

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 66831 / April 19, 2012

INVESTMENT COMPANY ACT OF 1940
Release No. 30039 / April 19, 2012

ADMINISTRATIVE PROCEEDING
File No. 3-14853

In the Matter of

**OX Trading, LLC,
optionsXpress, Inc., and
Thomas E. Stern,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-
AND-DESIST PROCEEDINGS
PURSUANT TO SECTIONS 15(b) AND
21C OF THE SECURITIES
EXCHANGE ACT OF 1934 AND
SECTION 9(b) OF THE INVESTMENT
COMPANY ACT OF 1940 AND
NOTICE OF HEARING**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (“Exchange Act”) and Section 9(b) of the Investment Company Act of 1940 (“Investment Company Act”) against OX Trading, LLC (“OX Trading”), optionsXpress, Inc. (“optionsXpress”), and Thomas E. Stern (“Stern”) (collectively, “the Respondents”).

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. OX Trading is a Delaware corporation with a principal place of business in Chicago, IL. It was created to provide price improvement to customers of optionsXpress. It was a subsidiary of optionsXpress Holdings, Inc. (“Holdings”) until September 1, 2011, when it became a wholly-owned subsidiary of The Charles Schwab Corporation (“Schwab”).

2. optionsXpress is a Delaware corporation with a principal place of business in Chicago, IL. optionsXpress is a self-clearing, retail, on-line broker specializing

in options and futures. It is registered with the Commission, the Financial Industry Regulatory Authority (“FINRA”), Chicago Board Options Exchange (“CBOE”), various stock exchanges, and 53 states and territories. optionsXpress was a wholly-owned subsidiary of Holdings until September 1, 2011, when it became a wholly-owned subsidiary of Schwab.

3. Stern, 66, of Chicago, IL, was the Chief Financial Officer, Secretary, Director, and Chief Compliance Officer of OX Trading; the Chief Financial Officer of optionsXpress; the Chief Administrative Officer of Holdings; the President and Chief Executive Officer, Chief Compliance Officer and Director of optionsXpress International, Inc.; and the Chief Financial Officer and Director of brokersXpress, LLC. He is a board member of the Options Clearing Corporation. He holds Series 3, 4, 7, 24, 27, and 63 licenses.

B. ALLEGATIONS

OX Trading Is Registered as a Broker-Dealer

4. OX Trading was formed in August 2007 with Stern as the Chief Financial Officer. Stern also served as OX Trading’s Chief Compliance Officer, responsible for the entity’s “regulatory functions,” including its legal formation and ensuring its proper registration status.

5. OX Trading was created to provide price improvement on orders from optionsXpress’ customers and to profit from those trades. The idea originated with the head of optionsXpress’ order desk. He felt that price improvement would be beneficial for optionsXpress’ customers and a way to generate profit for Holdings.

6. Price improvement generally means the execution of an order at a price better than the public quote at the time the market center received the order.

7. OX Trading was registered with the Commission as a broker-dealer as of February 1, 2008 and became a member of CBOE. According to Stern, it was his decision to have OX Trading register because “it was going to be active enough” and would be conducting “a lot of trades.”

8. After becoming registered as a broker-dealer, OX Trading received electronic requests for quotes (“RFQs”) from optionsXpress. These RFQs allowed OX Trading to determine whether it wanted to be the counterparty to an optionsXpress customer’s order. Generally, the decision whether or not to be a counterparty to the optionsXpress customer trade was done automatically through a computerized system.

9. Although the decision whether or not to be a counterparty to the optionsXpress customer trade was generally done automatically, on at least one occasion, optionsXpress’ head trader directed OX Trading to take the trade of an optionsXpress customer who he believed “deserved an execution” but who was “not getting executed in the marketplace.”

10. If OX Trading wanted to act as the counterparty to an optionsXpress customer order, OX Trading would send a notice back to optionsXpress with an order identifying an exchange to which the order should be sent. optionsXpress would then send a paired trade to one of several price improvement auctions offered by various exchanges, such as CBOE's Automated Improvement Mechanism ("AIM"). If OX Trading chose not to be the counterparty on an order, optionsXpress would route the trade to an exchange. This process has not changed since OX Trading's formation.

11. Although CBOE's AIM system was the first auction mechanism used by OX Trading, it later began using the NASDAQ Options Market system (no later than May 2009); International Stock Exchange's Price Improvement Mechanism (no later than early 2008); and BATS (no later than the fall of 2010).

12. OX Trading is not a member of FINRA and is not, and has not been, a member of any exchange other than CBOE.

13. OX Trading makes money when it trades as a counterparty to optionsXpress customer orders and hedges the positions created by those trades. According to OX Trading's head trader: "The entity's desire is to make money, so after we price improve a customer order we end up having a position. And we manage those positions in such a way to . . . capture profit within those trades. . . . OX Trading makes money if it sells an option at one price and buys it at a lower price and sells it at a higher price."

14. Holdings' former CEO described OX Trading similarly: "[OX Trading] generates revenue by trading, by entering into primarily options positions and hedging those positions and either letting them expire or trading out of them and generating profit by buying low and selling high or selling high and buying low."

15. OX Trading's personnel describe OX Trading as a liquidity provider.

16. Internal OX Trading documents described OX Trading as providing a "2 sided market."

OX Trading Deregisters

17. On December 31, 2008, an examiner in CBOE's Department of Member Firm Regulation ("DMFR") sent an email to Stern asking why OX Trading lost more than 15% of its excess net capital in November 2008. The CBOE examiner also asked OX Trading to complete a Member Questionnaire and inquired whether OX Trading only conducted proprietary trading or whether it also acted as a market maker.

18. Stern completed the questionnaire stating that OX Trading conducted only proprietary trading. The questionnaire did not list an outside auditor for the firm and stated that OX Trading facilitated "optionsXpress, Inc.'s customer in getting solicited by optionsXpress, Inc. for better than NBBO fill on CBOE AIM system. No other

primary trades other than to hedge or liquidate the above.” Stern did not respond to the examiner’s inquiry about the November 2008 loss.

19. The CBOE examiner again asked Stern for a detailed explanation of OX Trading’s November loss and told Stern that OX Trading was required to have an annual audit based on its CBOE membership status.

20. Stern responded that the loss was “due to the conversion from the inventory range to the customer range because of our desire for optionsXpress, Inc. the clearing firm, to be able to classify its margin debit receivable from OX Trading as a ‘good’ asset.” However, internal OX Trading emails indicate that at least part of the loss was due to poor trading performance.

21. Despite CBOE’s request, Stern refused to pay for an audit and subsequently decided to terminate OX Trading’s CBOE membership.

22. On February 2, 2009, Stern notified CBOE that “OX Trading has given notice to its lessor to terminate its [CBOE membership] lease. Once the lease is terminated, OX Trading will cease to be a CBOE member and a broker-dealer.” Then on February 25, 2009, Stern again notified CBOE that “[w]e will cease being a BD on Saturday.”

23. OX Trading ceased being a member of CBOE on March 2, 2009. Despite terminating its CBOE membership, OX Trading continued to conduct the same trading, but through a customer portfolio margin account at optionsXpress. Stern did not inform the CBOE that OX Trading would continue its operations as a customer of optionsXpress.

24. On May 11, 2009, the Commission’s Division of Trading and Markets Office of Financial Responsibility (“OFR”) notified OX Trading that “[b]roker-dealers who only transact business on an exchange must be a member of that exchange” and “[t]herefore, unless you can demonstrate within 35 days of receipt of this letter that you have applied for membership with an exchange or the FINRA, your registration with the Commission will be cancelled.” OFR then cautioned: “Please note that you may not engage in the securities business unless you are a member of an exchange or the NASD and that merely having made application for membership will not satisfy the legal requirement.” On June 17, 2009, OFR sent a second letter to OX Trading containing the same admonitions.

25. According to an email sent by Stern, OX Trading “stalled as long as we could,” but finally on August 18, 2009, Stern filed a form with the Commission to deregister OX Trading as a broker-dealer. The deregistration became effective October 17, 2009.

26. OX Trading continued to trade through a customer portfolio margin account at optionsXpress.

OX Trading Reregisters as a Broker-Dealer

27. In late 2009, CBOE's DMFR was conducting a routine portfolio margin exam of optionsXpress when they identified an account that was engaged in a significant amount of trading. As part of the exam, a CBOE examiner asked if any subsidiary of Holdings traded with its own capital and cleared through optionsXpress. Stern replied: "No brokerage subsidiary of optionsXpress Holdings, Inc. does any proprietary trading or makes trades with its own capital."

28. On February 3, 2010, CBOE notified Stern that CBOE would like to discuss why OX Trading was being treated as a customer account.

29. On February 8, 2010, Stern and several others from optionsXpress met with CBOE to discuss the registration status of OX Trading.

30. On April 16, 2010, CBOE sent a letter to optionsXpress' Chief Compliance Officer asking for a written statement detailing the reasons why OX Trading was not registered as a broker-dealer, including a legal analysis on which the decision was based.

31. The Compliance Officer forwarded the letter to Stern who replied: "Ask him/them to direct it to OX Trading" adding that "I am happy to spin this however it needs to be." The Compliance Officer then asked CBOE to send the letter to Stern. On April 20, 2010, CBOE resent the same letter, but addressed it to Stern.

32. Stern responded in a letter dated April 23, 2010. Instead of providing an explanation as to OX Trading's registration status, the letter contained numerous factual inaccuracies and no legal opinion or analysis.

33. CBOE responded to Stern's letter on April 27, 2010 and asked again for an explanation of why OX Trading believed it was not required to register as a broker-dealer and for a legal opinion to support its belief. Stern did not provide an explanation or a legal opinion.

34. On June 17, 2010, CBOE sent a letter to Stern stating that CBOE believed OX Trading was functioning as a dealer and was required to register as a broker-dealer. CBOE asked OX Trading to either cease operations or obtain a written opinion from the Commission confirming that OX Trading was not required to register. CBOE asked OX Trading to respond by June 22, 2010.

35. OX Trading did not respond until June 29, 2010, when its outside counsel asked for an extension of time within which to respond. Stern separately emailed the Director of CBOE's DMFR asking whether there was an "unofficial" way to resolve the matter and stating that it looked like OX Trading was "being penalized for trading only on AIM." OX Trading was not trading only on AIM.

36. On June 30, CBOE explained to optionsXpress' counsel that "[t]he characteristic that we see as primary in deeming OX Trading a 'dealer' is that it engages in a business of buying and selling securities for its own account. Moreover, this business is conducted entirely with optionsXpress, Inc. customer accounts."

37. In early July 2010, Stern contacted the Commission about reactivating OX Trading's registration noting that "we have no desire to apply for a no-action letter." At the same time, OX Trading's outside counsel sent a letter to CBOE offering to apply for dealer registration with the Commission and to obtain access/membership with an exchange.

38. On July 20, 2010, OX Trading filed an application for registration with the Commission and was granted conditional approval on August 26, 2010. For its SEC registration to become effective, OX Trading was required to be a member of FINRA or an exchange.

39. On August 31, 2010, OX Trading applied for BATS membership but withdrew its application on October 7, 2010. When asked why OX Trading withdrew its BATS application, OX Trading's head trader responded: "There was more anticipated oversight . . . than we thought."

40. On October 6, 2010, OX Trading filed an application with CBOE. The application was approved on November 9, 2010 and the necessary access permits were issued on November 12, 2010. However, OX Trading requested an effective date of December 1 so "we don't get charged [for November]." Nevertheless at CBOE's insistence, the SEC registration and CBOE trading permit became effective on November 16, 2010.

41. From March 2, 2009 to November 16, 2010, OX Trading executed approximately 1.3 million trades. Its gross profits from March 2009 to November 2010 were approximately \$3.5 million.

Post-Registration Misconduct

42. On July 29, 2011, the staff issued a Wells notice to OX Trading, optionsXpress, and Stern advising them that the staff intended to recommend to the Commission that it institute these proceedings against them in connection with OX Trading's operation as an unregistered dealer.

43. On August 1, 2011, Stern drafted an allegedly exculpatory letter on optionsXpress letterhead that he backdated to February 2, 2009. The letter was addressed to CBOE and signed by Stern. The letter was purported to show that Stern had informed CBOE that OX Trading would de-register and become a customer of optionsXpress.

44. Stern emailed in-house counsel a copy of the fabricated letter with the intent that it be used in their Wells response. Although it was not eventually attached

to the Wells response, the contents and exculpatory purpose of the fabricated letter were reflected in the Wells response.

45. Stern fabricated a second allegedly exculpatory backdated document on July 11, 2011 and amended it on July 12, 2011. The letter was attached to a Wells response submitted to the CBOE in an unrelated proceeding.

46. On February 27, 2012, Schwab informed the Commission staff, pursuant to Rules 17a-5(h)(2) and 17a-11(e) and (g), that it had identified a material internal control inadequacy at OX Trading.

C. VIOLATIONS

47. As a result of the conduct described above, from October 17, 2009 to November 16, 2010, OX Trading willfully violated Section 15(a) of the Exchange Act which makes it unlawful to induce or attempt to induce any purchase or sale of a security unless such a dealer is registered.

48. As a result of the conduct described above, from March 2, 2009 to November 16, 2010, OX Trading willfully violated Section 15(b)(8) of the Exchange Act that makes it unlawful for a broker-dealer to effect any transaction in any security (other than commercial paper, bankers' acceptances, or commercial bills) unless it is a member of a registered national securities association or effects transactions solely on a national exchange of which it is a member.

49. As a result of the conduct described above, Stern and optionsXpress caused and willfully aided and abetted OX Trading's violations of Sections 15(a) and 15(b)(8) of the Exchange Act.

III.

In view of the allegations made by the Division of Enforcement, the Commission deems it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine:

A. Whether the allegations set forth in Section II hereof are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations;

B. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 15(b) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Respondents pursuant to Section 9(b) of the Investment Company Act; and

D. Whether, pursuant to Section 21C of the Exchange Act, Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Exchange Act Sections 15(a) and 15(b)(8) and whether Respondents should be ordered to pay a civil penalty pursuant to Section 21B(a) of the Exchange Act, and whether Respondents should be ordered to pay disgorgement pursuant to Sections 21B(e) and 21C(e) of the Exchange Act.

IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondents fail to file the directed answer, or fail to appear at a hearing after being duly notified, the Respondents may be deemed in default and the proceedings may be determined against them upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondents personally or by certified mail.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 300 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision of this matter, except as witness or counsel in proceedings held pursuant to notice. Since this proceeding is not "rule making" within the meaning of Section 551 of the Administrative Procedure Act, it is not deemed subject to the provisions of Section 553 delaying the effective date of any final Commission action.

By the Commission.

Elizabeth M. Murphy
Secretary