . and had a concern." According to Feldman, Bottini also told him that optionsXpress was supposed to have a conference call with the Commission to discuss the matter.

On September 23, 2009, Bottini emailed Feldman a link to the then-recent Commission settlement in *Hazan Capital Management LLC*.[155] Feldman responded via email: "I do appreciate you taking the time to finally give me the opportunity to understand the issues involved here," and "I would certainly appreciate being kept in the loop as to any potential SEC-mandated changes as to that issue." Later the same day, Feldman emailed Bottini again, writing that he thought that the trading described in *Hazan* "was really very different" from his trades. Among other things, Feldman wrote that, while he used standard options, which "many times . . . do not get assigned 100%," *Hazan* involved FLEX options, which involved a one-day expiration. On this basis, Feldman "assume[d]" that his use of standard options was "thus very legitimate, and is indeed [m]ore arm[']s length than those 'FLEX' options."

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[155] *See supra* Section IV.B.2 (discussing *Hazan*).

Feldman emailed Bottini again several days later, asking about the call that optionsXpress was supposed to have had with the Commission. Feldman wrote that "I obviously would like to continue trading when appropriate" and asked "what will be needed to resume 'normal' operations." Bottini responded that he was "available to discuss" the matter more in a few days, but that "[t]hings look positive." Feldman testified that he and Bottini did, in fact, discuss the matter a few days later and that Bottini assured him "that the SEC had looked at it, and everything was fine going forward."[156]

D. Feldman openly pursued his options strategy at other broker-dealers

In October 2009, Feldman transferred part of his account from optionsXpress to another broker-dealer, Terra Nova Financial Group, Inc., and continued pursing his options strategy in his new account. Approximately a month later, however, Terra Nova's clearing firm, Penson Financial Services ("Penson"), told Feldman that his trades were causing the firm to incur increased collateral requirements. Penson therefore directed Feldman to move his trading positions back to optionsXpress, which Feldman did around December 2009.

In October 2010, the Commission informed Feldman that it intended to recommend instituting a proceeding against him. Despite this, Feldman continued using his trading strategy at two other brokers. These additional trades are not at issue here, but, by way of example, Feldman began placing trades with E*TRADE sometime around April 2011. He emailed Oscar Zeron ("Zeron") at E*TRADE to confirm whether he could use buy-writes: "I just want to confirm that, per your compliance ppl to whom you spoke, as long as the short shares are covered, it's no problem setting additional calls ico (to maintain the neutral hedge). Thanks, pls confirm." Zeron responded on June 27, 2011: "Correct! You can sell calls to hedge anytime." Zeron added on June 29, 2011, "Yes, you may implement BUY-Writes if applicable."

Although E*TRADE never expressed concern that Feldman's trades might themselves be violating Commission rules, the firm nevertheless became concerned with the potential strain that they could put on the firm's operations. As Roderick Mikus ("Mikus"), E*TRADE

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[156] After Bottini told Feldman that the Commission had determined that his trading activity was "fine," Feldman became aware of anonymous Yahoo! message board participants who were discussing an increase in Sears's trading volume, which was attributable to Feldman's trades. When a friend of Feldman's told him that the commenters had posited a variety of theories for the spike, including that Sears could be going private or instituting some type of stock buy-back program. Feldman emailed his friend that he "read the latest thread on the [Sears] 'volume spikes.' Very entertaining. (Until someone notifies the SEC, and they shut down the strategy!! Then we'll need a real job . . LOL." At the hearing, Feldman testified that his reference to the Commission was a self-deprecating joke, which is consistent with the evidence that, based on his communications with optionsXpress, he believed that the Commission was already fully aware of his strategy when he wrote the email.

Financial's Vice President of Securities Lending Operations and former COO for E*TRADE Clearing, explained, the firm (not Feldman) was obligated to deliver the shares related to Feldman's trades. Because of this, the firm was required "to go out and either have the customer cover or recall shares with a counterparty, or a multitude of different reasons to ensure that we have got enough shares to satisfy the delivery obligation." E*TRADE was concerned that the volume of Feldman's trades, combined with the volume of other customers' trades, could cause a "strain on the system." Mikus explained that this volume could, "at some point," cause E*TRADE not to "have enough shares available" to deliver to NSCC. Mikus nevertheless emphasized that the firm was meeting its delivery obligations by delivering shares from its inventory or from borrowing shares, which meant that Feldman's buy-writes neither caused E*TRADE to violate Regulation SHO nor caused the firm to have an ongoing CNS fail. Mikus eventually told Feldman to close out his positions. As Feldman explained it during the hearing, E*TRADE "asked [him] not to do [his trades] anymore, and [his] presumption was because it was costing them too much of a fee."

Feldman also employed his options strategy at TD Ameritrade. But TD Ameritrade told Feldman to stop after a couple months. Feldman testified that "what they told me was that the borrowing costs for them were so high on some of these stocks that they were actually paying out of pocket that they warned me to not do any more of those . . . and asked me not to do any more because it was costing them too much money."

VII. Feldman's Alleged Antifraud Violations

A. The Division failed to establish a violation of Securities Act Section 17(a), Exchange Act Section 10(b), or Exchange Act Rule 10b-5

The Division alleges that Feldman willfully violated Securities Act Section 17(a),[157] Exchange Act Section 10(b), and Exchange Act Rules 10b-5 and 10b-21,[158] which each prohibit fraudulent conduct.[159] In doing so, the Division makes essentially two fraud-related allegations

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[157] 15 U.S.C. § 77q(a)(1) and (3) (prohibiting "employ[ing] any device, scheme, or artifice to defraud" and "engag[ing] in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser").

[158] 15 U.S.C. § 78j(b) (making it unlawful for any person to "use or employ. . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe"); 17 C.F.R. § 240.10b-5(a) and (c) (barring "employ[ing] any device, scheme, or artifice to defraud" and "engag[ing] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person").

[159] Because the Division does not allege that Feldman made "any untrue statement of a material fact or [omitted] to state a material fact necessary in order to make the statements made . . . not misleading," neither Securities Act Section 17(a)(2) or Securities Act Rule 10b-5(b) are relevant here. 15 U.S.C. § 77q(a)(2); 17 C.F.R. § 240.10b-5(b).

against Feldman. The first is a contract-based theory: that Feldman sold call options with no intention of fulfilling the resultant delivery obligations when the options were exercised. The second is a more expansive manipulation-based theory: that Feldman's repeated use of buy-writes deceived market participants about the timely delivery of their shares. As explained below, the record does not support a finding of fraud under either theory.

1. Insufficient evidence of making promises with the intention not to fully perform them

Regarding the Division's first, contract-based fraud theory, courts have long held that entering into a promise with the secret reservation not to perform can amount to securities fraud.[160] That is not the case here. The Division claims that Feldman did this by repeatedly placing buy-writes with the secret intention of not fulfilling the delivery obligations that arose upon the exercise of the call options—or, at the very least, that he knew that his continual use of buy-writes made non-performance likely. The record and the law does not support imposing antifraud liability on such a theory.

The record contains no evidence that Feldman had any obligation, or even ability, to deliver shares to the entity exercising the call option (or, for that matter, to anyone other than optionsXpress).[161] Instead, it was the broker-dealers, like optionsXpress, that had the obligation and ability to deliver shares to NSCC upon receiving an assignment from OCC.[162] Although a

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[160] *See, e.g.*, *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588, 589, 596-97 (2001) (finding a Rule 10b-5 violation by noting that, "[t]o sell an option while secretly intending not to permit the option's exercise is misleading, because a buyer normally presumes good faith"); *Threadgill v. Black*, 730 F.2d 810, 811–12 (D.C. Cir. 1984) (stating that "fraud in the purchase or sale includes '[e]ntering into a contract of sale [of a security] with the secret reservation not to fully perform'" (quoting *Walling v. Beverly Enters.*, 476 F.2d 393, 396 (9th Cir. 1973) (observing that "[e]ntering into a contract of sale with the secret reservation not to fully perform it is fraud cognizable under §10(b)"))).

[161] As evidence that Feldman was required to deliver shares to the entities that ultimately exercised the call options, the Division points to CBOE's product specifications for equity options, found on its website, which states that "[e]xchange traded equity options are 'physical delivery' options[, which] means that there is a physical delivery of the underlying stock to or from your brokerage account if the option is exercised." http://www.cboe.com/products/equityoptionspecs.aspx (last visited Aug. 17, 2016). The OCC's website somewhat similarly states that "[e]xercise or assignment of equity options results in acquisition or delivery of the underlying shares." http://www.optionsclearing.com/clearing/clearing-services/specifications-equity-options.jsp (last visited Aug. 17, 2016). Neither of these statements articulate *who* must effect delivery (let alone state that a retail customer has the obligation to deliver shares).

[162] NSCC then delivered the shares to the downstream purchaser's broker, who in turn delivered the shares to the purchaser. *See supra* Section III.A.

"customer that writes an Option is contractually bound to its *broker* to perform,"[163] the broker has its own obligation as a NSCC and OCC participant to effect "delivery" of the underlying securities via the CNS system "regardless of whether [its] customers perform."[164] The Division's own expert conceded that optionsXpress, not Feldman, had control over the logistics of settlement and that Feldman relied on optionsXpress to effect delivery of securities. As the Commission has stated, when, as here, a seller "is relying on a broker-dealer . . . to make delivery on a sale, the seller would not be representing at the time it submits an order to sell a security that it can or intends to deliver securities on the date delivery is due."[165] There is no evidence that Feldman assumed any part of optionsXpress's delivery obligations, nor is there any evidence that optionsXpress (or any of the other brokers with which Feldman placed trades) asked Feldman to locate or deliver shares in response to an options assignment. Instead, the record suggests that, by complying with the broker-dealers' directions, Feldman did "just what he promised" the firms he would do.[166] And the Division's expert agreed that a "customer who satisfied all the obligations presented by [his] broker-dealer could do nothing more to satisfy any delivery" obligations that the customer might have.

Second, instead of evidence indicating that Feldman secretly intended not to deliver shares, as the Division alleges, the record shows that Feldman was notably open about what he was doing. There is no dispute that his brokers, including optionsXpress, were aware of Feldman's trading strategy and its reliance on the repeated use of buy-writes. Feldman also posted his trading strategy on a public web forum, and the Division concedes that the open interest and volume of written calls was publicly available information, which allowed the marketplace to see the high-volume and frequent same-day exercise of written calls. Nor does the record provide evidence that Feldman impliedly or explicitly promised any other entity that he would make additional undertakings to effect delivery of the underlying securities.

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[163] Form S-20, Registration Statement, The Options Clearing Corporation at p. 6 (Mar. 18, 2002) (emphasis added). Feldman's brokerage agreement with optionsXpress required Feldman to comply with the firm's buy-in directions. That agreement also gave optionsXpress control over Feldman's account so that it could take steps to fulfill its own delivery obligations—regardless of how or whether Feldman responded to the firm's buy-in directions. optionsXpress had the authority, for example, to use the funds in Feldman's account to purchase the shares on his behalf (even if that meant liquidating his other holdings) or to borrow shares without Feldman's consent.

[164] *Id.*

[165] "*Naked" Short Selling Antifraud Rule*, Rule 10b-21 Adopting Release, Exchange Act Release No. 58774, 2008 WL 4567304, at *8 (Oct. 14, 2008).

[166] *Guaray v. Winehouse*, 190 F.3d 37, 44 (2d Cir. 1999) (affirming dismissal of 10b-5 claim where there was no suggestion that the defendant "did not intend to do just what he promised at the times he made the statements to which [the plaintiff] now points").

Executing Feldman's trades may have contributed to optionsXpress's fails to deliver. And when it relied on Feldman's buy-writes to address its fails, optionsXpress did not timely close them out. But responsibility for the fails belonged to optionsXpress, which allowed them to persist through optionsXpress's own conduct (such as its decision to allow Feldman to place buy-writes in response to the firm's buy-in notices and its decision to rely on those buy-writes to satisfy the firm's obligations under Rule 204).[167] We accordingly find insufficient evidence to conclude that Feldman violated the anti-fraud provisions by making promises that he did not intend to keep.

2. Insufficient evidence of market manipulation

We similarly find that the record does not contain sufficient evidence to find market manipulation. Liability for market manipulation stems from Section 10(b)'s prohibition against "any manipulative or deceptive practice or contrivance."[168] The Commission has interpreted this prohibition as outlawing the "intentional interference with the free forces of supply and demand."[169] Investors, the Commission has explained, are "entitled to assume that the prices they pay and receive are determined by the unimpeded interaction of real supply and real demand."[170] Manipulative transactions "frustrate these expectations" by substituting "fiction for fact" and transforming a market into "a stage managed performance."[171] The key question for determining liability is whether a respondent engaged in a transaction that sent "a false . . . signal to the market."[172]

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[167] Feldman also employed the same trading strategy at other firms, and there is no evidence that his trades caused ongoing CNS fails to deliver or Regulation SHO violations elsewhere.

[168] 15 U.S.C. § 78j(b).

[169] *Donald L. Koch*, Exchange Act Release No. 72179, 2014 WL 1998524, at *9 (May 16, 2014), *aff'd in part and vacated in part on other grounds*, 793 F.3d 147, 158 (D.C. Cir. 2015) (vacating associational bar with municipal advisors and rating organizations because application was impermissibly retroactive); *see also ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 100 (2d Cir. 2007) (concluding that Rule 10b-5 prohibits market manipulation because manipulation "'connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities'" (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)); *Pagel v. SEC*, 803 F.2d 942, 944-45 (8th Cir. 1986) (affirming finding that, by engaging in market manipulation, respondents violated Section 17(a)), *aff'g* Exchange Act Release No. 22280, 1985 WL 548387 (Aug. 1, 1985).

[170] *Edward J. Mawod & Co.*, Exchange Act Release No. 13512, 46 SEC 865, 1977 WL 173385, at *4 (May 6, 1977), *aff'd*, 591 F.2d 588 (10th Cir. 1979).

[171] *Id.*

[172] *ATSI Commc'ns*, 493 F.3d at 100.

Open-market transactions, like the buy-writes used here, can form the basis for unlawful market manipulation if the alleged manipulator acts with the necessary intent.[173] As the Commission has held, although "fictitious trades frequently form the basis of manipulative activity [,] . . . it is not necessary that the transactions in question be fictitious."[174] It is enough if those otherwise legal trades were done with the intent to manipulate the market.[175] To establish such intent, the Division must show either that (1) the respondent intended "to deceive, manipulate, or defraud" or (2) the respondent's conduct was such "'an extreme departure from the standards of ordinary care . . . that the danger was either known to [respondent] or so obvious that the [respondent] must have been aware of it.'"[176] Here, there is insufficient evidence in the record for us to find that Feldman acted with scienter.

The Division's primary evidence of scienter are Feldman's various statements that he did not want to "settle" his position. The Division contends that these statements show that Feldman was intentionally using buy-writes to avoid delivering shares. Yet, as noted above, this argument conflates the concept of "delivery" applicable to broker-dealers and that applicable to customers like Feldman. Feldman did not have any reason to avoid delivery (or to cause broker-dealers like optionsXpress to avoid delivery): As the Division's expert conceded, Feldman's profits were unaffected by whether his broker-dealer actually delivered the shares via CNS. When read in this context, Feldman's statements about not wanting to "settle" suggest that he was simply trying to avoid exiting (*i.e.*, settling) his overall position, not that he was attempting to prevent shares from being delivered to those exercising the options that he wrote. In fact, Feldman tried to find ways to avoid the repeated cycle of buy-writes, since every buy-write cost him money, thus diminishing his overall gains.

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[173] *See, e.g.*, *Michael J. Markowski*, Exchange Act Release No. 43259, 2000 WL 1264292, at*4 (Sept. 7, 2000), *aff'd*, *Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001) (rejecting argument that "real" trades, which "involved real customers, real transactions, and real money," categorically "cannot be classified as an unlawful manipulation").

[174] *Koch*, 2014 WL 1998524, at *14 (quoting Thomas Lee Hazen, LAW OF SECURITIES REGULATION § 14.3[6][B] (1995)); *accord Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001) (stating that "we cannot find the Commission's interpretation to be unreasonable in light of what appears to be Congress's determination that 'manipulation' can be illegal solely because of the actor's purpose" (citing *Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837, 843–44 (1984)).

[175] *Koch*, 2014 WL 1998524, at *14 (recognizing that a market participant's "scienter renders his interference with the market illegal" (quoting *Kirlin Secs., Inc.*, Exchange Act Release No. 61135, 2009 WL 4731652, at *12 (Dec. 10, 2009))); *cf. Markowski*, 274 F.3d at 528–29 (rejecting the argument that manipulation required fictitious transactions).

[176] *Gregory O. Trautman*, Exchange Act Release No. 61167A, 2009 WL 6761741, at *16 (Dec. 15, 2009) (alterations in original) (quoting *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008)); *accord Ernst & Ernst*, 425 U.S. at 193 n.12 (defining scienter as "a mental state embracing intent to deceive, manipulate, or defraud").

Nor is there sufficient evidence to find that it was unreasonable—and therefore at least negligent under Section 17(a)(3)—for Feldman not to have known that his repeated use of buy-writes had a manipulative impact on the market.[177] The Division points to Feldman's alleged knowledge about the potential regulatory concerns his trades were causing for optionsXpress as evidence that he should have known that his trades were deceiving market participants about delivery of their shares. The record does not contain sufficient evidence to accept the Division's inference. . Regulation SHO does not apply to retail investors like Feldman, and the record does not show that he otherwise had any reason to know the regulation's intricacies. Nor was Feldman privy to optionsXpress's internal discussions about its own compliance, and he did not have access to CNS Accounting Summaries or the firm's books or records.

The only evidence of Feldman's insight into the firm's operations (and whether it was meeting its CNS delivery obligations) came from what the firm told him—yet he was never told that his trades were causing optionsXpress to violate Regulation SHO or that investors were not receiving their shares. To the contrary, optionsXpress repeatedly assured Feldman that his use of buy-writes was an acceptable response to the firm's buy-in directions. When Feldman placed a buy-write, for example, the firm typically would send him a written confirmation that his trade had covered the short position for which the firm issued a buy-in notice. Although optionsXpress also told Feldman that the Commission had concerns with his trading strategy, the firm subsequently assured Feldman that the Commission had reviewed his trading and concluded that "everything was fine going forward." To be sure, optionsXpress's assurances were *false*—since optionsXpress had not been forthcoming with Commission staff (as detailed *supra* Section IV.B.c). But there is no evidence that Feldman knew that. Similarly, when Penson, E*TRADE, and TD Ameritrade each told Feldman that they would no longer place his buy-writes, they explained their actions by referring to only increased fees or increased collateral requirements that Feldman's trades caused the firms to incur.[178]

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[177] The Supreme Court has never addressed whether negligence is *necessary* to prove a violation of those provisions. In fact, the Court has suggested that, at least under Section 17(a)(3), the focus is only on the "*effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible" for the conduct. *Aaron v. SEC*, 446 U.S. 680, 696–97 (1980). But the evidence of even the effect of Feldman's buy-writes on members of the investing public is insufficient to find fraud.

[178] *See supra* Section VI.D. Penson and E*TRADE employees had internal discussions about their firms' delivering shares to NSCC, but the record contains no evidence that anyone at either firm shared those concerns with Feldman or that it was failing to deliver shares. On January 14, 2015, Feldman filed a motion to adduce additional evidence and to supplement his brief to the Commission based on the Commission's decision to institute administrative proceedings against certain Penson executives for alleged violations of Regulation SHO in May 2014. *See Thomas R. Delaney II*, Exchange Act Release No. 72185, 2014 WL 2038877 (May 19, 2014) (instituting proceedings). Because we dismiss this proceeding as to Feldman, his motion is moot.

Nor do we find that Feldman's receipt of *Hazan* was enough to have reasonably alerted him of the potentially manipulative impacts of his trades. The *Hazan* proceeding was brought against a registered broker-dealer, which the Commission found had colluded with a counterparty to postpone and avoid delivery of shares. Feldman's case contains no evidence (or even allegation) of collusion with a counterparty.[179] While the facts in *Hazan* were analogous enough to optionsXpress's situation such that the firm reasonably should have questioned its role as a broker in relying on Feldman's buy-writes to satisfy its obligations under Rule 204(a), we do not believe *Hazan* was analogous enough to Feldman's situation to suggest to him, in the face of assurances provided by his broker, that he was violating the law.

Further, there is no evidence, or even allegation, that Feldman had any motive to deceive the market about the volume of his trades. We accordingly find insufficient evidence to conclude that Feldman violated the anti-fraud provisions by engaging in market manipulation. In dismissing the proceedings against Feldman, we do not imply that an investor's use of buy-writes cannot be part of a fraudulent scheme.[180]

B. The Division failed to establish a violation of Exchange Act Rule 10b-21

The record also does not support a finding that Feldman violated the so-called "naked short selling antifraud rule," which is Exchange Act Rule 10b-21.[181] That rule states that 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 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."[182] To demonstrate a violation of Rule 10b-21, we must find "(1) scienter; (2) that an order was submitted to sell an equity security; (3) the seller deceived a broker or dealer, a participant of a

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179 Because of the frequency of the buy-writes, other market participants began to anticipate them and often had "resting orders" in place to take the other side. In fact, optionsXpress was aware that a single market maker was on the other side of many buy-writes. But neither the firm nor Feldman ever found out that counterparty's identity.

180 *See, e.g.*, *Gonul Colak*, Exchange Act Release No. 71461, 2014 WL 345644 (Jan. 31, 2014) (finding fraud in a settled matter against two retail investors for their use of buy-writes); *SEC v. Kupersmith*, Litigation Release No. 22637, 2013 WL 865278 (Mar. 7, 2013) (describing consent decree where defendants allegedly orchestrated an illegal "free-riding" scheme of selling stocks before paying for them).

181 17 C.F.R. § 240.10b-21.

182 *Id.*

registered clearing agency, or a purchaser about its intention or ability to deliver the security; and (4) the seller failed to deliver the security."[183]

As discussed above, there is no evidence or allegation that Feldman deceived his broker about his intent or ability to deliver shares. The only question is whether he knew or should have known that he was deceiving downstream purchasers about his ability or intent to deliver shares. The record does not provide sufficient evidence to make such a finding. Among other things, Feldman was open about his trading strategy, even describing it in a public blog post; optionsXpress repeatedly assured Feldman that his trades were not causing the firm to have fails to deliver; optionsXpress had the ability to purchase shares on Feldman's behalf to address fails to deliver; and Feldman had no other way to know whether his trades were ultimately causing purchasers not to receive their shares.[184]

C. No aiding and abetting or causing violations by optionsXpress

The Division alleges that optionsXpress aided, abetted, and caused Feldman to commit antifraud violations. To establish either aiding and abetting or causing liability, there must first be a primary violation.[185] Because the record in this case does not support a finding that Feldman committed fraud, there is no primary violation and thus no basis for aiding and abetting or causing liability.

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For these reasons, we dismiss the proceeding in its entirety as to Feldman.[186]

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[183] In the adopting release, the Commission stated that "we intend the scienter requirement of Rule 10b-21 to be the same as that required under Rule 10b-5." "*Naked" Short Selling*, 2008 WL 4567304, at *6 n.55.

[184] *See supra* note 180 (discussing Commission's findings of fraud violations where respondents deceived their brokers about their intent or ability to deliver shares).

[185] *See Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (stating that, for aiding and abetting liability, the Commission must find that (1) the principal, or primary wrongdoer, has violated the securities laws; (2) the aider and abettor provided substantial assistance to the primary violator; and (3) such assistance was rendered with knowledge of, or extreme recklessness regarding, the securities law violation); *Gregory M. Dearlove*, Exchange Act Release No. 57244, 2008 WL 281105, at *31 (Jan. 31, 2008) (stating that, for causing liability, the Commission must find that (1) a primary violation occurred; (2) an act or omission by the causer contributed to the violation; and (3) the causer knew that his or her conduct would contribute to the violation).

[186] This disposition makes it unnecessary to address Feldman's February 4, 2016, motion for leave to file additional briefing addressing the alleged retroactive application of Section

(continued…)

VIII. Constitutional Arguments

A. The Appointments Clause does not apply to Commission ALJs

Respondents argue that Chief ALJ Brenda P. Murray—who presided over this matter and issued the Initial Decision—was not appointed in a manner consistent with the Appointments Clause of the Constitution. We find that the appointment of Commission ALJs is not subject to the requirements of the Appointments Clause.

Under the Appointments Clause, certain high-level government officials must be appointed in particular ways: "Principal officers" must be appointed by the President (and confirmed by the Senate), while "inferior officers" must be appointed either by the President, the heads of departments, or the courts of law.[187] The great majority of government personnel are neither principal nor inferior officers, but rather "mere employees" whose appointments are not restricted by the Appointments Clause.[188] The Division does not dispute that Chief ALJ Murray was not appointed by the President, the head of a department, or a court of law.[189] Respondents therefore contend that her appointment violates the Appointments Clause because, in their view, Chief ALJ Murray should be deemed an inferior officer. The Division counters that she is an employee and thus there was no violation of the Appointments Clause.

As we have previously explained,[190] the D.C. Circuit's decision in *Landry v. FDIC* guides our resolution of this question.[191] *Landry* held that, for purposes of the Appointments

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(…continued)

929P(a)'s amendments to the Securities Act and the Exchange Act regarding civil penalties. We deny that motion as moot.

[187] The Clause provides that the President "by and with the Advice and Consent of the Senate, shall appoint . . . Officers of the United States . . . but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments." U.S. Const. Art. II, § 2, cl. 2.

[188] *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000) (quoting *Freytag v. Commissioner*, 501 U.S. 868, 882 (1991)); *see also Buckley v. Valeo*, 424 U.S. 1, 126 (1976).

[189] The Commission constitutes the "head of a department" when its commissioners act collectively. *See Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 512-13 (2010).

[190] *David F. Bandimere*, Exchange Act Release No. 76308, 2015 WL 6575665, at *19 (Oct. 29, 2015), *pet. for review filed*, No. 15-9586 (10th Cir. Dec. 22, 2015); *Timbervest, LLC*, Advisers Act Release No. 4197, 2015 WL 5472520, at *24 (Sept. 17, 2015), *pet. for review filed*, No. 15-1416 (D.C. Cir. Nov. 13, 2015); *Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 75837, 2015 WL 5172953, at *21 (Sept. 3, 2015), *pet. for review denied*, ___ F.3d ___, 2016 WL 4191191 (D.C. Cir. Aug. 9, 2016).

Clause, ALJs at the Federal Deposit Insurance Corporation ("FDIC"), who oversee administrative proceedings to remove bank executives, are employees rather than inferior officers. *Landry* explained that the touchstone for determining whether adjudicators are inferior officers is the extent to which they have the power to issue "final decisions."[192] Although ALJs at the FDIC take testimony, conduct trial-like hearings, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders, they "can never render the decision of the FDIC."[193] Instead, they issue only "recommended decisions," which are reviewed *de novo* by the FDIC Board of Directors; "[f]inal decisions are issued only by the FDIC Board."[194] The FDIC ALJs thus function as aides who assist the Board in its duties, not officers who exercise significant authority independent of the Board's supervision. Because ALJs at the FDIC "have no such powers" of "final decision," the D.C. Circuit "conclude[d] that they are not inferior officers."[195]

The mix of duties and powers of the Commission's ALJs are very similar to those of the ALJs at the FDIC.[196] Like the FDIC's ALJs, the Commission's ALJs conduct hearings, take testimony, rule on admissibility of evidence, and issue subpoenas. And like the FDIC's ALJs, the Commission's ALJs do not issue the final decisions that result from such proceedings. Just as the FDIC's ALJs issue only "recommended decisions" that are not final, the Commission's

(…continued)

[191] 204 F.3d 1125 (D.C. Cir. 2000).

[192] *Id*. at 1133-34. Respondents assert that the Commission has changed its views on this point, having previously taken the position in *Free Enterprise Fund* that members of the PCAOB were inferior officers even though they lacked authority to issue final decisions. *See* Brief for the United States, *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd*., 561 U.S. 477 (2010) (No. 08-861), 2009 WL 3290435 (Oct. 13, 2009). Respondents misapprehend what was at issue in *Free Enterprise Fund*. There, it was "undisputed" that PCAOB Board members were inferior officers, so there was no occasion to address the distinction between mere employees and inferior officers. *See id.* at 29 n.8. Further, that case did not turn on the absence or presence of adjudicative finality, because PCAOB Board members performed "enforcement or policymaking functions." *Free Enter. Fund*, 561 U.S. at 507 n.10.

[193] *Landry*, 204 F.3d at 1133.

[194] *Id*.

[195] *Id*. at 1134.

[196] The D.C. Circuit recently rejected the argument that the Commission's ALJs are "constitutional Officer[s] who must be appointed pursuant to the Appointments Clause," and, in so doing, found the "FDIC regime considered in *Landry*" does not differ in any material way from the regulatory regime governing our ALJs. *Raymond J. Lucia Cos., Inc. v. SEC*, ___ F.3d ___, 2016 WL 4191191, at *1, 6 (D.C. Cir. Aug. 9, 2016).

ALJs issue "initial decisions" that are likewise not final.[197] Respondents may petition the Commission for review of an ALJ's initial decision,[198] and it is our "longstanding practice [to] grant[] virtually all [such] petitions for review."[199] Indeed, we are "unaware of any case in which the Commission has declined to grant" a respondent's timely petition for review from an ALJ's initial decision.[200] Absent a petition, we may also choose to review a decision on our own initiative.[201] In either case, our rules expressly provide that "the initial decision [of an ALJ] shall not become final."[202] Even where an aggrieved person fails to file a timely petition for review of an initial decision and we do not order review on our own initiative, our rules provide that "*the Commission* will issue an order that the decision has become final," and it becomes final only "upon issuance of the order" by the Commission.[203]

Moreover, as does the FDIC, we review our ALJs' decisions *de novo*. Upon review, we "may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part,"

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197 *See* Rule of Practice 360(a)(1) & (d), 17 C.F.R. § 201.360(a)(1) & (d).

198 Rule of Practice 411(b), 17 C.F.R. § 201.411(b).

199 Exchange Act Release No. 35833, 1995 WL 368865, at *80-81 (June 9, 1995). We reiterated this policy in the context of amendments to our Rules of Practice in 2004 that eliminated the filing of oppositions to petitions for review. We deemed such oppositions pointless, "given that the Commission has long had a policy of granting petitions for review, believing that there is a benefit to Commission review when a party takes exception to a decision." Exchange Act Release No. 48832, 2003 WL 22827684, at *13 (Nov. 23, 2003).

200 Exchange Act Release No. 33163, 1993 WL 468594, at *59 (Nov. 5, 1993).

201 Rule of Practice 411(c), 17 C.F.R. § 201.411(c); *see also* 15 U.S.C. § 78d-1(b) (providing that "the Commission shall retain a discretionary right to review the action of any . . . administrative law judge . . . upon its own initiative or upon petition"). We have *sua sponte* ordered review on a number of occasions. *See, e.g.*, *MGSI Sec., Inc.*, Exchange Act Release No. 42717, 2000 WL 462952, at *1 (Apr. 25, 2000) ("The Commission has determined to review the decision on its own initiative for the limited purpose described below."); *Robert I. Moses*, Exchange Act Release No. 37795, 1996 WL 580130, at *1 (Oct. 8, 1996) ("On our own motion, we ordered a limited review of the [initial] decision . . . ."); *accord Dian Min Ma*, Exchange Act Release No. 74887, 2015 WL 2088438, at *1 (May 6, 2015); *Michael Lee Mendenhall*, Exchange Act Release No. 74532, 2015 WL 1247374, at *1 (Mar. 19, 2015); *George C. Kern, Jr.*, Exchange Act Release No. 29356, 1991 WL 284804, at *1 (June 21, 1991).

202 Rule of Practice 360(d)(1), 17 C.F.R. § 201.360(d)(1).

203 Rule of Practice 360(d)(2), 17 C.F.R. § 201.360(d)(2) (emphasis added). An initial decision does *not* become final simply "on the lapse of time" for seeking review. Exchange Act Release No. 49412, 2004 WL 503739, at *12 (Mar. 12, 2004). And any sanctions become effective only after the date specified in the Commission's notice of finality. Rule of Practice 360(d)(2), 17 C.F.R. § 201.360(d)(2) ("The order of finality shall state the date on which sanctions, if any, take effect.").

any initial decision.[204] We do not defer to our ALJs' factual findings.[205] Moreover, "any procedural errors" made by an ALJ in conducting the hearing "are cured" by our "thorough, *de novo* review of the record."[206] And although our ALJs may oversee the taking and hearing of evidence, we have made clear that we have "plenary authority over the course of [our] administrative proceedings and the rulings of [our] law judges—both before and after the issuance of the initial decision and irrespective of whether any party has sought relief."[207] This includes authority over all evidentiary and discovery-related rulings. Lastly, we are not limited by the record that comes to us from the ALJ. We may expand the record by "hear[ing] additional evidence" ourselves or remanding for further proceedings before the ALJ, and may "make any findings or conclusions that in [our] judgment are proper and on the basis of the record."[208]

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[204] Rule of Practice 411(a), 17 C.F.R. § 201.411(a); *see also* 5 U.S.C. § 557(b) ("On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision . . . .").

[205] We do not view the possibility that we might make a factual finding partially based on an ALJ's demeanor-based credibility determinations to vest them with the type of authority that would qualify them as inferior officers. *First*, as we have repeatedly made clear, we do not accept such determinations "blindly," and we will "disregard explicit determinations of credibility" when our *de novo* review of the record as a whole convinces us that a witness's testimony is credible (or not) or that the weight of the evidence warrants a different finding as to the ultimate facts at issue. *Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 WL 1447865, at *10 (Mar. 19, 2003), *aff'd*, 75 F. App'x 320 (5th Cir. 2003); *accord Francis V. Lorenzo*, Exchange Act Release No. 74836, 2015 WL 1927763, at *10 n.32 (Apr. 29, 2015), *petition for review filed*, No. 15-1202 (D.C. Cir. July 1, 2015); *Irfan Mohammed Amanat*, Exchange Act Release No. 54708, 2006 WL 3199181, at *8 n.46 (Nov. 3, 2006), *petition denied*, 269 F. App'x 217 (3d Cir. 2008); *see also Kay v. FCC*, 396 F.3d 1184, 1189 (D.C. Cir. 2005) ("The law is settled that an agency is not required to adopt the credibility determinations of an administrative law judge."). *Second*, our practice in this regard is no different from the FDIC's and so does not warrant a departure from *Landry*. *Compare [Redacted] (Insured State Nonmember Bank)*, FDIC-82-73a, 1984 WL 273918, at *5 (June 18, 1984) (stating, "as a general rule," that "the assessment of the credibility of witnesses" by the FDIC's ALJs is given "deference" by the FDIC) *with Ramon M. Candelaria*, FDIC-95-62e, 1997 WL 211341, at *3-4 (Mar. 11, 1997) (noting that the FDIC ALJ found respondent to be "entirely credible" but rejecting respondent's testimony "in light of the entire record").

[206] *Heath v. SEC*, 586 F.3d 122, 142 (2d Cir. 2009); *see also, e.g.*, *Fields*, 2015 WL 728005, at *20 ("[O]ur *de novo* review cures any evidentiary error that the law judge may have made.").

[207] *Mendenhall*, 2015 WL 1247374, at *1. Further, our "ALJs' rulings are not precedential and are not binding on the Commission or on other ALJs." *Bandimere*, 2015 WL 6575665, at *23 n.138 (collecting cases).

[208] Rules of Practice 411(a), 452; 17 C.F.R. §§ 201.411(a), 452.

Respondents rely on several decisions—all since vacated on jurisdictional grounds—in which district courts have found that the Commission's ALJs are inferior officers.[209] Those decisions decline to follow the D.C. Circuit's reasoning in *Landry* and rely instead on *Freytag v. Commissioner*,[210] in which the Supreme Court held that a "special trial judge" of the Tax Court was an inferior officer. But we agree with *Landry's* analysis and the distinctions that the D.C. Circuit identified between ALJs and the special trial judges at issue in *Freytag*.[211] The greater role and powers of the special trial judges relative to Commission ALJs, in our view, makes *Freytag* inapposite here. First, unlike the ALJs whose decisions are reviewed *de novo*, the special trial judges made factual findings to which the Tax Court was required to defer, unless clearly erroneous.[212] Second, the special trial judges were authorized by statute to "render the [final] decisions of the Tax Court" in significant, fully-litigated proceedings involving declaratory judgments and amounts in controversy below $10,000.[213] As discussed above, our ALJs issue initial decisions that are not final unless the Commission takes some further action. Third, the Tax Court (and by extension the court's special tax judges) exercised "a portion of the judicial power of the United States," including the "authority to punish contempts by fine or imprisonment."[214] Commission ALJs, by contrast, do not possess such authority.[215] And while

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[209] *See Gray Financial Group Inc. v. SEC*, No. 15-cv-00492, ECF No. 56 (N.D. Ga. Aug. 4, 2015), *vacated*, ___ F.3d ___, 2016 WL 3361478 (11th Cir. June 17, 2016); *Duka v. SEC*, No. 15 Civ. 357(RMB)(SN), 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015), *vacated*, ECF No. 79, No. 15-2732 (2d Cir. June 13, 2016) (following *Tilton v. SEC*, ___ F.3d, 2016 WL 3084795 (2d Cir. June 1, 2016)); *Hill v. SEC*, No. 1:15-CV-1801-LMM, 2015 WL 4307088 (N.D. Ga. June 8, 2015), *vacated*, ___ F.3d ___, 2016 WL 3361478 (11th Cir. June 17, 2016).

[210] 501 U.S. 868 (1991).

[211] *Landry*, 204 F.3d at 1133 (explaining that the special trial judges at issue in *Freytag* exercised "authority . . . not matched by the ALJs").

[212] See id.

[213] *Freytag*, 501 U.S. at 882.

[214] *Id.* at 891.

[215] *See* Rule of Practice 180, 17 C.F.R. § 201.180. The Commission's rules provide ALJs with authority to punish contemptuous conduct in only the following, limited ways: If a person engages in contemptuous conduct before the ALJ during any proceeding, the ALJ may "exclude that person from such hearing or conference, or any portion thereof" or "summarily suspend that person from representing others in the proceeding in which such conduct occurred for the duration, or any portion, of the proceeding." *Id.* § 201.180(a). If there are deficiencies in a filing, a Commission ALJ "may reject, in whole or in part," the filing, such filing "shall not be part of the record," and the ALJ "may direct a party to cure any deficiencies." *Id.* § 201.180(b). Finally, if a party fails to make a required filing or to cure a deficiency with a filing, then a Commission ALJ "may enter a default . . . , dismiss the case, decide the particular matter at issue against that person, or prohibit the introduction of evidence or exclude testimony concerning that

(continued…)

Commission ALJs may issue subpoenas to compel compliance, they are powerless to enforce their subpoenas; the Commission must seek and then obtain an order from a federal district court to compel compliance.[216] In this respect, too, our ALJs are akin to the FDIC's ALJs that *Landry* found to be "mere employees." [217] The fact that our ALJs may rule initially on certain evidentiary matters and discovery issues (subject to our *de novo* review) does not distinguish them from the FDIC's ALJs in *Landry* who have the same authority.

Based on the foregoing, we conclude that the mix of duties and powers of our ALJs is similar in all material respects to the duties and role of the FDIC's ALJs in *Landry*.[218] Accordingly, we follow *Landry*, and we conclude that our ALJs are not "inferior officers" under the Appointments Clause.[219]

B. Dual for-cause removal restrictions on Commission ALJs are constitutional

In a footnote, respondents also argue that the manner of removing ALJs is unconstitutional in light of the Supreme Court's decision in *Free Enterprise Fund v. Public*

(…continued)

matter." *Id.* § 201.180(c). Any such ruling would, of course, be subject to *de novo* Commission review.

[216] *See* 15 U.S.C. § 78u(c).

[217] *See* 12 C.F.R. §§ 308.25(h), 308.26(c), 308.34(c) (providing that an aggrieved party must apply to a federal district court for enforcement of a subpoena issued by a FDIC ALJ).

[218] We do not find any relevance in the fact that the federal securities laws and our regulations at times refer to ALJs as "officers" or "hearing officers." There is no indication that Congress intended "officers" or "hearing officers" to be synonymous with "Officers of the United States," U.S. Const. art. II, § 2, cl. 2, and the word "officer" in our regulations has no such meaning. We also note in this regard that the Administrative Procedure Act "consistently uses the term 'officer' or the term 'officer, employee, or agent'" to "refer to [agency] staff members." Kenneth Culp Davis, *Separation of Functions in Administrative Agencies,* 61 HARV. L. REV. 612, 615 & n.11 (1948). *Cf.* 5 U.S.C. §§ 556, 557 (referring to the individual who presides over a hearing as the "presiding employee").

[219] Beyond *Landry*, we believe that our ALJs are properly deemed employees (rather than inferior officers) because this is how Congress has chosen to classify them, and that decision is entitled to considerable deference. *See Burnap v. United States*, 252 U.S. 512, 516 (1920). For example, as we discussed above, Congress created and placed ALJ positions within the competitive service system, just like most other federal employees. Like such other employees, an ALJ who believes that his employing agency has engaged in a prohibited personnel practice can seek redress either through the Office of Special Counsel or the Merit Systems Protection Board. *See* 5 U.S.C. §§ 1204, 1212, 1214, 1215, 1221. And ALJs—like other employees—are subject to reductions-in-force. *See id.* § 7521(b).

Company Accounting Oversight Board.[220] In that case, the Court held that the structure of the Public Company Accounting Oversight Board (PCAOB) was unconstitutional because it "commit[ed] substantial executive authority to officers protected by two layers of for-cause removal."[221] The PCAOB consisted of inferior officers who exercised executive power, but who could only be removed for cause by principal officers—SEC Commissioners—who themselves could only be removed for cause by the President.[222] The Court found this "novel structure" contrary to "Article II's vesting of the executive power in the President," including the President's obligation to "ensure that the laws are faithfully executed," because it deprived the President of sufficient control over members of the PCAOB.[223]

Based on *Free Enterprise*, respondents take the position that the Commission's ALJs are unconstitutional because they are likewise protected by two layers of for-cause removal: Commission ALJs can be removed only for cause by the Merit Systems Protection Board, and members of that board can be removed only for cause by the President.[224] But *Free Enterprise* did not establish a categorical rule prohibiting two layers of for-cause removal wherever it may be found in the Executive Branch. Indeed, the Supreme Court emphasized that the "size and variety of the Federal Government . . . discourage general pronouncements" about what removal structures may, or may not, be constitutional in different situations.[225] Thus, contrary to respondents' view, *Free Enterprise* did not turn on the technicalities of removal; it turned instead on the core constitutional question of whether "Article II's vesting of the executive power in the President," including his authority to ensure that the laws are faithfully executed, was frustrated by the distinctive structure and features of the PCAOB.[226]

When *Free Enterprise* is so understood, it becomes apparent that "the real question is whether the removal restrictions [at issue] are of such a nature that they impede the President's ability to perform *his* constitutional duty, and the functions of the officials in question must be analyzed in that light."[227] For the reasons explained below, we adhere to our previously stated view that ALJs differ from the PCAOB members in a number of significant ways, and those

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220 561 U.S. 477 (2010).

221 561 U.S. at 505.

222 *Id*. at 486-87.

223 *Id*. at 505, 496.

224 *See* 5 U.S.C. §§ 7521, 1202(d).

225 561 U.S. at 506.

226 *Id*. at 496.

227 *Morrison v. Olson*, 487 U.S. 654, 691 (1988) (emphasis added).

differences obviate any constitutional concerns from the dual for-cause removal restrictions in the context of ALJs.[228]

First, the Court in *Free Enterprise* made clear that its "holding . . . does not address that subset of independent agency employees who serve as administrative law judges," and the Court indicated that there would be no separation-of-powers problem if ALJs are deemed to be employees rather than inferior officers.[229] *Free Enterprise* left little doubt that civil servants who are not "executive officers" may enjoy multiple layers of protection from presidential removal without violating the separation of powers. Our conclusion *supra* that the Commission's ALJs are employees therefore disposes of respondents' *Free Enterprise* objection.

Second, even if the Commission's ALJs are considered officers in the constitutional sense, the nature of their duties differs so dramatically from those of the PCAOB as to obviate any potential concerns about the removal limitations. The PCAOB was "charged with enforcing the Sarbanes-Oxley Act, the securities laws, the Commission's rules, its own rules, and professional accounting standards," among other duties.[230] It was "empowered to take significant enforcement actions" and engage in the "daily exercise of prosecutorial discretion"—all core "executive activities typically carried out by officials within the Executive Branch."[231] In contrast, as the Court in *Free Enterprise* recognized, ALJs are "unlike members of the Board" insofar as they "perform adjudicative rather than enforcement or policymaking functions"[232]—and limited adjudicative power at that. And the exercise of such "adjudicative" functions beyond presidential control has long been deemed constitutionally permissible.[233]

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[228] *Timbervest, LLC*, 2015 WL 5472520, at *26. Courts that have addressed the question have indicated that the limitations on removal of Commission ALJs are not unconstitutional. *See Duka v. SEC*, 2015 WL 1943245, at *8-10 (S.D.N.Y. Apr. 15, 2015) (finding no likelihood of success on removal issue); *Hill*, 2015 WL 4307088, at *19 n.12 (expressing "serious doubts" that the removal restrictions are unconstitutional).

[229] *Free Enter. Fund*, 561 U.S. at 507 n.10.

[230] *Id*. at 485.

[231] *Id*. at 504; *see also id.* at 485 (explaining that the Board has "expansive powers to govern an entire industry").

[232] *Id*. at 507 n.10.

[233] *See Humphrey's Executor v. United States*, 295 U.S. 602, 627-8 (1935) (explaining that a "judicial aid" who acts in an adjudicative capacity "cannot in any proper sense be characterized as an arm or an eye of the executive"); *Weiner v. United States*, 357 U.S. 349 (1958) (upholding war claims commission over which the President had no power of removal). *Morrison* is not to the contrary. The Court there did "not mean to suggest that an analysis of the functions served by the officials at issue is irrelevant"—only that the functions "must be analyzed in th[e] light"

(continued…)

Third, even if the Commission's ALJs were empowered to exercise the kind of power that the Constitution requires the President to control, removal would be only one of many means of control. *Free Enterprise* acknowledged that one level of for-cause removal was permissible.[234] But two levels of for-cause removal were problematic *in that case* because "[n]either the President, nor anyone directly responsible to him, nor even an officer whose conduct he may review only for good cause, has full control over the Board."[235] As *Free Enterprise* observed, the PCAOB had "significant independence in determining its priorities and intervening in the affairs of regulated firms (and the lives of their associated persons) without Commission preapproval or direction."[236] Our ALJs are very different, as they merely take the cases that we assign to them after we initiate an administrative proceeding, and every one of their decisions can be revisited in the course of our *de novo* review. Nor are we even required to delegate functions to ALJs in the first place.[237]

Fourth, unlike the structure of the PCAOB, the ALJ system is not novel and has been in place for over 70 years. The Court emphasized in *Free Enterprise* that "'[p]erhaps the most telling indication of the severe constitutional problem with the [PCAOB] is the lack of historical precedent for this entity.'"[238] But the ALJ system and the tenure protections ALJs enjoy have been in place since the Administrative Procedure Act was enacted in 1946. This system is not an unusual innovation, but rather a system that has been working effectively for almost 70 years. Unlike in *Free Enterprise*, the challengers here are the ones advocating for radical change. When persons within an independent agency perform adjudicative functions, they are "to be nonpartisan; and [they] must, from the very nature of [their] duties, act with entire impartiality."[239] A system in which adjudicators are brought more directly within the President's

(…continued)

of "whether the removal restrictions are of such a nature that they impede the President's ability to perform his constitutional duty." 487 U.S. at 691.

234 561 U.S. at 501; *see also Humphrey's Executor*, 295 U.S. 602.

235 *Free Enter. Fund*, 561 U.S. at 496.

236 *Id*. at 504-05.

237 *See* 15 U.S.C. § 78d-1(a).

238 561 U.S. at 505 (quoting *Free Enter. Fund v. Pub.Co. Accounting Oversight Bd.*, 537 F.3d 667, 699 (D.C. Cir. 2008) (Kavanaugh, J. dissenting)).

239 *Humphrey's Executor*, 295 U.S. at 624; *see also Wiener*, 357 U.S. at 353 ("one who holds his office only during the pleasure of another, cannot be depended upon to maintain an attitude of independence against the latter's will") (quoting *Humphrey's Executor*, 295 U.S. at 629).

control could undermine that impartiality. We do not believe such a result is compelled by *Free Enterprise*, nor do we believe that it would be wise.[240]

Accordingly, we reject respondents' challenge to the dual for-cause removal limitations on Commission ALJs.

An appropriate order will issue.[241]

By the Commission (Chair WHITE and Commissioners STEIN and PIWOWAR).

Brent J. Fields
Secretary

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[240] We also note that the standard for removing Commission law judges differs from the "unusually high standard" that was applicable to the PCAOB in *Free Enterprise*. *Id*. at 503. The Board members could only be removed for "willful violations of the Act, Board rules, or the securities laws; willful abuse of authority; or unreasonable failure to enforce compliance." *Id*. This is different from an "ordinary dual for-cause standard," *id*. at 502, like the one that governs ALJs, *see* 5 U.S.C. § 7521(a).

[241] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No.10125 / August 18, 2016

SECURITIES EXCHANGE ACT OF 1934
Release No. 78621 / August 18, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

OPTIONSXPRESS, INC. and
JONATHAN I. FELDMAN

ORDER DISMISSING PROCEEDING AS TO JONATHAN I. FELDMAN AND IMPOSING REMEDIAL SANCTIONS AS TO OPTIONSXPRESS, INC.

On the basis of the Commission's opinion issued this day, it is

ORDERED that this proceeding is hereby dismissed as to Jonathan I. Feldman; and it is further

ORDERED that optionsXpress, Inc., cease and desist from committing or causing any violations or future violations Rule 204 of Regulation SHO of the Securities Exchange Act of 1934; and it is further

ORDERED that optionsXpress, Inc., pay $1,574,599 in disgorgement, plus prejudgment interest of $2,026,550, such prejudgment interest calculated beginning from November 1, 2008, in accordance with Commission Rule of Practice 600; and it is further

ORDERED that optionsXpress, Inc., pay a civil money penalty in the amount of $2,000,000.

Payment of the amounts to be disgorged and the civil money penalties shall be: (i) made by United States postal money order, certified check, bank cashier's check, or bank money order;

(ii) made payable to the Securities and Exchange Commission; (iii) mailed to Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, 6500 South MacArthur Blvd., Oklahoma City, OK 73169; and (iv) submitted under cover letter that identifies the respondent and the file number of this proceeding.

By the Commission

Brent J. Fields
Secretary