I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Peter J. Bottini (“Bottini”), Phillip J. Hoeh (“Hoeh”), and Kevin E. Strine (“Strine”) (collectively, “Respondents”).

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the “Offers”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over them and the subject matter of these proceedings, which are admitted, Respondents consent to the entry of this Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below:
III.

On the basis of this Order and Respondents’ Offers, the Commission finds¹ that:

Summary

These proceedings arise out of optionsXpress, Inc.’s (“optionsXpress”) violation of the delivery and close-out requirements of Regulation SHO of the Exchange Act (“Reg. SHO”). From at least October 2008 to March 18, 2010, optionsXpress failed to satisfy its close-out obligations under Rules 204 and 204T of Reg. SHO by repeatedly engaging in a series of transactions, known as “resets,” which gave the appearance of having purchased shares to close-out an open failure-to-deliver position while in fact not doing so.

The resets were accomplished by optionsXpress facilitating its customers buying shares and simultaneously selling deep in-the-money call options that were essentially the economic equivalent of selling shares short. The purchase of shares created the illusion that the firm had satisfied the close-out obligation; however, the shares that were ostensibly purchased in the reset transactions were never actually delivered to the purchasers because on the same day the shares were “purchased,” the deep in-the-money calls were exercised, thereby effectively reselling the shares. These paired reset transactions were not bona fide purchases because their purpose was to perpetuate an open short position while giving the illusion of satisfying the delivery and close-out requirements of Reg. SHO.

During the relevant period, optionsXpress and several customers routinely engaged in these paired reset transactions in a number of securities, including Sears Holding Corporation, American International Group, Chipotle Mexican Grill, Inc., Joseph A. Bank Clothiers, Inc. and Mead Johnson Nutrition Company. As a result, optionsXpress and its customers had continuous failures to deliver in these and other securities that persisted for months, thereby undermining the purpose of Rules 204 and 204T of Reg. SHO.

From at least October 2008 to March 18, 2010, Respondents Bottini, Hoeh, and Strine were a cause of optionsXpress’ violations of Rules 204 and 204T of Reg. SHO as they knew or should have known that their acts or omissions as described below would contribute to these violations.

Respondents

1. Peter Bottini, age 42, is a resident of Chicago, IL and is in charge of trading and customer service for optionsXpress. He holds Series 3, 4, 7, 24, 55, and 63 licenses.

2. Phillip Hoeh, age 43, is a resident of Glen Ellyn, IL and joined optionsXpress as its Chief Compliance Officer on March 19, 2009. He holds Series 4, 7, 8, 14, 24, 27, 55, and 63 licenses.

¹ The findings herein are made pursuant to Respondents’ Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.
3. **Kevin Strine**, age 48, is a resident of Round Lake, IL and is the Vice President of Compliance at optionsXpress. He reported directly to Hoeh and is a lawyer licensed in Wisconsin and holds Series 4, 7, 24, and 63 licenses.

**Other Relevant Entity**

4. **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 a broker-dealer registered with the Commission and with 53 states and territories. It is also a member of the Financial Industry Regulatory Authority (“FINRA”), the Chicago Board Options Exchange (“CBOE”), and various stock exchanges. optionsXpress was a wholly-owned subsidiary of optionsXpress Holdings, Inc. until September 1, 2011, when it became a wholly-owned subsidiary of The Charles Schwab Corporation.

**The Regulatory Framework of Regulation SHO**

5. Reg. SHO Rules 204 and 204T deal with the requirement to close-out failures to deliver. Rule 204T became effective on September 18, 2008 and Rule 204 became effective on July 31, 2009. Rules 204 and 204T require participants of a registered clearing agency to deliver equity securities to a registered clearing agency when delivery is due; that is, by settlement date. Settlement date is generally three days after the trade date (“T+3”). optionsXpress is a participant of a registered clearing agency.

6. Rules 204 and 204T were adopted, among other things, to address abusive “naked” short selling and failures to deliver. Abusive “naked” short selling generally refers to selling short without having stock available for delivery and failing to deliver stock within the standard three-day settlement cycle. For short sales, if the participant does not deliver securities by T+3 and has a failure-to-deliver position at the clearing agency, it must take affirmative action to close-out the failure-to-deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours on the settlement day following the settlement date (“T+4”).

7. A participant of a clearing agency does not fulfill its close-out requirements under Rules 204 and 204T if it enters into an arrangement with another person to purchase or borrow securities as required, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow. Moreover, where a participant of a clearing agency subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant’s fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement.

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2 The three-day settlement period generally applies to most exchange-traded security transactions, including stocks, bonds, municipal securities, electronically-traded funds, and limited partnerships. Government securities and stock options settle on the next settlement day following the trade (or T+1).
The Violative Trading Activity

8. There were six self-directed customer accounts at optionsXpress (the “Customers”) engaged in reverse conversions and similar options trading strategies starting no later than October 2008. In these transactions, the Customers simultaneously entered into the sale of a put and purchase of call with identical strike prices and expiration dates creating a synthetic long position. The Customers would also hedge their synthetic long position by creating a short position, generally, by selling deep-in-the-money calls. The synthetic long and short positions were for an equal number of shares/contracts and thus, through this set of transactions, the Customers eliminated directional risk in the stock price.

9. The deep-in-the-money calls sold to create the short position referenced hard-to-borrow securities and were frequently exercised. After the options were exercised and assigned to the Customers, the Customers had a synthetic long position and a short stock position for which they (and optionsXpress) were required to deliver shares by T+3. However, neither optionsXpress nor the Customers delivered the shares by T+3 thus creating a failure-to-deliver position.

10. Instead of closing out the failure-to-deliver position and delivering the shares, optionsXpress and the Customers would give the appearance of closing out their fails by entering into a “buy-write”, i.e., they would simultaneously buy the shares they needed to cover the failure-to-deliver position and write (sell) standard deep-in-the-money calls for an equivalent number of shares. The newly written deep-in-the-money calls were generally exercised the same day they were sold (and thus were assigned to the Customers later that same day) putting the Customers back in their original short position, continuing the failure-to-deliver position, and causing them to enter into another buy-write the following day. As a result, optionsXpress maintained a net short position at the end of each day.

11. optionsXpress and the Customers knew, or should have known, that most, if not all, the calls that were sold as part of the buy-writes would be exercised and assigned on the same day they were sold, resulting in shares not being delivered on settlement. Thus, optionsXpress and the Customers knew, or should have known, that these transactions would result in failures-to-deliver.

12. The buy-writes continued on a daily basis until the original synthetic long position was unwound or expired. As a result, optionsXpress had a continuous negative (or failure-to-deliver) position in a number of securities in the National Securities Clearing Corporation’s Continuous Net Settlement system for extended periods of time.

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3 An option that is “deep in-the-money” has a strike price that is far below (in the case of a call option) or far above (in the case of a put) the market price for the given security. Selling deep-in-the-money calls is essentially the economic equivalent of selling shares unless the stock price drops precipitously and therefore approaches the strike price.

4 To enter into the buy-write, the Customers paid a certain amount, generally between 1 and 2 pennies per share.
The Regulatory Guidance of Regulation SHO

13. In 2003, the SEC issued guidance to “disabuse traders of any notion” that a married stock/option trade designed to give the appearance of a long position could be used to circumvent regulatory requirements. SEC Interpretive Rel. 34-48795 (Nov. 21, 2003). In July 2007, the American Stock Exchange (“AMEX”) fined several entities and individuals for violating Reg. SHO Rule 203 based on trading activity similar to what the Customers were doing. In the Matter of Scott H. Arenstein and SBA Trading, LLC (July 20, 2007); In the Matter of Brian A. Arenstein and ALA Trading, LLC (July 20, 2007). In the Arenstein cases, the respondents engaged in a series of reset transactions, mostly married puts, but also some buy-writes, that employed short-term options to circumvent the close-out obligation of Rule 203.

14. Following the release of the Arenstein cases, CBOE sent a regulatory circular to its members, including optionsXpress, “strongly cautioning” its members that transactions “pairing the close-out with one or more short-term options positions that are utilized to reverse that close-out are deemed improper reset arrangements that do not satisfy the Regulation SHO close-out requirement.” CBOE Regulatory Circular RG07-87 (Aug. 9, 2007). “Short sales of threshold securities (that result in fails to deliver) paired with one or more short-term option transactions, for example, including, but not limited to, reverse conversions and deep in-the-money long call/short stock, are highly indicative of transactions that may be assisting a contra-party faced with a close-out obligation in creating the appearance of a bona-fide stock purchase.” Id. (emphasis added). CBOE then noted that while its examples involved market-makers, “the same analysis would apply to similar arrangements between any market participants.” Id. CBOE closed by recognizing “that transactions matching options with stock may be used as part of a legitimate trading strategy, and we do not want to discourage their use for that purpose.” Id.

15. In August 2009, the SEC brought settled enforcement actions against several entities and individuals regarding similar options trading and violations of Rule 203. In the Matter of Hazan Capital Management, LLC and Steven M. Hazan, Exchange Act Release No. 34-60441 (Aug. 5, 2009); In the Matter of TJM Proprietary Trading, LLC, Michael R. Benson, and John T. Burke, Exchange Act Release No. 34-60440 (Aug. 5, 2009). In the Hazan and TJM cases, the respondents engaged in a series of sham reset transactions that employed short-term paired stock and options positions (married puts and/or buy-writes using both FLEX options and standard exchange-traded options) to circumvent the close-out obligations of Rule 203. Three months later, the SEC brought settled enforcement actions against several other entities regarding similar trading and violations of Reg. SHO. In the Matter of Rhino Trading, Fat Squirrel Trading Group, Damon Rein, and Steven Peter, Exchange Act Release No. 34-60941 (Nov. 4, 2009).

Bottini, Hoeh, and Strine Knew or Should Have Known that the Trading was Problematic

16. On October 15, 2008, less than a month after the Commission issued its emergency order putting Rule 204T into effect, one of optionsXpress’ traders sent an internal email which described the trading: “the customer has short positions on hard to borrow stocks where the customer has to buy in every day. Our customer is buying back the short and writing in the money calls which are assigned on a daily basis.” Two weeks later, the firm’s Clearing Department raised
concerns that the stock was not being bought in at market open. Strine replied back to the Clearing Department and the traders telling them: “According to the rules, they need to be closed out at the opening. The industry is pushing back on this, and requesting the [whole] day, but as it is now, we need to cover at the open.”

17. The following month, the Clearing Department informed Bottini of the “vicious cycle” that the buy-writes were causing: “Since we have an open CNS fail and as soon as we buy to cover, the customer shorts a call which gets assigned immediately, we are in a vicious cycle.”

18. In mid-November 2008, Bottini sent an email to the Clearing Department about an article in The Wall Street Journal describing the trading activity in the Arenstein cases and noting that FINRA had several cases involving this activity. Bottini wrote: “There is an article in the WSJ about how short sellers in [Sears] are using options to circumvent the SEC cover rule. I think we need to review this.” The Clearing Department emailed back: “[The Customers are] definitely doing this.”

19. In July 2009, Bottini asked one of the exchanges for a fee modification for the buy-writes. As part of the request, Bottini noted that “[w]e do have some larger retail clients that have developed some ‘predictable’ strategies/behavior.” According to Bottini, the market makers using the exchange had begun to anticipate the buy-writes – meaning that the counterparties to the buy-writes were anticipating that the buy-writes would occur each day. Due to the fees, Bottini and optionsXpress worked to find another market for the buy-writes.

20. On August 5, 2009, the SEC instituted the Hazan and TJM settled actions, which were reviewed by Hoeh and Strine. Strine immediately recognized the similarities between the conduct in those actions and the Customers’ trading, but advised that there were distinguishing factors and the trading continued.

21. The following day, a trader at optionsXpress notified the Customers that “[u]nfortunately we will need to change how buy ins are covered. . . . This means once we get the buy in lists, the shares will need to be covered immediately in the morning. I apologize for this unfortunate change, but the SEC won’t budge on these rules.” In response to a question from one of the Customers, a trader at optionsXpress elaborated: “Compliance has also notified me that this could change further by having us place the covers in your account at the market, and have the customer place any option orders.” Nonetheless, and despite Strine’s advice in October 2008, optionsXpress was still not placing the buy-in orders at market open. In fact, optionsXpress did not consistently execute the buy-writes at or near market open.

“Perpetual” Buy-In Procedures

22. On August 10, 2009, one of optionsXpress’ traders emailed Strine with concerns about the short sale process: “Not sure what Phil [Hoeh] brought up on Friday, but we’re still getting the buy in report pretty late in the morning.” He then raised concerns about optionsXpress’ stock borrowing process noting that the “SEC is really cracking down on this.” Later the same day the trader noted that buy-ins were another issue: “I know we’re the traders over here, but it seems we’re giving them too much leeway with these buy writes instead of covering them on the short
shares first.” Strine responded: “I agree that we need to tighten up our procedures on the buy-ins. To do this, we will no longer allow customers to conduct their own buys. We will process the buy-in for each account at the open.” The decision to no longer allow customers to conduct their own buy-ins was made by a group of people that included Hoeh and Bottini.

23. On August 19, 2009, the optionsXpress Compliance Department instituted new buy-in procedures. Strine wrote the new procedures at the direction of Hoeh. The decision to implement the new procedures was made by a group including Hoeh and Bottini. The new procedures called for two buy-in lists instead of one: a regular list and a list of failure-to-deliver positions where “the fail is continuously open due to customers being assigned in the money short calls,” also known internally as the “perpetual,” “chronic,” or “rolling fails” list. There were different procedures for the two lists.

24. According to Hoeh, a “perpetual fail” was “a fail where the issue, specific issue or security is failing a number of days . . . to me it would be if firms didn’t close out the fail and left it alone and it would be a perpetual fail if they didn’t meet their close-out obligations and let that fail continue.” He also noted that “the rule requires us to reduce that fail to deliver, so you would violate Rule, you know, 203 and 204 if you had a fail and you didn’t close it out within the required time frames.”

25. After the new procedures were issued, Bottini followed up with the trading desk saying: “Did we contact our largest clients?” An optionsXpress trader responded: “Definitely, spent a lot of time on the phone with [the Customers] yesterday.” The traders communicated to the Customers that: “Basically they have told us our practices our [sic] not consistent with the rules, and that changes must be made.”

26. On August 20, 2009, one of the optionsXpress traders asked Strine and Hoeh if they could continue to place the buy-writes. Hoeh responded citing Reg. SHO and the Rule 204 issuing release: “we . . . must execute the buy-in on the open for the specified amount to cover the fail. The customer then can do whatever other transaction they want but it is a separate transaction.” Hoeh also reminded the trader that “[i]t is expected that buy-ins are occurring at or close to the open, within the first 30 minutes of trading has been accepted to be the ‘beginning’ of trading hours.” Strine also responded: “the answer is absolutely not. We do not want to be an active party in the call transactions. We are fulfilling our obligation to issue the buy-in. If we process the buy-write, regulators could consider the buy-ins as sham transactions.” Strine forwarded his response to Hoeh adding: “I believe that if we do the buy-write for them, auditors will consider them sham transactions as the SEC did with the two fined prop trading institutions [Hazan and TJM].”

27. After receiving the guidance from Hoeh and Strine, the optionsXpress trader told the other traders: “Compliance is telling us that buy-writes can no longer be used to cover a buy-in. We must place the orders separately. Since this will ultimately shut down these orders, we can place them another way. . . . Execution will put in market orders to cover the shares at the open. All we require the customer to do is call in and place a not held option order with execution. The outcome will basically be the same, but two separate orders will be in customers [sic] account, which the SEC wants to see.”
28. Following the issuance of the new procedures, the traders generally entered the buy-in order at or before market open, but marked the order as “do not send to exchange”—meaning that the order was not automatically routed to an exchange for execution. Instead, the traders paired the stock order with the option order and called a floor broker to manually place the buy-write later in the day. This change did not substantively alter the buy-write procedures except the Customers contacted optionsXpress earlier in the day. According to Bottini, the buy-writes would not be executed at market open because they were being sent to a floor broker on a best efforts basis.

29. Sometime between August 20, 2009 and September 23, 2009, Bottini suggested, and Hoeh agreed, that the firm’s best execution obligation required optionsXpress to combine the buy-in order with the sale of calls as a buy-write. According to Hoeh, the final decision to allow the Customers’ buy-writes to continue was made by himself, Bottini, and optionsXpress’ Chief Financial Officer (“CFO”). According to Hoeh and Strine, the best-execution obligation was the primary reason that optionsXpress determined that the buy-writes were permissible under Reg. SHO.

Communications with the Regulators

30. On September 23, 2009, optionsXpress received a letter of caution from CBOE. CBOE noted that optionsXpress conducted buy-ins on the morning of T+4, but found that the firm called certain customers prior to the execution of those buy-ins, which was a deviation from optionsXpress’ procedures. That deviation allowed the Customers to buy themselves in with a buy-write. In response to CBOE’s concerns, optionsXpress began emailing the Customers, instead of calling them. Otherwise, there were no changes to the procedures and optionsXpress continued to execute the Customers’ buy-writes.

31. On that same day, an optionsXpress trader forwarded a copy of the Hazan order to Bottini, citing the language about sham transactions. The trader then stated: “I am not placing any orders today.” Bottini responded minutes later: “Please execute the buy ins and customer orders today. Compliance has reviewed and is not convinced this applies. They have asked our regulator for an opinion and have not received it.” Later that day, Strine emailed Hoeh, Bottini, the CFO, and other senior executives regarding Hazan: “We addressed this issue back in August when the SEC issued its findings in these cases. Although I see issues with what our customers are doing, I pointed out distinguishing factors in my response back in August. . . . Additionally, we have responded to four inquiries regarding this issue: one from CBOE and three from FINRA. While the FINRA issues are still ongoing, CBOE didn’t seem to have any issues with our response.” The Clearing Department also contacted Strine noting that Strine and Hoeh had previously addressed the issue by saying buy-writes were not allowed: “Don’t want to get anyone in trouble, but somewhere down the road this is going to bite us.”

32. On September 24, 2009, Hoeh, Strine, the CFO, and optionsXpress’ in-house counsel called FINRA to ask questions about the Customers’ trading. FINRA said it would not discuss the issue because of its ongoing inquiry. The same day, the same four individuals (including Hoeh and Strine) called the SEC’s Division of Trading and Markets (“Trading & Markets”). According to optionsXpress, Trading & Markets told optionsXpress to “keep doing
what you’re doing—keep closing out” and that Trading & Markets would get back to optionsXpress on the best execution question.

33. After the call, upon further investigation, Trading & Markets learned additional facts that optionsXpress did not disclose on the call, including that FINRA had an open inquiry and that the customers were using deep-in-the-money calls to circumvent Reg. SHO. As a result, on October 2, 2009, Trading & Markets called optionsXpress and spoke to its in-house counsel and the CFO, telling them that the SEC declined to get involved and that it could provide optionsXpress with “no comfort.” optionsXpress’ in-house counsel informed Bottini, Hoeh, and Strine of the call.

34. After the October 2, 2009 call with Trading & Markets, Hoeh, Strine, the CFO, and in-house counsel called FINRA. optionsXpress told FINRA that it had received a call from the SEC, and that the SEC had declined to be involved. optionsXpress also said that it was at a loss about what to do and was seeking guidance on the activity. FINRA told optionsXpress that if it wanted guidance, it should send a request in writing to FINRA’s general counsel or the SEC. optionsXpress did not submit a written request for guidance to either the SEC or FINRA’s general counsel. Instead, optionsXpress continued executing the Customers’ buy-writes.

35. Two weeks after the October 2, 2009 call, Strine emailed several optionsXpress employees, including Hoeh, about another Reg. SHO issue and noted that “[w]e are already under heavy scrutiny from regulators on our short sale practices, and this problem could push us over the edge.”

36. On December 30, 2009, the SEC Division of Enforcement made its first request for information to optionsXpress. On January 14, 2010, Hoeh, Strine, the CFO, and in-house counsel had a call with FINRA staff. During the call, FINRA staff expressed concern that the buy-ins did not result in a net flat or long position at the end of the day. Despite the expression of concern from an employee of FINRA, optionsXpress continued to allow the buy-writes.

37. On February 17, 2010, optionsXpress and all of the Customers received subpoenas from the SEC. On February 23, 2010 and March 4, 2010, SEC staff told optionsXpress that they had “grave concerns” about the trading. The buy-writes continued.

The Trading Finally Ceases

38. On March 9, 2010, Bottini, Hoeh, and the CFO called CBOE, asking it to advocate on optionsXpress’ behalf in connection with the SEC investigation. CBOE instead referred optionsXpress to the CBOE’s regulatory circulars which discussed sham transactions and the Arenstein cases. The same day, optionsXpress decided to halt the trading, but allowed it to continue until the March options expiration. The decision to halt the trading was made by Bottini and Hoeh.

39. As a result of the conduct described above, from at least October 2008 to March 2010, optionsXpress violated Rules 204 and 204T of Exchange Act Reg. SHO by failing to satisfy its close-out obligations.
Violations

Bottini Caused optionsXpress’ Violations of Reg. SHO

40. As a result of the conduct described above, Bottini was a cause of optionsXpress’ violations of Rules 204 and 204T of Exchange Act Reg. SHO. Bottini knew or should have known that his acts or omissions as described above would contribute to these violations.

Hoeh Caused optionsXpress’ Violations of Reg. SHO

41. As a result of the conduct described above, Hoeh was a cause of optionsXpress’ violations of Rules 204 and 204T of Exchange Act Reg. SHO. Hoeh knew or should have known that his acts or omissions as described above would contribute to these violations.

Strine Caused optionsXpress’ Violations of Reg. SHO

42. As a result of the conduct described above, Strine was a cause of optionsXpress’ violations of Rules 204 and 204T of Exchange Act Reg. SHO. Strine knew or should have known that his acts or omissions as described above would contribute to these violations.

Undertakings

43. Respondents Bottini, Hoeh, and Strine shall cooperate fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the Order.

44. In connection with such cooperation, Respondents Bottini, Hoeh, and Strine shall (a) produce, without service of a notice or subpoena, any and all non-privileged documents and other information requested by the Commission’s staff; (b) be interviewed by the Commission’s staff at such times as the staff reasonably may request and to appear and testify without service of a notice or subpoena in such investigations, litigations, hearings or trials as may be requested by the Commission’s staff; and (c) in connection with any testimony of the Respondents to be conducted at deposition, hearing or trial pursuant to a notice or subpoena, agree that any such notice or subpoena for Respondents’ appearance and testimony may be served by regular mail on their respective counsel.

45. In determining whether to accept the Respondents’ Offers, the Commission has considered these undertakings.
IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in the Respondents’ Offers.

Accordingly, it is hereby ORDERED that:

Pursuant to Section 21C of the Exchange Act, Respondents Bottini, Hoeh, and Strine cease and desist from committing or causing any violations and any future violations of Rule 204 of Exchange Act Regulation SHO.

By the Commission.

Elizabeth M. Murphy
Secretary