UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-14848

In the Matter of

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

Respondents.

RESPONDENT THOMAS E. STERN'S RESPONSE TO THE DIVISION OF ENFORCEMENT'S POST-HEARING BRIEF

Respondent Thomas E. Stern ("Mr. Stern"), by and through his attorneys, respectfully submits this Response to the Division of Enforcement's Post-Hearing Brief ("Response").

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INTRODUCTION

After seventeen days of trial testimony, the Division of Enforcement ("Division") has failed to prove that Mr. Stern knowingly and willfully aided and abetted, or even acted as a contributing cause of, alleged violations of the securities laws. To the contrary, the trial established that Mr. Stern served as optionsXpress, Inc.'s ("optionsXpress") Chief Financial Officer ("CFO"), its regulatory liaison, and as a "utility infielder," performing spot-projects and dispensing the wisdom he had amassed more than 35 years in the securities industry. Regardless of the role, the evidence at trial demonstrated that Mr. Stern's involvement in and responsibility for the trading at issue in this case was limited and reasonable, such that it could not amount to a violation of securities laws.

As CFO, Mr. Stern was responsible for understanding and monitoring the firm's capital position and filing financial reports with regulators; he was not responsible for deciding how optionsXpress would comply with Rule 204 of Reg. SHO or in deciding whether its customers could engage in certain options trading.[1] In this capacity, Mr. Stern relied on the executive officers in charge of compliance and trading—Phillip Hoeh and Peter Bottini, respectively—to make decisions regarding compliance and customers' trading. Interestingly, the Division chose not to call these two executive officers as witnesses at trial, although the Securities and Exchange Commission ("SEC") separately has entered into settlements with them about the conduct at issue in this case. Even though they were not witnesses at trial, trial testimony established that Mr. Hoeh, not Mr. Stern, oversaw optionsXpress' compliance with Reg. SHO, while Mr. Bottini oversaw optionsXpress' interactions with its customers.

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[1] Rule 204 is found at 17 C.F.R. § 242.204. Throughout this brief, we refer to 17 C.F.R. § 242.200, *et. seq* as "Reg. SHO."

For instance, the evidence proved that, after August 2009, Messrs. Hoeh and Bottini made the decision to pair customers' sales of deep-in-the-money calls with optionsXpress' purchases of stock needed to cover open short positions (we refer to these paired transactions as "buy-writes"). In addition, testimony at trial established that Messrs. Hoeh and Bottini discussed the buy-writes with Mr. Stern—and agreed to call regulators to discuss the trading at issue—but that they did not look to Mr. Stern for affirmative guidance or direction as to whether the buy-writes were legally appropriate. Also, although these executive officers asked Mr. Stern to look over the shoulders of the trading and operations group members responsible for taking actions required by Reg. SHO for a limited period, in order to make sure certain internal compliance policies were being met, they did not ask for him to ensure that optionsXpress was generally compliant with Reg. SHO.

Stretching the evidence and attempting to draw unsupported inferences, the Division argues that Mr. Stern was ***aware*** of the customer trading at issue in this case and knew there was some question as to whether or not the buy-writes in which optionsXpress engaged were proper. The Division further argues that Mr. Stern became "intimately familiar" with the trading at issue by looking over shoulders and having the types of conversations described above. The preponderance of the evidence, however, demonstrates that Mr. Stern did not know—nor should he have known—that there was anything improper about the trading at issue in this case, irrespective of whether he was ***aware*** of the trading.

Perhaps to make up for its lack of evidence, the Division also makes a number of *ad hominem* attacks on Mr. Stern, none of which relate to the legal issues in this case. *See, e.g.,* Div. Br. at 41. Based on these character attacks, the Division asserts that Mr. Stern had the requisite state of mind to be held responsible as an aider and abetter of alleged primary violations

committed by optionsXpress and Mr. Jonathan Feldman ("Mr. Feldman"). Div. Br. at 41. The Division further argues that he should be deemed a "cause" of violations by optionsXpress and Mr. Feldman because he did not stop the buy-writes. *Id.* at 40-41.

Yet, when examining the facts that actually apply to this case, it is plain—*ad hominem* attacks notwithstanding—that the Division simply has not presented sufficient evidence to prove that Mr. Stern knowingly or negligently assisted or caused: (i) optionsXpress's alleged failure to properly close out short stock positions in accordance with Rule 204 of Reg. SHO, or (ii) Mr. Feldman's alleged manipulative and deceptive scheme that purportedly violated 15 U.S.C. § 77q(a) ("Section 17(a)"), 15 U.S.C. § 78j(b) ("Section 10(b)"), and 17 C.F.R. §§ 240.10b-5 & 10b-21 ("Rule 10b-5" and "Rule 10b-21," respectively). In the subsequent sections, Mr. Stern sets forth proposed findings of fact and legal arguments germane to each of these issues.[2]

PROPOSED FINDINGS OF FACT

Mr. Stern's Role at optionsXpress, Inc.

1. Mr. Stern worked at optionsXpress, Inc. from 2001 through 2012. Tr. at 1618:2-16 (Stern).[3] During that time, Mr. Stern was the Chief Financial Officer ("CFO") of optionsXpress, Inc. and the firm's Series 27 registered Financial Operations Principal ("FINOP"). Tr. at 1622:3-18 (Stern). In this capacity, Mr. Stern reported to Ned Bennett, the Chief Executive Officer of optionsXpress, Inc. Tr. at 1622:19-23 (Stern); Div. Ex. 162 (Stern Tr.) at 22:18-21.

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[2] Mr. Stern also adopts and incorporates, by reference, the findings of fact and legal arguments from the post-hearing briefs of the other Respondents in this matter. Mr. Stern refers to Mr. Feldman's brief and findings of fact as JF Br. and JF FOF, respectively, and to optionsXpress' brief and findings of fact as OXPS Br. and OXPS FOF, respectively.

[3] Mr. Stern cites to the hearing transcript as "Tr." Mr. Stern also cites to his own investigative testimony as "Stern Tr."

2. As optionsXpress, Inc.'s CFO and FINOP, Mr. Stern was responsible for reporting the financial capital conditions of the brokerage firm and understanding the implications of financial capital requirements on operations. Tr. at 1627:9-1628:2 (Stern); *See also* NASD Rule 1022. Mr. Stern also was responsible for the firm's portfolio margin reporting. Tr. at 1629:20-1630:5 (Stern); Div. Ex. 162 (Stern Tr.) at 25:3-8.

3. Adam DeWitt—not Mr. Stern—was the CFO of optionsXpress Holdings, the parent company of optionsXpress, Inc. Tr. at 1630:2-5, 1835:10-16 (Stern). In that capacity, Mr. Dewitt managed the risk associated with portfolio margining and evaluated the costs associated with borrowing stock. Tr. at 1630:2-5; 1647:25-1648:6 (Stern).

4. Ben Morof, the former Chief Compliance Officer of optionsXpress, Inc., left the firm in 2009. Tr. at 1623:14-17 (Stern). After Mr. Morof left, optionsXpress selected Mr. Stern to step in as the firm's primary regulatory liaison because he had more than 35 years of industry experience. Tr. at 1623:20-25 (Stern).

5. As the firm's primary regulatory liaison, Mr. Stern received regulatory correspondence on behalf of optionsXpress, Inc. Tr. at 1630:12-18 (Stern); Tr. at 3460:5-25 (Strine). He also reserved conference rooms, coordinated meetings and escorted visiting regulators around the office. Tr. at 1831:17-1833:16 (Stern); Tr. at 3460:5-25 (Strine). Essentially, he served as the firm's host. Tr. at 1831:17-21 (Stern); Tr. at 3460:5-25 (Strine) (describing Mr. Stern as "kind of the face of the company").

6. As the regulatory liaison, Mr. Stern did receive some correspondence regarding Reg. SHO compliance. The majority of regulatory correspondence regarding Reg. SHO, however, was exchanged between regulators and members of optionsXpress' Compliance

Department (such as Ben Morof, Phil Hoeh and Kevin Strine.) *See, e.g.*, Resp. Ex. 40, 151, 415; Tr. at 3461:22-3462:5 (Strine).

7. Mr. Stern was not a compliance officer at optionsXpress and he did not make decisions regarding Reg. SHO compliance. Tr. at 270:7-22 (Risley); Tr. at 504:15-22 (Tortorella); Tr. at 646:14-19 (Coronado); Tr. at 1223:12-23 (Stella); Tr. at 1819:7-11, 1830:18-1831:2 (Stern); Tr. at 3458:12-3459:25 (Strine).

8. Kevin Strine—not Mr. Stern—was responsible for putting together optionsXpress' responses to regulatory inquiries and requests. Tr. at 3461:22-3462:5 (Strine). Mr. Stern simply collected the responses and sent them to the regulators. Tr. at 3460:5-25 (Strine) (noting that Mr. Stern "was just the central point [of contact]" and that Mr. Stern was simply responsible for "mak[ing] sure that nothing was missed").[4]

9. Mr. Stern at no point "overruled" the Compliance Department at optionsXpress, nor did he have the power to do so. Tr. at 1819:7-11 (Stern); Tr. at 3458:12-3459:25 (Strine).

10. Mr. Stern had no authority over trading procedures at optionsXpress. Tr. at 348:23-349:14 (Molnar); Tr. at 504:3-18 (Tortorella); Tr. at 646:20-647:4 (Coronado); Tr. at 1223:17-20 (Stella); Tr. at 1819:2-6 (Stern).

11. Jay Risley, the Executive Vice President of Operations, not Mr. Stern, was responsible for ensuring that optionsXpress' buy-in procedures occurred as designed. Tr. at 1831:3-16 (Stern).

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[4] The Division cites to Mr. Strine's testimony as support for the misleading proposition that Mr. Stern "was the point person for the firm's [regulatory] responses." Div. FOF at ¶ 5. In reality, as Mr. Strine made plain, Mr. Stern was simply a "go-between" who would collect the regulatory responses from others at optionsXpress and send them along to the regulators. Tr. at 3460:5-25 (Strine). The correspondence between CBOE and FINRA on the one hand, and optionsXpress on the other hand makes clear that optionXpress' primary regulators understood Mr. Stern's role in the process to be non-substantive. *See* Resp. Ex. 40, 151, 415.

12. Mr. Stern did not oversee day-to-day operations at optionsXpress. Tr. at 646:5-647:4 (Coronado) (correcting his prior misstatement).[5]

13. Mr. Stern was a "utility infielder" at optionsXpress. Tr. at 1627:9-1628:2 (Stern). Mr. Stern's colleagues often would ask him for his opinion on various topics because he had more than 35 years of industry experience. Tr. at 1627:16-1628:2, 1818:10-23 (Stern); Tr. at 3458:12-3459:5 (Strine).

Mr. Stern's Background/Regulatory Record

14. Prior to joining optionsXpress, Mr. Stern traded on the floor of the Chicago Board Options Exchange ("CBOE") for roughly 17 years. Tr. at 1626:6-1627:5 (Stern).

15. Prior to 2011, Mr. Stern had a completely clear regulatory record after more than 35 years in the securities industry. Tr. at 1810:23-1811:4 (Stern).

16. In 2011, Mr. Stern's [redacted]

17. Mr. Stern admits that he submitted a Wells response to CBOE on August 12, 2011 that contained inaccurate information. Tr. at 1792:1-3 (Stern). Mr. Stern admits this was his fault, and he takes full responsibility for this unfortunate oversight. Tr. at 1783:15-20, 1784:20-1785:2, 1792:11-15 (Stern).

18. The Wells response incident of 2011 was an anomaly—Mr. Stern had never made such mistakes in the course of his lengthy career. Tr. at 1812:19-1813:4 (Stern). It was Mr. Stern's practice to be forthright and forthcoming with regulators. Tr. at 1813:5-14 (Stern).

[5] The Division cites to Mr. Coronado's admitted misstatement as support for its disingenuous assertion that Mr. Stern "oversaw the day-to-day operations at optionsXpress." Div. FOF at ¶ 4.

19. On August 8, 2012, Mr. Stern submitted a Letter of Consent in order to resolve a proceeding initiated by CBOE's Business Conduct Committee. Div. Ex. 420 (CBOE Decision) at 1-2. Mr. Stern submitted this Letter of Consent without admitting or denying that a violation of Exchange Rules had been committed. *Id.* CBOE accepted Mr. Stern's Letter of Consent in a decision dated September 20, 2012. *Id.*

Mr. Stern's Participation In Calls With Regulators

20. On September 24, 2009, Messrs. Hoeh and Bottini pulled Mr. Stern into a discussion they were having about the buy-write trades. Tr. at 1817:6-11 (Stern). Messrs. Hoeh and Bottini explained their reasons for bundling the trades as buy-writes and asked Mr. Stern to provide a "sanity check" for them. Tr. at 1817:15-1819:1 (Stern). They did not ask Mr. Stern for guidance or direction as to whether the buy-writes were legally appropriate. Tr. at 1818:10-1819:1 (Stern). Messrs. Hoeh and Bottini determined they should seek regulatory guidance regarding the buy-writes. Tr. at 1817:15-1818:9 (Stern).

21. Later that same day, as Mr. Stern was walking through the office, Hillary Victor, optionsXpress' in-house counsel, and Peter Bottini stopped him and asked him to join them on a call with regulators from the Financial Industry Regulatory Authority ("FINRA"). Tr. at 1816:12-1817:5 (Stern). Compliance officers Philip Hoeh and Kevin Strine were also on the call for optionsXpress. Tr. at 3405:2-14 (Strine).

22. optionsXpress specifically called FINRA to determine if it was the SEC's intent—through Reg. SHO or otherwise—to prohibit retail customers like Mr. Feldman from selling in-the-money calls at the same time as a Reg. SHO buy-in was taking place for the same security. Tr. at 2715:21-2716:6, 2717:9-19 (Aylward); Tr. at 3407:15-25 (Strine); Resp. Ex. 665 (Notes of FINRA's Jocelyn Mello) at 1; Resp. Ex. 729 (Victor's Notes) at 2.

23. In addition, optionsXpress sought guidance as to whether it could pair its buy-in with the customer's purchase of calls in the same security as a "buy-write." Tr. at 3404:11-24 (Strine). At that time, FINRA had detailed information about the buy-writes. Tr. at 3405:7-3406:9 (Strine).

24. On the call with FINRA, Mr. Stern diagramed the customer trades at issue and explained the OCC's random assignment process. Tr. at 1728:17-1729:2 (Stern). Mr. Stern handled this portion of the call because Ms. Victor asked him to do so—likely because of his extensive trading experience. Tr. at 1729:3-12 (Stern).

25. During the call, optionsXpress gave FINRA the name and phone number of the CBOE investigator who reviewed the customer trading at issue and concluded that optionsXpress had not violated Reg. SHO. Tr. at 2716:21-2717:3 (Aylward); Resp. Ex. 665 (Notes of FINRA's Jocelyn Mello) at 2.

26. optionsXpress also explained to FINRA that its compliance team reviewed the rules and available regulatory guidance, but couldn't find a rule that was directly on point with regard to the customer trading at issue. Tr. at 2718:7-14 (Aylward); Resp. Ex. 665 (Notes of FINRA's Jocelyn Mello) at 1-2.

27. optionsXpress told FINRA that it would allow the trading at issue to continue, including pairing trades as buy-writes unless its regulators provided clear guidance to the contrary because optionsXpress had concerns about another rule addressing best execution. Tr. at 2721:3-13; 2724:11-25 (Aylward); Resp. Ex. 665 (Notes of FINRA's Jocelyn Mello) at 2.

28. FINRA declined to comment, given its pending investigation of optionsXpress, and suggested optionsXpress call the SEC. Tr. at 2720:6-23 (Aylward). FINRA did not point

optionsXpress to a specific rule or suggest that optionsXpress review any particular regulatory Settlements or circulars. Tr. at 2719:5-15 (Aylward); Tr. at 3408:24-3409:8 (Strine).

29. Mr. Stern did not make any statements about Jonathan Feldman or Mark Zelezny on the September 24, 2009 call with FINRA. Tr. at 1828:22-1829:1 (Stern).

30. Later that same day, Mr. Stern participated in a call with regulators from the SEC's Division of Trading & Markets ("Trading & Markets"). Tr. at 1731:19-1732:1 (Stern); Tr. at 3416:10-19 (Strine). Ms. Victor, Mr. Hoeh and Mr. Strine also participated in this call from optionsXpress. Tr. at 1731:19-1732:1 (Stern); Tr. at 3416:10-19 (Strine).

31. Ms. Victor "took the lead" on the call with Trading & Markets. Tr. at 3416:23-3417:6 (Strine). Mr. Stern again diagramed the customer trades at issue because Ms. Victor, Mr. Hoeh and Mr. Strine asked him to do so. Tr. at 1732:10-1733:8 (Stern).

32. On the call with Trading & Markets, Mr. Stern attempted to explain that optionsXpress was entering the order for the stock buy-in, and the customer was entering the order to sell calls. Tr. at 1735:16-1736:4 (Stern). In providing examples of the trading at issue, optionsXpress was attempting to explain that the customers (i) had control over the writing of calls (Tr. at 1735:16-1736:4 (Stern)); and (ii) were not assigned on the same amount of calls every day—the number was "different" (Tr. at 3421:12-3422:16 (Strine)).

33. During the call, optionsXpress also referred Trading & Markets to Daniel Overmyer, the CBOE investigator who reviewed the customer trading at issue and concluded that optionsXpress had not violated Reg. SHO. Tr. at 3684:6-17 (Tao); Resp. Ex. 579 (Notes of Trading & Markets' Victoria Crane) at 2.

34. Despite the fact that Ms. Tao previously had discussed optionsXpress' customer trading with Mr. Overmyer *and* reviewed a detailed memo Mr. Overmyer drafted regarding the

same trade activity, Ms. Tao claims she drew no connection between her prior communications with Mr. Overmyer and the trading described by optionsXpress on the September 24, 2009 call. Tr. at 3662:14-3663:16; 3684:21-3685:1 (Tao).

35. Trading & Markets approved optionsXpress' use of buy-writes, saying: "keep doing what you're doing." Tr. at 1746:1-12 (Stern); Resp. Ex. 729 (Victor's Notes) at 3; Resp. Ex. 246 (Stern Email) at 2.[6]

36. Ms. Victor and Mr. Stern had a third regulatory phone call—this time with Trading & Markets—in early October 2009. Tr. at 1753:3-9 (Stern). Mr. Stern does not recall Trading & Markets saying anything in October 2009 suggesting that the SEC wanted optionsXpress to stop doing buy-writes. Div. Ex. 168 (Stern Tr.) at 336:10-339:25.

37. There is no evidence that, after the October 2009 call, Ms. Victor instructed or advised anyone at optionsXpress to stop the buy-write trading.

38. Messrs. Stern and Strine do not recall a subsequent call with FINRA on October 2, 2009. Tr. at 1755:10-20 (Stern); Tr. at 3434:20-3435:6 (Strine).[7]

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[6] The Division attempts to discredit Mr. Stern's recollection of the guidance offered by Trading & Markets by attacking his character (Div. Br. at 40-42), but Mr. Stern's recollection is supported by both Ms. Victor's handwritten notes from the phone call and a contemporaneous email sent by Mr. Stern to Mr. Bottini. In fact, Ms. Tao—not Mr. Stern—offers a dubious, unsupported version of events. *See* Tr. at 3611:4-23, 3612:22-3613:13 (Tao).

[7] The Division cites to *SEC v. Daifotis*, 2012 WL 2051193 (N.D. Cal. June 7, 2012), for the proposition that the Court should find the lack of recollection by Messrs. Stern and Strine on this point "troubling." Div. FOF at ¶¶ 206 and 272. To begin with, when two witnesses have the same recollection—particularly when one is not involved in the litigation—it should be corroborative, rather than "troubling." In addition, Mr. Stern's recollection at trial was the same as it was during his investigative testimony, which took place closer in time than the trial. Div. Ex. 168 (Stern Tr.) at 339:23-25. Regardless, *Daifotis* does not address the issue for which the Division cites it; instead, the case is a pre-trial decision addressing solely the admissibility of ***expert opinions*** and offers no guidance whatsoever regarding a court's determination of the credibility of ***fact witnesses*** who have already testified at trial. *See Daifotis*, 2012 WL 2051193 at *1 ("In this enforcement action, the Securities and Exchange Commission moves to exclude opinions in various sections of the expert report of Charles R. Lundelius.").

Mr. Stern's Limited Reg. SHO Involvement

39. In 2008, optionsXpress changed its buy-in procedure in order to comply with a Rule 204T emergency order and began buying-in its customers on T+4. Tr. at 3283:10-3284:18 (Strine).

40. Ned Bennett, the CEO of optionsXpress, Inc. and the Executive Vice Chairman of optionsXpress Holdings, and David Fisher, the CEO of optionsXpress Holdings, asked Mr. Stern to review the implementation of the new buy-in procedure. Tr. at 1834:9-1835:2 (Stern). Mr. Bennett and Mr. Fisher consulted Mr. Stern because he was their "utility infielder." *Id.* Mr. Stern specifically checked to make sure customers could no longer buy themselves in. Tr. at 1688:23-1689:21 (Stern).[8]

41. Sometime later in 2009, Adam Dewitt, the CFO of optionsXpress Holdings, Inc. (optionsXpress' parent company) came to Mr. Stern and told him that optionsXpress was experiencing larger than normal capital requirements at the Depositary Trust Company ("DTC"), the National Securities Clearing Corporation ("NSCC"), and the Options Clearing Corporation ("OCC"). Tr. at 1835:10-1836:4 (Stern). Other options companies noticed similar increases in their capital requirements around this same time. Tr. at 832:24-833:6 (Crain); Tr. at 1848:22-1849:9 (Stern).

42. Mr. DeWitt asked Mr. Stern to monitor liquidity at optionsXpress to determine why its clearing firms were suddenly requiring significant additional cash. Tr. at 1836:5-24 (Stern). Mr. Stern concluded that the additional capital requirement came primarily from option assignments that created short stock positions and, ultimately, necessitated buy-ins. Tr. at 1836:25-1837:20 (Stern); *See also* Div. Ex. 168 (Stern Tr.) at 257:14-258:12 (Stern noting in

[8]Mr. Stern continued checking to make sure optionsXpress customers could no longer buy themselves in for approximately two weeks. Div Ex. 162 (Stern Tr.) at 64:3-19.

investigative testimony that a "fail at T+4 would become a capital haircut if not bought in," and that he was responsible for evaluating such matters).

43. Mr. Stern based his findings on information he received from Kevin Strine, Scott Tortorella and Ron Molnar. Tr. at 1837:21-1838:7 (Stern). Mr. Stern reported his findings to Jay Risley, Ned Bennett, Adam DeWitt and David Fisher, who ultimately decided to change the firm's procedures so that buy-ins would happen on T+1. *Id.* Mr. Stern simply provided his recommendation on the subject—he did not participate in the decision to alter the firm's buy-in procedure. *Id.*

44. Mr. Risley, Mr. Molnar and Mr. Tortorella put the revised buy-in procedures together and drafted a document outlining the new procedures. Tr. at 295:9-23 (Molnar); Tr. at 1838:18-1839:7 (Stern); Div. Ex. 128 (Molnar-Hoeh Email).

45. The Operations Department consulted with the Compliance Department—not Mr. Stern—on how to best handle the buy-in procedures. *See* Resp. Ex. 526 (Strine-Molnar Email); Div. Ex. 128 (Molnar-Hoeh Email); Tr. at 1839:8-1840:20 (Stern).

46. After optionsXpress switched to the T+1 buy-in procedure, Mr. Stern spent two or three days monitoring the implementation of the new policy. Tr. at 1673:9-1674:1 (Stern); Div. Ex. 162 (Stern Tr.) at 80:17-23. Mr. Stern took it upon himself to make sure the firm was following its amended procedures—this was not his job function. Tr. at 1675:20-1677:15 (Stern).

47. Mr. Stern supported, but was not involved in, optionsXpress' March 2010 decisions to handle all buy-ins at stock purchase and to no longer allow buy-write bundling. Tr. at 1841:12-1842:13 (Stern).[9]

[9] The Division cites to Mr. Stern's trial testimony for the grossly exaggerated assertion that Mr. Stern was involved in optionsXpress' decision to halt the buy-write trades. Div. FOF at ¶ 237. Mr. Stern merely offered his personal

48. During the period of time in which optionsXpress was bundling buy-writes together, three different attorneys employed by optionsXpress—Ben Morof, Hillary Victor and Kevin Strine—all reviewed prior Reg. SHO enforcement actions and distinguished the improper activity in those cases from the customer trading and buy-writes they saw at optionsXpress. *See* Tr. at 216:12-217:10 (Risley); Tr. at 3295:1-3297:5, 3337:14-3339:5 (Strine); Resp. Ex. 729 (Victor's Notes) at 2.

Mr. Stern's Involvement With Messrs. Feldman And Zelezny

49. During Mr. Stern's tenure at optionsXpress, he had only one brief, non-substantive conversation with Mr. Feldman. Tr. at 1635:24-1636:11 (Stern) (stating he only met Mr. Feldman once and they only spoke for "about 3 to 5 minutes"); Tr. at 2623:5-21 (Feldman) (acknowledging that Mr. Stern "popped in to say hello" during his visit to optionsXpress, but they never had a substantive discussion regarding trading strategy).

50. Mr. Stern had conversations about Mr. Feldman with August Payne, but those conversations concerned only the number of shares that needed to be covered in Mr. Feldman's account (an issue that impacted optionXpress' capital position with its clearing firms, *supra* at ¶42). *See* Resp. Ex. 939 (Payne Tr.) at 114:14-115:18. Messrs. Stern and Payne never discussed Mr. Feldman's Sears (or "SHLD") positions or Reg. SHO. *Id.* at 117:12-19, 135:11-12.

51. On one occasion, Mr. Stern spoke with the CEO of Penson about Mr. Feldman's account. Tr. at 1848:22-25 (Stern). Penson's CEO told Mr. Stern that Penson could no longer carry Mr. Feldman's account because the associated capital requirement was so large. Tr. at 1849:1-19 (Stern).

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recommendation that the firm stop the trading—he was not involved in the ultimate policy decision. Tr. at 1696:22-1697:5 (Stern).

52. Mr. Stern learned that Mark Zelezny was a portfolio margin customer only after optionsXpress received a letter of caution from CBOE regarding Mr. Zelezny's trading activity. Tr. at 1637:18-1638:6 (Stern). Mr. Stern never made the observation that both Messrs. Feldman and Zelezny were using box spread trading strategies. Tr. at 1637:7-17 (Stern).

53. Mr. Stern knew nothing about optionsXpress' buy-in process prior to seeing CBOE's letter of caution in September 2009. Tr. at 1669:8-20 (Stern).

54. After optionsXpress received CBOE's letter of caution in September 2009, Mr. Stern learned that, after a detailed examination, CBOE had not concluded that it violated Reg. SHO to sell deep-in-the-money calls at the same time as buying-in stock. Tr. at 1815:13-25 (Stern).

Expert Testimony Of John M. Ruth

55. Mr. Ruth has a B.A. in economics from Indiana University and an MBA in finance from the Kellstadt Graduate School of Business at DePaul University. Resp. Ex. 250 (Ruth Rpt.) at ¶ 1.

56. Mr. Ruth has nearly 20 years of experience in the financial industry. *Id.* at ¶ 2. Mr. Ruth holds his Series 4, 7, 10, 24, 55 and 63 FINRA licenses. *Id.* He is also registered as an NFA Principal, Associate Member, Branch Manager and Series 3 Associated Person. *Id.*

57. From 2000 through March 2012, Mr. Ruth worked for Goldman Sachs Execution & Clearing L.P. ("GSEC"), a prominent broker-dealer that serves as the clearing broker for some of the largest liquidity providers and options market makers in the securities industry. *Id.* at ¶ 3. At GSEC, Mr. Ruth held the titles of Vice President and Managing Director. *Id.*

58. Mr. Ruth was the only testifying expert at trial with actual experience managing a broker-dealer and complying with Reg. SHO. Mr. Ruth offered a series of uncontested opinions

regarding how actors in the securities industry would behave generally and how they would react to regulatory guidance. Because Mr. Ruth was credible and his opinions supported by the evidence and otherwise uncontested, the Court adopts many of Mr. Ruth's opinions.

59. To begin with, the Court adopts Mr. Ruth's opinions concerning Mr. Stern's position within optionsXpress:

- At a trading firm, the CFO would not reasonably be expected to know the details of the firm's trading policies and procedures, including the customers' trading strategies or the manner in which the firm closed out short positions. *Id.* at ¶ 50.
- It was reasonable, in the industry, for an individual in Mr. Stern's position to rely on his colleagues who were closer to the trading at issue—specifically Peter Bottini and Phil Hoeh, who were in charge of the customer service trading desk and compliance, respectively—to provide him with information about the buy-writes. *Id.* at ¶ 50. It would be unusual for someone in Mr. Stern's position to have authority over such matters. *Id.*

60. In addition, the Court adopts Mr. Ruth's opinions about the trading at issue in this case:

- The options trading strategies employed by the customers in this case were non-directional, delta neutral strategies that allowed the traders to profit from arbitrage rather than the downward movement of the stock price. *Id.* at ¶ 28. Reg. SHO does not address such economically legitimate, non-directional trading strategies that employ common options products. *Id.*

- The trading in this case differs from the trading at issue in prior enforcement actions because, in this case, the buy-writes did not involve the sale of deep-in-the-money calls to a pre-arranged party using customized, quickly expiring, FLEX options. *Id.* at ¶ 38.
- The calls that were sold in the buy-writes had an economic purpose other than avoiding a delivery obligation. *Id.* at ¶ 39. The in-the-money calls were sold in order to re-establish the hedge, which was a necessary part of the underlying non-directional, delta neutral trade. *Id.*
- At the time of the trading in this case, the law was not clear as to whether it would be improper to use two common options trades—a buy-write and a deep-in-the-money call—in order to comply with Reg. SHO and renew a hedge in a common option trade (the reversal). *Id.* at ¶ 41.
- The SEC has not (despite repeated requests from the International Securities Exchange) regulated the use of deep-in-the-money calls. *Id.* at ¶ 43. Nor is there any guidance—or even industry standard definition—for what constitutes a "deep" in-the-money call. *Id.*
- Given the amount of uncertainty surrounding how Reg. SHO applied to options trades, optionsXpress looked for guidance and received comfort that its approach to closing out short positions created by the exercise and assignment of deep-in-the-money calls was appropriate. *Id.* at ¶ 42. Its primary regulator, the CBOE, gave it comfort that its use of buy-writes was appropriate. *Id.*
- It was reasonable for optionsXpress to believe—after having received no guidance to the contrary despite having been investigated, audited, subjected to surveillance by, and having repeatedly sought advice from, its regulators—that the buy-writes were an

appropriate way to cover short positions while allowing its clients to remain hedged. *Id.* at ¶ 48.

- The failure of regulators to express a contrary view—even with full knowledge of the trading activity—makes optionsXpress' actions even more reasonable. *Id.* at ¶ 49.

61. Finally, the Court adopts Mr. Ruth's opinions about the actions taken and conclusions drawn by Mr. Stern about the trading in this case:

- Within the context set forth in Findings of Fact ¶¶ 59-60, Mr. Stern acted as a reasonable industry participant in his dealings with respect to Reg. SHO compliance—particularly since he was, at best, an industry resource with respect to the issue, coming in and out of the issue but having no actual authority over or responsibility for how optionsXpress complied with the regulation. Resp. Ex. 250 (Ruth Rpt.) at ¶ 51.
- Within the context set forth in Findings of Fact ¶¶ 59-60, Mr. Stern was not reckless, but was acting reasonably within industry standards, in not offering an opinion that optionsXpress stop using buy-writes and in believing that the trading at issue was appropriate under Reg. SHO. Resp. Ex. 250 (Ruth Rpt.) at ¶ 52.

LEGAL ARGUMENTS

I. NO PRIMARY VIOLATION

As set forth more completely in the post-hearing briefs filed by Respondents optionsXpress and Feldman, which Mr. Stern has incorporated by reference, the Division has failed to prove that there was a primary violation of Rule 204 of Reg. SHO, Section 17(a), Section 10(b), or Rules 10b-5 and 10b-21. Because the Division has not proven a primary securities law violation, Mr. Stern cannot be responsible for either aiding and abetting or causing a primary violation.

In addition to the arguments offered by Respondents optionsXpress and Feldman in their post-hearing briefs, Mr. Stern disputes the Division's assertion that optionsXpress has not proved its entitlement to a pre-fail credit under Rule 204(e). Rule 204(e) provides that a party can receive credit for purchases that take place ***before*** the fail to deliver on T+3, even though the purchases have not been delivered into the CNS system, as long as certain conditions are met. optionsXpress proved at trial, through the unrebutted testimony of Dr. Atanu Saha based on optionsXpress' books and records, that optionsXpress had met Rule 204(e)'s requirements ***99.3% of the time***.

The Division argues that Rule 204(e) imposes requirements on firms seeking to close out potential fail to deliver positions (*i.e.,* an open short position prior to the close of business on T+3) that are more stringent than those found in Rule 204(a). Div. Br. at 18-19. According to the Division, Rule 204(e) requires that a firm attempting to close out a position ***prior to*** T+4 purchase or borrow sufficient shares to ensure that its entire firm is net flat or long and that it demonstrate its compliance with Reg SHO by reducing its CNS fail to deliver to zero. Div. Br. at 19. The Division's interpretation of Rule 204(e) is out of step with the intent of the rule and would wreak havoc on the options industry.

To begin with, as the drafters of Rule 204 have indicated, the Rule 204(e) exception to Rule 204(a) was intended to "encourage broker-dealers to close out fail to deliver positions prior to the close-out date." 74 Fed. Reg. at 38276. The first two subparts of Rule 204(e) require (i) a bona fide purchase and (ii) prior to the close of ordinary business on T+3. Each of these requirements has been met in this case. OXPS Br. at 22-27. Next, read in harmony with the drafters' intent and in context with Rule 204(a), Rule 204(e)(3) and (4) simply require that a firm

have purchased or borrowed securities in like kind and quantity as the fail to deliver position and that it be able to demonstrate that it has done so on its books and records.

The Division argues that Rule 204(e)(3) (and Rule 204(a), for that matter) requires a broker or dealer to "reduce its [CNS] failure to deliver position to zero." Div. Br. at 19. The Rule includes no such explicit language—in either section (a) or (e). Further, reading such a requirement into the Rule would wreak havoc on the options industry. To begin with, as CNS employee Louis Colacino testified at trial, CNS nets all trades in a single day and does not account for purchases that may be offset by newly assigned options. *See* OXPS Br. at 11. Thus, in order for an ***options*** broker or dealer to cure the CNS fail, it would have to require that all of its customers refrain from exercising puts or immediately unwind all call positions for each security for which it had a fail to deliver position, lest the customer obtain an open short stock position through the exercise of puts or receive a random assignment on its calls sufficient to offset the purchase of shares at CNS.

The Division further argues that Dr. Saha's analysis of optionsXpress' books and records was insufficient to meet Rule 204(e)(4)'s requirements because Dr. Saha did not look beyond the six accounts at issue in this case. Div. Br. at 19. However, the Division misunderstands Rule 204(e), which only requires that the firm demonstrate that it has "purchase[d] or borrow[ed] a quantity of securities sufficient to cover the entire amount of that broker-dealer's fail to deliver position ... in that security." 74 Fed. Reg. 38266 at 38276. In other words, the broker or dealer must simply prove that it had covered the amount of its fail on its books and records, not that it closed "out its short position." *See id.*

This is, in fact, what Dr. Saha did: he analyzed the trading in the six accounts that had fail to deliver positions. Indeed, Dr. Saha testified that the full extent of the fail to deliver position—

found in the accounts of six optionsXpress customers—was closed out in full ***99.3% of the time*** by T+3. As Dr. Saha further testified, his analysis was based on the "trade data from the books and records" of optionsXpress. OXPS FOF at 274-276 He amplified this point in his analysis of the trading activity in Sears Holdings Corp., in a color chart (at page 31 of Resp. Ex. 248 (Saha Rpt.), OXPS FOF at 294) that clearly demonstrates that optionsXpress was purchasing the exact amount of shares for which it had a reported failure to deliver. Finally, Dr. Saha testified that analysis of the accounts of optionsXpress' customers that did not have a failure to deliver position likely would show that optionsXpress had inventory in the securities with fail to deliver positions that could raise the total coverage to 100%. OXPS FOF at 278.[10] The Division has not alleged, much less presented a shred of evidence (save the CNS data, which was discredited for the purpose of showing Reg. SHO compliance or lack thereof by Mr. Colacino (OXPS Br. at 12) and whether delivery had occurred by Dr. Harris (Tr. at 1451:18-22)) suggesting, that optionsXpress had any other failure to deliver in the securities at issue.[11]

In short, the Division's reading of Rule 204(e) is untenable; it goes against the intent of 204(e) exception in a manner harmonious with the rule itself (set out in Rule 204(a)), as the drafters and would wreak havoc on the industry. Instead, the Court should read the Rule requiring a broker or dealer to demonstrate, on its books and records, that (i) it entered into a bona fide purchase, (ii) by the close of ordinary business on T+3, (iii) of a like kind and quantity

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[10] The Division's expert, Dr. Lawrence Harris, offered testimony that bolsters Dr. Saha's findings. In his report, he admitted that delivery occurred consistent with a purchase of like kind and quantity of securities 98.4% of the time within five days of T+3. Div. Ex. 310 (Harris Rpt.) at ¶ 196. Dr. Harris did not look at what occurred between T+3 and T+8 with respect to delivery. Tr. 1490:1-8, 1491:2-4 (Harris). Thus, Dr. Harris' findings are consistent with Dr. Saha's findings.

[11] The Division referenced 204(e) in paragraph 17 of the Order Instituting Proceedings, but did not suggest that optionsXpress had failed to meet the strictures of the rule. In addition, no one from CBOE, FINRA or Trading & Markets ever suggested that optionsXpress was not sufficiently curing fail to deliver positions because it was curing them pre-fail, even though the regulators had trade-blotter level detail about the trading at issue.

of securities as demonstrated on its books and records, (iv) sufficient to net out against what appeared in CNS on T+4 as a fail to deliver. And, as Dr. Saha testified at trial (based on optionsXpress's books and records), optionsXpress did just that.

B. NO AIDING AND ABETTING

1. Legal Standard for Aiding and Abetting.

In order for the Division to establish that a respondent has aided and abetted a primary violation of the securities laws, it must prove—by a preponderance of the evidence—the following three elements: (1) that there is an independent, primary securities law violation committed by a party other than the alleged aider and abettor; (2) that the alleged aider and abettor was aware or knew that his or her actions were part of an overall course of conduct that was improper or illegal; ***and*** (3) that the alleged aider and abettor knowingly and substantially assisted the primary violation. *Monetta Fin. Servs., Inc. v. SEC*, 390 F.3d 952, 956-57 (7th Cir. 2004) (emphasis added); *In the Matter of Harrison Securities, INC., Frederic C. Blumer, and Nebrissa Song*, Rel. No. 256, 2004 WL 2109230 (Sept. 21, 2004); *In the Matter of Warren Lammert, et al.*, SEC Rel. No. 348, 2008 WL 1867960, at *1 (April 28, 2008) (applying preponderance of the evidence as the standard of proof in administrative proceedings) (decision made final by SEC Rel. No. 2737, 2008 WL 2219923 (May 29, 2008)). Regardless of whether or not the primary violation requires proof of scienter, the accused aider and abettor must have acted with scienter. *Lammert*, 2008 WL 1867960, at *1.

Scienter is "knowing or intentional conduct, or reckless conduct to the extent that it reflects some degree of intentional or conscious misconduct, or what we have called deliberate recklessness." *In the Matter of Michael C. Pattison, CPA*, SEC Rel. No. 3407, 2012 WL 4320146, at *12 (September 20, 2012) (internal quotations omitted). In other words, scienter is a reflection of the respondent's subjective state of mind. As a result, if the Division relies (as it

does with respect to Mr. Stern) on objective evidence to show recklessness, it must prove that the respondent's conduct "departs so far from the standards of ordinary care that it is very difficult to believe the [respondent] was not aware" that he was providing substantial assistance to an act that violated the securities laws. *In the Matter of David Kaup, et al.*, 2012 WL 5217741, at *5-6, CFTC Docket No. 13-30 (October 22, 2012) (internal quotations omitted). Said differently, "[r]eckless conduct is conduct [that] is highly unreasonable and ... represents an extreme departure from the standards of ordinary care" such that the danger must have either been "known to the defendant or so obvious that the defendant must have been aware of it." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)) (quoted in *In the Matter of Anthony Fields, CPA,* SEC Rel. No. 474, 2012 WL 6042354, at *9 (December 5, 2012) (internal quotations omitted)). As a result, "aiding and abetting liability cannot rest on the proposition that the person 'should have known' he was assisting violations of the securities laws." *Howard v. Sec. & Exch. Comm'n.*, 376 F.3d 1136, 1143 (D.C. Cir. 2004).

2. **The Division Has Not Proved That Mr. Stern's Conduct Was An Extreme Departure From Standards Of Ordinary Care.**

Analogous case law demonstrates that Mr. Stern's conduct was not an "extreme departure" from standards of ordinary care. In *In the Matter of Warren Lammert, et al.*, the Division had issued an Order Instituting Proceedings ("OIP") against three respondents who were alleged to have been involved in market timing trades, in violation of Section 17(a) and Section 10(b), among other laws. They also were alleged to have "willfully aided and abetted and caused" primary violations by Capital Management LLC. *Lammert*, 2008 WL 1867960, at *1-2 & n. 2. In analyzing the facts, Administrative Law Judge Carol Fox Foelak concluded that

none of the three respondents had "willfully aided and abetted" primary violations. She reached this conclusion largely based on a few facts that are very similar to the facts in this matter.

In particular, Judge Foelak concluded that:

> No Respondent acted with knowledge that his role was part of an overall activity that was improper or encountered red flags that should have alerted him to improper conduct of a primary violator; nor was there a danger so obvious that any Respondent must have been aware of it. As a general matter, Respondents did not conceal the timing relationships with TWC and Brean Murray, which were widely known at Janus, including to legal department and personnel responsible, *inter alia,* for drafting prospectuses. ***The general belief at Janus, shared by Respondents, legal department personnel, and others, was that timing that did not disrupt portfolio management of a fund was permissible under its prospectus.***

Id. at *19 (emphasis added). In essence, Judge Froelak found that the trading at issue in *Lammert* was widely known within Janus and that the personnel at Janus who were in charge of compliance and trading decisions—including Janus' legal department—believed the trading was acceptable. Accordingly, she found that the three respondents had not engaged in an "extreme departure from standards of ordinary care" by allowing the trading at issue.

Similarly, in this case, the evidence demonstrates that there were no glaring red-flags, particularly in light of the CBOE's decision, on three separate occasions, that the buy-writes did not merit regulatory sanction. OXPS FOF at 208, 271-272. To begin with, countless credible witnesses—including from the Chicago Board Options Exchange—testified that the question of whether the buy-writes were appropriate was unsettled. OXPS FOF at 213. Mr. Stern also testified that, when he read the relevant settlements, he believed the trading by optionsXpress' customers was distinguishable from the trading those matters described as abusive.

The Division asserts that, because FINRA had on-going investigations and the SEC and FINRA refused to give optionsXpress comfort that the buy-writes were legally compliant, Mr. Stern should have known that the trading was problematic. Yet, even presuming Mr. Stern was

aware of such facts (he was not), such action (or inaction) by regulators does not necessarily amount to a "red-flag." Indeed, it would be reasonable to conclude that the SEC and FINRA would reach the same conclusion that the CBOE had reached after substantively investigating the same issues. As Mr. Ruth testified, an industry participant like Mr. Stern could have reasonably concluded that the buy-writes were an appropriate way to cover short positions while allowing customers to remain hedged, given the fact that the CBOE found no Reg. SHO violation, and the SEC and FINRA offered no guidance to the contrary. Stern FOF at 60.

Furthermore, the trading in question was widely known to optionsXpress' legal and compliance personnel. Stern FOF at 20, 48. The buy-writes themselves were even approved by Phil Hoeh, the head of compliance, at a minimum. *Id.* at 20. Just as in *In the Matter of Warren Lammert,* the open nature of the activity, as well as the approval of the senior-level optionsXpress officers responsible for the trading, suggests that it was not an extreme departure from standards of ordinary care for Mr. Stern not to stop the trading (even assuming he could have).

Perhaps more importantly, optionsXpress' regulators themselves had difficulty determining whether the buy-writes violated Reg. SHO. Indeed, after one thorough examination and two detailed examinations, the Chicago Board Options Exchange ***thrice*** concluded that the buy-writes were appropriate. OXPS FOF at 182, 214. Similarly, Trading & Markets seems to have struggled to determine whether the buy-writes violated Reg. SHO. Indeed, at one point, Trading & Markets "made it clear, very clear, crystal clear, that there was no violation" of Reg. SHO. *Id.* at 213 Even after receiving a detailed explanation of the trading activity from the CBOE, Trading & Markets did not change its opinion. *Id.* at 169-176, 213. Yet, now, Trading & Markets seems to have taken the position that such trading ***does*** violate Reg. SHO. FINRA

similarly struggled, investigating the buy-writes for nearly a year without stopping—even temporarily—the trading. Throughout 2009, none of these regulators issued any cautionary advice to optionsXpress concerning the trading, even though it was well-known to them. *See* Stern FOF at 28, 35. Clearly, the "standard of ordinary care" against which Mr. Stern's conduct must be judged is one in which industry experts (including the authors of Reg. SHO—see OXPS FOF at 183, 213, 242-246) have struggled to determine whether the buy-writes were illegal.

The evidence thus demonstrates that the Division has failed to prove that the trading here "so obvious[ly]" violated legal requirements that Mr. Stern "must have been aware of" the purported violation. *Howard v. Securities & Exchange Commission*, 376 F.3d 1136, 1143 (D.C. Cir. 2004). Even if the buy-writes at issue did, in fact, violate Reg. SHO, this was by no means settled during the relevant time, which undermines any claim that Mr. Stern must have known he was aiding and abetting wrongdoing. As the D.C. Circuit noted in *Howard*, the Division cannot expect a respondent to understand the legal requirements of a securities "rule whose language [is] silent on the subject." *Howard*, 376 F.3d at 1147-49. The *Howard* court based its reasoning, in part, on the fact that "the applicable law . . . has never been clear." *Id.* at 1145.

In short, the overwhelming weight of the evidence demonstrates it was not an "extreme departure from the standards of ordinary care" for Mr. Stern (who did not actually have authority to stop the trading) to fail to insist, as the Division suggests he should have, that optionsXpress cease the buy-writes. *See* Div. Br. at 41; *see also In the Matter of Warren Lammert, et al.*, SEC Release No. 348, 2008 WL 1867960, at *19 (April 28, 2008) (discussing factual basis for not attributing scienter to a corporate executive). Such a conclusion is further supported by the expert testimony of John M. Ruth, who concluded Mr. Stern was not reckless, but was acting reasonably within industry standards, in not offering an opinion that optionsXpress stop using

buy-writes and in believing that the trading at issue was appropriate under Reg. SHO. As a result, the Court should conclude that Mr. Stern lacked the requisite scienter to aid and abet violations of Rule 204 of Reg. SHO, Section 10(b), Rules 10b-5 and 10b-21, and Section 17(a)(1) & (2).[12]

C. NO CAUSING

1. Legal Standard for Causing.

Under Section 21C(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), the Commission may impose a cease-and-desist order upon any person who is violating, has violated, or is about to violate any provision of the Exchange Act and upon any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation. 15 U.S.C. § 78u-3. After the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the securities laws also provide for the imposition of a "civil penalty" for any person deemed to have been the "cause" of a securities violation. 15 U.S.C. § 78u-2(a)(2). To "cause" a securities law violation under Section 21C of the Exchange Act, three elements must be established: (1) a primary violation, (2) an act or omission by the respondent that was a cause of the violation; and (3) the respondent knew, or should have known, that his conduct would contribute to the violation. *In the Matter of Navistar Int'l Corp., et al.*, 2010 WL 3071892, at *13, Release No. 3165 (Aug. 5, 2010).

Under the case law established prior to Dodd-Frank, the Division did not need to prove that there was a "direct nexus between the respondent's conduct and the violation," but needed

[12] Because Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-21 promulgated thereunder require scienter, the Division would have to prove that Mr. Stern had scienter in order for him to be deemed to have "caused" a violation of these acts and rules. *Howard v. Securities & Exchange Commission*, 376 F.3d 1136, 1141-1142 (D.C. Cir. 2004). Mr. Stern's lack of scienter makes it impossible for him to have "caused" violations of these acts and rules, as well.

only to prove that the respondent's conduct was more than a "factor to some degree." *In the Matter of Robert Fuller,* 2002 WL 1772928, at *8, Rel. No. ID-210 (Aug. 2, 2002). Said differently, a person must have been a "contributing cause" of the primary violation. *In the Matter of Robert Fuller,* 2003 WL 22016309, Rel. No. 34-48406 (Aug. 25, 2003); *see also In the Matter of Navistar Int'l Corp., et al.*, 2010 WL 3071892, at *13, Rel. No. 3165 (Aug. 5, 2010) (Commission need not show that respondent's conduct was a proximate cause of the primary violations). However, the rationale for such a slim causal relationship has changed, post-Dodd-Frank.

Prior to Dodd-Frank, the Commission justified the rather negligible causal-relationship needed for a Section 21C violation by noting that the relief allowed under that section was merely a cease-and-desist order. To this end, the Commission has noted that "[l]imitations such as proximate causation may be appropriate in tort actions where the issue is whether a defendant is sufficiently close in the chain of causation that he or she should be required to pay plaintiff's monetary damages." Brief of the Securities and Exchange Commission in *McConville v. Sec. and Exch. Comm'n*, 2005 WL 3749754, at *54-56, Case No. 05-2510 (7th Cir. 2005). Such a strict causal nexus was not appropriate, the Commission argued, when Section 21C had merely the broad-ranging cease-and-desist remedy. *See id.*

Since the enactment of Dodd-Frank, however, Section 21C has more of a tort-damages remedy, with the imposition of civil penalties. *See* Section 21B(a)(2)(b), 15 U.S.C. § 78u-2(a)(2)(b). Indeed, under some circumstances, the Commission can extract monetary penalties up to $100,000. Section 21B(a)(2)(B)(3). As a result, a more causal relationship that is more proximate than the current "factor to some degree" test is appropriate. *See, e.g., In the Matter of Gregory M. Dearlove, CPA*, 2006 WL 2080012, at *49, Rel. No. ID – 315 (July 27, 2006)

(discussing the need for the Commission to establish the extent of the nexus required between a respondent's conduct and the primary violation the respondent allegedly caused). Because of the threat of monetary penalties, Mr. Stern urges this Court to adopt the "substantial nexus" test urged by other similarly situated courts. *See id.* (citing *In the Matter of Jeffrey M. Steinberg*, 2001 WL 1632978, at *1, SECDIG 2001-244-2 (Dec. 20, 2001)).

Regardless of the standard—a substantial or merely contributing cause—the Commission must establish that Mr. Stern was negligent in not knowing that his actions were contributing to a violation of the securities laws. *Navistar*, 2010 WL 3071892, at *13. The Restatement (Third) of Torts offers the following definition for negligence: "A person acts negligently if the person does not exercise reasonable care under all the circumstances." Restatement (Third) of Torts: Liability for Physical and Emotional Harm § 3 (2012). Conduct that displays reasonable care is the same as conduct that is reasonable, conduct that shows "ordinary care," conduct that avoids creating an "unreasonable risk of harm," and conduct that shows "reasonable prudence." *Id.* at cmt. a. Furthermore, an actor's compliance with the custom of the community, or of others in like circumstances, is evidence that the actor's conduct is not negligent. *Id.* at § 13.

2. **The Division Has Not Proved That Mr. Stern Had Sufficient Authority Or Involvement To Have Been A Contributing Or Substantial Cause Of The Alleged Violations.**

The evidence adduced at trial demonstrates that Mr. Stern was aware of the buy-writes and had some limited involvement with them. However, the Division did not present a single witness who testified that Mr. Stern, as optionsXpress' CFO, had responsibility for buy-writes or authority to decide whether buy-writes continued. In the limited instances in which Mr. Stern was involved with buy-writes, it is clear from the evidence that he either was a bit-player or that his involvement was in no way related to the violations alleged in this case. As a result, the

Division has not proved that Mr. Stern's involvement was more than a "factor to some degree" in the alleged violations.

As a preliminary matter, the facts in this case are very different than those in which this Court has found a causing violation. In such cases, respondents have had authority over the areas in which alleged violations occurred or actual and meaningful roles in conduct resulting in the alleged violations. In *In the Matter of Stephen J. Horning,* 2006 WL 2682464, at *17-18, Rel. No. ID – 318 (Sept. 19, 2006), for instance, the Court concluded that Mr. Horning had authority over the areas in which violations had occurred. In another matter, *In the Matter of Robert M. Fuller*, 2002 WL 1772928, at *9-10, Rel. No. ID – 210 (Aug. 2, 2002) (Murray, J.), Mr. Fuller had opened a trading account and transferred funds into that account for trading that was contrary to that described in an initial public offering prospectus offered by the company that he founded and for which he served as chairman of the board. In other words, Mr. Fuller was personally involved in conduct that led to the violation. As described below, Mr. Stern neither had personal responsibility for the departments of optionsXpress in which alleged violations occurred nor was he meaningfully personally involved in conduct that led to or contributed to the alleged violations.

a. Mr. Stern's Role As CFO And FINOP Had Nothing To Do With Reg. SHO Compliance.

At trial, it was established that Mr. Stern was optionsXpress' Chief Financial Officer. In this capacity, he had primary responsibility for reporting the financial capital conditions of the brokerage firm and understanding the implications of financial capital requirements on operations. Stern FOF at 2. Adam DeWitt, the CFO of optionsXpress Holdings, Inc. (optionsXpress' parent company) managed risk associated with portfolio margining and evaluated the costs associated with borrowing stock. *Id.* at 3.

As CFO, Mr. Stern's most significant involvement with the trading at issue in this case (as described more fully in optionsXpress' post-hearing brief) was based on his review of the impact the trading had on the firm's capital. In particular, when the customers' trading positions became larger, the firm's capital requirements at the NSCC and the OCC increased, requiring more capital. *Id.* at 41. Mr. DeWitt asked Mr. Stern to monitor liquidity and determine what was causing the increase in capital requirements. *Id.* at 42. Mr. Stern concluded that the increase was due primarily to option assignments that created short stock positions and, in turn, necessitated buy-ins. *Id.* Based on this information, Jay Risley, Ned Bennett, Adam DeWitt and David Fisher ultimately decided to change optionsXpress' procedures so that any open, naked, short position would be bought-in within one day of the trade resulting in the short position, or T+1.[13] In other words, Mr. Stern conveyed accurate information and a group of decision-makers concluded that buy-ins would occur before the date required under Rule 204 of Reg. SHO. Certainly, Mr. Stern's limited involvement in the change to the T+1 (which is not alleged to be problematic under the securities laws) does not make him more than a factor to same degree of any of the violations alleged in this case.

b. Mr. Stern Had No Substantive Involvement In Reg. SHO As Regulatory Liaison.

At trial, it was further established that, beginning some time in 2009, Mr. Stern became the "primary regulatory liaison" for optionsXpress. Stern FOF at 4. In this capacity, he received regulatory correspondence on behalf of optionsXpress and served as the "host" or "coordinator" for regulators' examinations of optionsXpress. *Id.* at 5. Mr. Stern's only interaction with the trading at issue in this case in his capacity as the primary regulatory liaison was that he was

[13] Mr. Stern has adopted and attempted to use consistently the definitions and conventions in optionsXpress' post-hearing brief, including those for the number of days after the trading day, or "T," that a short stock position was bought in.

copied on correspondence between the optionsXpress and its regulators. *Id.* at 6. However, it was not his responsibility to respond to such correspondence, as Kevin Strine and the compliance department handled such responses. *Id.* at 8. Mr. Stern's receipt of correspondence and role as regulatory host does not rise to the level of personal involvement needed to establish a causing violation.

c. As A "Utility Infielder," Mr. Stern Had No Involvement In Anything Related To The Alleged Violations In This Case.

Finally, it was established at trial that Mr. Stern was a "utility infielder" at optionsXpress. As a "utility infielder," Mr. Stern's colleagues would come to him in order to "ask [him] questions or get some of [his] interpretations of things that had happened, you know, how they conducted business in the past. [His] experience with the industry. Things like that. So we would discuss things with [him]. But it wasn't necessarily asking [him] for [his] interpretation of a rule or asking [him] how the firm should handle, in particular Tom, how the firm should handle a particular activity." Stern FOF at 13. As a result, the firm's compliance department did not look to Mr. Stern for help interpreting Reg. SHO or in understanding its obligations under Rule 204. *Id.* at 45.

In this capacity, Mr. Stern provided limited assistance, when asked, in ensuring that traders were closing out short positions as required by the policies and procedures established by out optionsXpress' compliance department. *Id.* at 46. He was not ultimately responsible for these policies and procedures—nor was there any evidence adduced at trial suggesting that Mr. Stern knew or should have known the policies and procedures were not being followed. Given his limited personal role in compliance, Mr. Stern's assistance in this regard cannot make him more than a factor to some degree of alleged securities violations, either.

In addition, Mr. Stern was asked—again as a "utility infielder"—to participate in calls with FINRA and the SEC in which optionsXpress sought guidance regarding the use of buy-writes. *Id.* at 21, 30. His only role on those calls was to explain the trading at issue. *Id.* at 24, 31. Others, including the head of compliance and one of optionsXpress' in-house lawyers, discussed the significance of the trading and sought advice from the SEC. *Id.* at 30, 31. The Division suggests that, in providing information about the trades, Mr. Stern somehow provided false information to Trading & Markets in two respects. Div. Br. at 23-24. However, the complete record in this case demonstrates that the Division's position is not credible.

First, the Division argues that Mr. Stern did not review actual trading before providing a "verbal diagram" of the box-spread trading engaged in by optionsXpress's customers. However, Mr. Stern's "verbal diagram" was of a three or four legged box-spread (Tr. at 1733:9-11 (Stern)), the same type of trade that the Division's own experts explained to the Court. Accordingly, this was not a "false" statement, regardless of whether Mr. Stern's example was based on optionsXpress's trading records.

Second, the Division argues that Mr. Stern has admitted that he gave a numeric example in an "attempt to show that the buy-in amount was not linked to the amount of assignment." Div. FOF at 200. The Division has put forward no evidence suggesting either (i) that Mr. Stern represented his example as anything other than just that (in other words, as not being correlated to a specific trade) or (ii) that Mr. Stern's numeric example was not, in fact, accurate. Regardless, the Division fails to note that, during the call, Mr. Stern also explained that optionsXpress was "looking for guidance as to whether or not [bundling] it as a buy-write, to fulfill our [best-]execution ... responsibility was an acceptable practice." Div. Ex. 168 (Stern Tr.) at 325:8-20. To this end, Mr. Stern further explained to the SEC that "[w]e can only do a

buy-write with an equivalent amount of stock and options, so that would mean that 10,000 shares, you would have [to do] it with a hundred options." *Id.* As a result, Mr. Stern provided numeric examples simply to demonstrate that the customers were in charge of the sale of calls (Tr. at 1735:16-1736:4 (Stern)) and, as Mr. Strine also explained, to show that customers were not fully assigned every day. Tr. at 3421:12-3422:16 (Strine). In short, the complete record demonstrates that Mr. Stern did not misrepresent the trading at issue—and that he used numeric examples in a larger context in which he more completely explained buy-writes.

Regardless, there is not a single violation alleged by the Division that Mr. Stern could have "caused" by providing an inaccurate description of the trading at issue, as none of the Division's allegations hinge on information provided to the SEC. Rule 204 has to do with the manner in which open short positions are closed out; Mr. Stern's comments to Trading & Markets did not impact how optionsXpress was attempting to close out open short positions. Section 17(a), Section 10(b) and Rules 10b-5 and 10b-21 each pertains to a form of fraud on market participants; Trading & Markets is not a market participant. As a result, Mr. Stern's statements to Trading & Markets cannot be a "factor" at any level in the alleged violations, much less "more than a factor to some degree" or even a "substantial factor."

In short, Mr. Stern had limited personal involvement in Reg. SHO compliance. He was not in charge of Reg. SHO compliance, nor did he have sufficient involvement or authority to be anything more than a bit-player in Reg. SHO compliance. He certainly had no involvement in an aspect of Reg. SHO that contributed to one of the violations alleged in this matter. As a result, the Division has failed to demonstrate that Mr. Stern engaged in conduct that "caused" an alleged violation in this case.

3. The Commission Has Not Proved That Mr. Stern Knew Or Should Have Known That His Conduct Contributed To A Securities Law Violation.

Even if the Division established at trial that Mr. Stern engaged in conduct that had a causal nexus to the alleged violations in this case (and it did not), the Division failed to demonstrate that Mr. Stern knew or should have known that his conduct was contributing to a securities violation. The Division has presented no evidence suggesting that Mr. Stern ***knew*** the trading in question was violative of any of the securities laws. As a result, the Division needed to prove that Mr. Stern ***should have known***—in other words, that he acted unreasonably in not knowing—that his conduct was contributing to a securities law violation. However, the evidence adduced at trial is overwhelmingly to the contrary.

To begin with, as discussed above, optionsXpress' own regulators could not decide whether the buy-writes at issue in this case violated any of the securities laws. *See supra* at 24-25. Because the standard for determining negligence is the conduct of others in the community, it was entirely reasonable for Mr. Stern himself to believe that the conduct in question was appropriate. In other words, the fact that others in the community thought that it was an open question as to whether the buy-writes were appropriate makes it ***not negligent*** for Mr. Stern to have similarly concluded.[14]

Next, as established through the expert testimony of John M. Ruth, it was reasonable for Mr. Stern to have relied "on his colleagues who were closer to the trading at issue—like Peter Bottini and Phil Hoeh, who were in charge of the customer service trading desk and compliance, respectively—to provide him with information about the buy-writes. In fact, it would be unusual

[14] Mr. Stern is not arguing that he relied on the regulators—as the Division may suggest—but that the conduct of experts in the industry, like the regulators at the CBOE and the individuals at Trading & Markets who drafted Reg. SHO, set the standard for reasonable conduct. Their doubt as to whether the conduct at issue in this case was or was not legal is strong evidence that it was, in fact, similarly reasonable for Mr. Stern to conclude that it was an open question as to whether the buy-writes were appropriate.

for someone in Mr. Stern's position to have authority over such matters." Stern FOF at 59. Messrs. Bottini and Hoeh—along with Ben Morof, Hillary Victor, and Kevin Strine (each an attorney)—all concluded that the buy-writes in question were appropriate and that the activity of optionsXpress' customers was distinguishable from the settlements in which the SEC found trading to be violative of the securities laws. *Id.* at 48. As Mr. Ruth concluded, reliance on such individuals meant that "Tom Stern was not reckless, but was reasonable, in not requiring that optionsXpress stop using buy-writes." *Id.* at 61. Tom Stern also was reasonable in believing that the buy-writes were bona fide transactions and were appropriate under Reg. SHO." *Id.*

In conclusion, the Division has failed to prove that Mr. Stern acted unreasonably in believing that the trading at issue in this case complied with the securities laws.[15] The evidence is overwhelmingly to the contrary. To begin with, optionsXpress' regulators could not easily, definitively conclude that the trading at issue in this case was violative of the securities laws—providing strong evidence that it was reasonable for an individual in Mr. Stern's position to conclude that, at worst, it was an open question. Next, three lawyers at optionsXpress, the head of compliance, and a junior compliance officer all concluded that neither the trading in which optionsXpress' customers were engaged nor the buy-writes were violative of the securities laws. Finally, Mr. Ruth, an expert with 20 years experience running a broker-dealer, established the industry standard of care, under which it was reasonable for Mr. Stern to believe the trading at issue in this case did not violate the securities laws. As a result, to the extent Mr. Stern did engage in conduct that "caused" a violation of the securities laws (regardless of the causal nexus this Court deems appropriate), he reasonably did not know that his conduct was contributing to such a violation.

[15] Mr. Stern's reasonable conduct also negates the Division's claim under Section 17(a)(3).

D. NO CIVIL PENALTY OR BAR WARRANTED

The Division also failed to establish that a civil penalty is warranted. The Commission may only impose such a penalty if Mr. Stern acted with extreme recklessness (*see Howard*, 376 F.3d at 1143) or willfully aided and abetted a violation by another person ***and*** if doing so serves the public interest. *See* 15 U.S.C. §§ 78u-2, 80b-3(i), and 80a-9(d). The Division failed to demonstrate either component. As discussed previously (*see supra* at 35), the record plainly undermined any finding that Mr. Stern acted with extreme recklessness or willfully aided and abetted a violation. Thus, the Court should decline to impose a penalty for this reason alone. The Court should also order no penalty because the Division failed to establish that such a penalty would serve the public interest.[16]

The Division further overreaches by asking the Court to permanently bar Mr. Stern from the securities industry. Again, the record provides no support for such a sanction, which requires a showing that Mr. Stern willfully violated federal securities laws. Mr. Stern's lack of a willful violation demonstrates that he poses no future risk to investors or the marketplace and, as such, the Court should decline to impose an industry bar. Furthermore, Mr. Stern's errant responses in his Wells response were unfortunate mistakes, for which he has taken full responsibility (Stern FOF at 17)—further indicating that a bar is inappropriate and unnecessary.

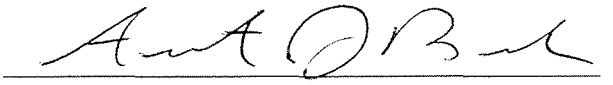
[16] As noted in optionsXpress' post-trial brief, the Division failed to prove that the trading in question caused any harm to other market participants or in any way undermined market integrity. OXPS Br. at __.

CONCLUSION

For each of the above reasons, Respondent Thomas E. Stern respectfully requests that the Order Instituting Proceedings against him in this matter be dismissed in its entirety, together with any and all additional relief the Court deems just and proper.

Dated: January 11, 2013

Respectfully Submitted,

By: 

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